INTRODUCTION

The problem of social order is one of the most enduring questions in the social sciences. German sociologists Georg Simmel may have put it most eloquently in his 1910 essay when he asked “How is Society Possible?,” but the question is rooted in a discourse started at least by Hobbes in the 17th century. The contention of Hobbes (1651) was that social order was impossible without a sovereign. Life would be ‘nasty, brutish and short’ without the establishment of a social compact with the sovereign to reign in the nature proclivities of man. Others such as Locke (1681) countered that social order was indeed possible without a sovereign, but would not be as productive a society as one with a reliable sovereign. Those who argued that society was indeed possible, in fact desirable, without a sovereign – such as Godwin (1793) – tended to rely on a utopian depiction of
humanity in order for the system to be self-sustaining. But in the development of economic science, an argument emerged which claimed that there were strong principles of self-governance in operation within an economy populated not with utopian creatures but flesh and blood humans. The decentralized decisions of many participants would be coordinated through the principle of self-interest to yield a social order that would be desirable. This demonstration struck at the heart of the Hobbesian analysis of social order that required a sovereign’s dictate in order for cooperation among more than a small number to emerge.

Within the system of property, contract and consent, Hume (1740) and Smith (1776) argued, and the self-interest of economic actors can be enlisted to generate public benefits. Provided that the framework was in place, neither a preacher nor a policeman, the classical liberal economists argued, was necessary for advanced economic relationships to be undertaken and prosperity and peace to be achieved. Absent clearly defined and enforced property rights, however, and self-interest can lead to less than desirable states of affairs, e.g., the tragedy of the commons where a common pool resource is over utilized and thus depleted prematurely to the detriment of the group. This is the standard line of economic liberalism from Hume and Smith to Buchanan (1975) and Hayek (1960). The economic role of the state is limited to the clarification of property rights and the enforcement of property rights and contracts. But we contend that

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For the most part, classical liberal economists also admit the existence of other imperfections that may demand an increased role of the state, e.g., externalities, etc. But within the classical liberal tradition there are also arguments that these imperfections ultimately derive from a failure to clearly define and enforce property rights. Buchanan (1975) distinguishes between the protective state, the productive state and the redistributive state. The protective state is what we have been discussing, the productive state is mainly focused on the provision of public goods, and the redistributive state is in Buchanan’s framework where the state’s influence becomes detrimental to economic progress and social cooperation. We are arguing that the state’s detrimental influence is in evidence much earlier in the analysis, including in the area of the protective state where the search for a binding constraint has proven to be elusive.
even this modest role for the state in economic affairs overstates the historical and theoretical role of the state in development of advanced economic relationships. Complicated economics relationships have historical developed outside the shadow of the state in many sectors. In short, markets are more robust vehicles for social cooperation than even most economic liberals recognize. They work to coordinate economic affairs among actors even in the absence of full information and in small number settings. Moreover, actors come to tacitly recognize the property rights of others well before the state formally recognizes their existence. Exchange relationships and social cooperation under the division of labor exist prior to, and anterior to, the formal rules of the state. Thus, the economic role of the state we contend is at best redundant and more often detrimental with regard to economic development.

Following up on the recent studies by Stringham (2002a, b), we focus our attention on the emergence of financial markets for several reasons. The common perception is that complicated financial instruments require state sanction to emerge. It is argued that in the absence of state regulation of financial markets, cheating will be common. We argue that the evidence does not support this pessimistic view. In fact, markets are capable of generating endogenously the rules that govern their operation and these rules discipline cheating severely. Finally, if we can persuasively argue that self-governance in financial markets is effective --- with the complicated nature of transactions that take place --- then the argument for self-governance in economic life, we contend, is much stronger than even economic liberalism has led us to believe. As a foil for this study we will critically examine the work of Timothy Frye (2000) on the financial exchanges in the Russian transition economy. Frye’s work represents a significant step
forward in the literature on financial markets in transition economies. Many studies prior
to Frye insisted that institutions of corporate governance needed to exist prior to the
introduction of privatization and that the rules which defined these institutions of
corporate governance were the appropriate domain of the state (Frydman and
Rapaczynski, 1994). Without an activist state establishing the framework, and regulating
the practices, corporate governance will be ineffective and the market economy will be
littered with opportunism and inefficient organizations. Frye does much to dispel this
argument. But, despite Frye’s advances over the previous literature, we will argue that
his introduction of political actors into the discussion of the mechanics of self-governance
ultimately confuses the issue.

**TYPES OF ANALYSIS OF SELF-GOVERNING ORDERS**

To motivate his discussion of the emergence of financial markets in post-communist
Russia, Frye distinguishes between three different approaches to the study of self-
governing organizations: sociological, economic, and political (Frye, 2000:17-55). Self-
governance has not gone unrecognized in the modern social scientific literature. Scholars
have recognized pockets of self-organization in a variety of walks of life. Most scholars,
however, provide arguments for the severe constraints on self-governance becoming a
general vehicle for social cooperation. There are restrictions placed on its
generalizability. In sociological theories the constraint tends to be density of social ties.
In social situations where strong family networks dominate social intercourse,
cooperation outside formal legal arrangements can be relied upon. By implication, however, it is argued that social intercourse with anonymous others requires formal law. One of the main arguments of economic sociology is that economic success by agents requires not strong social ties, but weak social ties. Successful job search, as examined by Mark Granoveter (1995), for example, is not so much that your cousin or best friend gets you a job, but that a friend of a friend’s friend knows of a job that you might like. It is the “strength of weak ties” that leads to individual success in the market setting. But for our purposes two things stand out in this result: (1) it is a challenge to the atomistic notion of markets, and (2) it implies that there are limits to the benefits of “strong ties”. While we agree with both --- notions of an atomistic market are unrealistic, and social relations limited to kin and family cannot be relied upon to generate advanced economic interaction --- we reject the implication the sociological conclusion on self-governance that it only works in situations of strong ties – i.e., dense social ties. Our argument is that while we agree with the sociologists that markets are not atomistic, we believe that even in situations of involving more anonymity, social cooperation can emerge through self-governance.²

Mechanisms of self-governance have not escaped the attention of economists either. Though like their sociological counterparts, they tend to be more pessimistic about

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² The classic reference on this is Adam Smith where he states that the number of exchanges and economic relationships that must be forged in order to provide even the most basic goods and services to the common day laborer “exceeds all computation.” Men are constantly in need of the services of his fellow man for their survival. “In civilized society he stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons. In almost every other race of animals each individual, when it is grown up to maturity, is entirely independent, and in its natural state has occasion for the assistance of no other living creature. But man has almost constant occasion for the help of his brethren, and it is vain for him to expect it from their benevolence only.” (Smith 1776: 11, 14). Also see Mises (1949:143-176), where he shows the applicability of the law of comparative costs to a general theory of social cooperation. For an application of these principles to a number of areas see Rothbard (1970, 1978).
the generalizability of self-governance than need be. In the standard economics literature it is argued that trades outside of formal law can work provided we are dealing with an ethnically homogenous group in a small number setting. In this environment in which there are many shared points of orientation among the population and it is easy to recognize deviations from the expected behavior, reputation and ostracism work to discipline actors. Economic interactions are self-governing provided the population is homogenous and it is easy to identify cheaters. But what about self-governance when the population is heterogeneous and anonymous? The economics literature believes that in such situations self-governance cannot be relied upon to discipline deviants and thus social cooperation will break down unless backed by the state as a third-party enforcer. We argue that contrary to this argument that self-governance can work to discipline market actors even in situations of ethnic diversity and large numbers. The economics literature is overly pessimistic about the ability of the mechanisms of self-governance to discipline market participants in situations where detection of their cheating others is very low. The standard argument by those even attentive to the power of self-governing mechanisms, such as Greif (1989) and Landa (1995), is that it requires relatively small homogenous groups (where costs of communicating and sharing information are low) and agents with low discount rate (so threat of a truncated future is bothersome). Beyond these circumstances, however, economists generally believe that the informal mechanisms of self-governance will break down and social cooperation will only result through the formal mechanisms of the state enforced law. Evidence from both historical studies and from experimental economics, though, seems to suggest that reputation and the discipline of repeated dealings; the threat of exclusion from the trading group and
social ostracism; and ultimately the cost of forgone opportunities for mutual gain all work on the self-interest of agents to act in a manner that produces social cooperation among agents even in ‘unfavorable’ circumstances according to standard theory. It seems that human actors tend to trust more than strict rationality might dictate, and in turn cooperate more with anonymous strangers even when we could cheat without detection. The economic theory of self-governance has been developed quite far in the past decade, but it must be developed must further if these anomalous results are to be explained.

Finally, the literature in political science has also recognized the importance of self-governance. In fact, in the entire discussion of civil society and social capital in Robert Putnam’s *Making Democracy Work* (1993) was motivated to a large extent by the discussion of self-governance in Tocqueville’s *Democracy in America* (1835). But, in our opinion, the emphasis on bottom-up self-ordering in Tocqueville is often missed in these discussions. Instead, the political science literature tends to focus attention on how the state creates space in the social world for self-governing orders by providing information and delegating authority. In this regard, self-governance is an important vehicle for reducing the administrative burden of the state sector. Self-governance, in short, supposedly enables the state to concentrate on those aspects of governance that it can accomplish effectively by reducing the administrative tasks of the state. But this position is at once too optimistic and too pessimistic from our perspective. Too optimistic because it holds that if we restrict the scope of government we can minimize the problems of bureaucratic coordination. Too pessimistic because it suggests that self-governance can only take place in the ‘shadow of the state’.
It is indeed the case that the sociological and economic literatures do not exhaust the manner in which actors develop mechanisms for self-governance. The problems in this literature are a lack of imagination on how ethnically diverse populations placed in anonymous situations can nevertheless come to cooperate within one another to realize the mutual gains from exchange. But the political science literature seems to suffer a more fatal flaw than lack of imagination --- it contradicts itself. The work inspired by Putnam argues that the bottom-up civil society recognized by Tocqueville as vital for the function of democracy in the US, can only be had through a top down imposition of civic responsibility?!

In Frye’s more subtle discussion, he is also nevertheless caught in a contradiction when he tries to argue that “politics underpins social order.” (2000:2) Frye argues that the state does best with regard to self-governance when it does essentially nothing at all. The state plays an important role by delegating authority, lowering taxes, and generally easing the costs of communication between economic actors and facilitating their private dealings.3 If the state does anything at all to actively intervene in these private dealings, it undermines self-governing forces. But if it does nothing, we ask how can it in fact be the source of self-governance? Frye’s political approach to self-governance is fundamentally incoherent, and ultimately the strengths in his analysis can be traced to his integration of economic and sociological approaches to self-governance that drive his case studies despite his claims to the contrary.4

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3 Frye writes “state policy can be an important promoter of self-governance and social capital. By organizing brokers and providing resources that reduced the costs of sharing information, state agents helped brokers trade in the absence of reliable third party enforcement.” (2000:141)

4 To put it simply, Frye argues that when state policy is to delegate regulatory authority to the self-governing market participants, and keep taxes low so market participants freely share information about their dealings and thus information is spread easily about the compliance performance of various participants, he is in essence arguing that the state can promote self-governance by getting out of the way. If the state simply creates space for self-governance, the mechanisms of self-governance still remain to be explained. And, thus, the sociological and economic approaches come back to the forefront of the analysis.
Frye characterizes the different approaches to self-governance as follows:

Table 1. Theories of When Self-Governance Can Occur

<table>
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<tr>
<th>Characteristics required for successful Self-governance</th>
<th>Sociological Approach</th>
<th>Existing Economic Approach</th>
<th>Political Approach</th>
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<td></td>
<td>Dense social ties</td>
<td>Small Groups</td>
<td>Delegation</td>
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<td>Homogenous agents</td>
<td>Low tax rates</td>
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<td>Low discount rates</td>
<td>Government</td>
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We believe that each of these existing literatures is lacking. To demonstrate our argument we will focus on the complicated arrangements that are involved in financial markets. Our work can be viewed as a commentary on the growing literature on law and finance and in particular the work on the emergence of financial markets. In countering the argument of Frye and others concerning the essential role of politics, we provide evidence that financial markets have arisen without the assistance of government.

The benefits of exchange are too strong to be ignored and the costs of cheating are too great to be tolerated, so financial markets develop elaborate mechanisms themselves to discipline actors. Trading arrangements evolve to select populations of traders precisely because of their trustworthiness and promise-keeping skills. Rather than

The political approach does not provide the mechanism for successful self-governance, just a precondition. It should not be surprising that if the state is demanding to regulate economic affairs and engages in predatory taxation, that above ground institutions of self-governance will not be able to flourish.
assisting markets government policies often actually interfere with everyday trading. Bad policies make brokers less able to use reputation and exclusion as a means of disciplining trading partners. The institutions of corporate governance, in other words, do not require the state to exist, but once they are incorporated into the state gambit they are often corrupted. The disciplinary function of corporate governance does its job best when it is independent of the state.

The disciplinary mechanism that lies at the core of our basic gains from trade model of social interaction is reputation and ostracism from future trades. In large number situations where reputation is more difficult to communicate, we argue that emerging financial markets possess ways to provide information surrogates for the face-to-face reputational signals we see coordinating affairs in small number situations. In the absence of the state, traders for example form “clubs” to provide various goods such as rule enforcement. We illustrate this evolution of markets within markets by way of a historical examination of stock markets in Amsterdam and London in the seventeenth and eighteenth centuries.

We see that stock exchanges endogenously evolve rules and practices that allow individuals to realize mutual gains and discipline opportunistic behavior. Exchanges may have exclusion tactics that are designed to limit the trading opportunities of potentially untrustworthy individuals. Access to the market will be denied, and contracts will not be honored unless an individual passes a series of tests that qualify them for membership first. Another way that exchanges self-police their operations is that the brokers themselves discriminate between potential trading partners and develop social
relationships, which work to pool social interactions between heterogeneous actors into relatively homogenous groupings (at least on the margin that matters for trading). Politics and the state have no role in governing the operation of this interaction, and to introduce politics into self-governance is to unjustifiably attempt to capture by public means the process of private want satisfaction. The government has no economic role to serve in this market, except to accept what is currently being practiced, or to corrupt those practices in a detrimental fashion.

**ALTERNATIVE EVIDENCE**

We believe that although Frye has done an excellent service by providing many of the details of the Russian experience with financial markets since the collapse of communism, by no means should the various Russian exchanges (commodities, currency and stock) be considered an exemplar of successful financial exchanges. In fact, the volatility in the market that was evident during the 1998 crisis can be traced to the political entanglements which still dominate the commercial landscape in Russia (see Gaddy and Ickes, 1998). The continued subsidization of key industries, and the mixed ownership forms which were mistakenly interpreted as privatization resulted in hybrid forms of enterprises that were neither truly private yet now also lacked the previous structure of public oversight. Russian statistics tended to overstate the extent of large-scale privatization, and underestimate the amount of privatization that took place through

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5 Alternatively, exchanges may allow anyone can join without some prior set of qualifications, but may require individuals to post an upfront deposit of a significant sum, e.g., when individuals are required to
entry of new enterprises as individuals attempted to hide from the view of the
government their economic activity for fear of public predation through taxation and
regulation. However insightful Frye’s discussion of the emergence of various exchanges
in post-communist Russia may be, he cannot escape the fact that the short-term time
frame of his analysis does not provide the analyst with enough historical distance to offer
the assessments over alternative hypothesis.

To put it bluntly, while the hypotheses Frye raises concerning economic,
sociological, and political approaches to self-governance are for the most part intriguing,
the data he employs from Russia cannot be relied upon to adjudicate between them. The
time period of analysis is just too short --- the story he tells is just beginning and his
assessment of the role of state policy in self-regulation necessarily truncates the story
prematurely. Looking at the history of the more significant stock markets, we find a
completely opposite picture than the one drawn by Frye. The conjectures of political
approach to self-governance are simply not consistent with the historical record.

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6 See Boettke (2001) for an examination of the problems of post-Soviet transitional political economy.
7 See Frye (2000:165-192) for a discussion of the role of state policy in promoting self-governance, and in
particular a case study of NAUFOR, a Russian self-regulating organization. To reiterate, Frye emphasizes
the following positive role state policy can play in promoting the emergence of self-governance: delegation
of authority, low taxes, and policies that encourage information sharing among members of the self-
governing organization. The criteria of success Frye employs are contract compliance, reporting rates, and
longevity of the self-governing organization. However, we must keep in mind that in the context of the
socialist economies, where state-owned enterprises were inefficient, or worse negative value-added,
survival of an enterprise during the transition period is not necessarily a positive sign. In fact, inefficient
organizations should be shut down, rather than sustained, and thus, the survival of inefficient firms could
even be interpreted as lack of reform, not success of reforms. This is not only relevant to former state-
owned enterprises, but various banks and firms within the financial sector in general. In a profit/loss
system, firms enter and exit continually. To give another example, the development of trade associations in
the former socialist economies is interpreted as the development of a vibrant civil society. Evidence can be
provided that firms that joined trade associations have fared better in the transition process than firms that
did not join. However, is this evidence of civil society bolstering a competitive market economy, or the
forming of interest groups to protect firms from the rigors of competitive pressure?
First let us consider the world’s oldest stock market, that of Amsterdam. The market for equities emerged after the creation of the Dutch East India Company in 1602. (Israel, 1989; 1995) After its inception, investors could transfer the ownership of their shares by going to the offices of the Company and paying them a small fee. (Neal, 1990a:195) This system was quite straightforward and required little trust between the two, since the clerk would look in the books to make sure that Investor A really had a share to transfer to Investor B at which time B would give A the money. The downside was that there were significant transaction costs of having to go to the company’s offices each time. Exacerbating matters were delays at the East India Company’s offices, since it had not anticipated that the high demand for transferring shares and it was not adept at these tasks.

Figure 1 Transfer of shares at Company Offices involved no risk of default but high transaction costs

Brokers, however, figured out a way to eliminate much of these costs. Rather than having investors visit the East India Company for every trade, brokers decided they could
make many transactions and then settle with each other on a future date. This provided great savings in transactions costs for the investors, but it introduced a new risk. When shareholders went to the Company to make the trade they knew they would get the share or the money immediately, but when they made a trade with a broker that would be settled at a future date there were now chances for default. A broker or another investor could make an agreement and then lose his shirt before settlement, or, even worse, he could engage in intentional fraud and have no intention to actually deliver his side of the bargain.

Figure 2 Trade with Broker could lower transaction costs associated with going to Company Offices for each transaction but it introduces additional risk of default

If it is correct that politics underpins social order, we would expect to see these transactions with brokers to take place only after one of two things: either government

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8 Depending on the arrangements and who bore the risks, there could be three additional parties who could
courts provided enough assurance by effectively enforcing contracts, or government encouraged brokers to form a self-regulating organization that provided those same assurances. In the seventeenth-century the Dutch government did neither. The political authorities considered much of the transactions associated with the stock market as wasteful, manipulative, and immoral (De Vries and Van Der Woude, 1997:150; Garber, 2000:34). Rather than playing an active role to encourage trading, they actually tried to discourage it. Starting in 1610 they passed ordinances against “trading in wind,” (Kellenbenz, 1957, pp.134-5) which outlawed all but the most straightforward of transactions. Market participants were prohibited from making trades where the shares were not actually transferred within two weeks. These ordinances effectively outlawed short sales, forward contracts, and most everything besides the simplest contracts. Likewise, government did not play an active role promoting a self-governing organization: anyone could participate and there were no formal rules.

This situation, according Frye, would be a recipe for disaster. If there were any dealing with brokers it would be limited to the simple transactions where courts would be able to play a role. Although these appear to be the worst possible circumstances for an advanced stock market, in actuality we can see that the market did remain undeveloped, as Frye’s theory would lead us to believe. Evidence about how the Amsterdam stock market functioned can be found in Joseph Penso de la Vega (1688). The Dutch government’s wishes notwithstanding, Amsterdam brokers simply ignored the law and went on to make numerous types of transactions that were unenforceable in government courts. By the time Vega was writing, a quite advanced securities market had developed.

default: one’s broker, the other investor, or the other investor’s broker.
Contracts included short sales, forward contracts, hypothetication, securitization, and options. Since these transactions were actually prohibited by law, we know for certain that Dutch traders were not relying on courts to enforce their contracts.

How was it possible for the market to thrive if government was not playing an active role? As detailed in Stringham (2002c), we can see that rather than relying on law, market participants relied on reputation and the discipline of continuous dealings to induce contractual performance. (Klein, 1997; Smith, 1766) In numerous passages of de la Vega (1688) it is evident that reputation played a very important role. For example De la Vega wrote, (1688:201) “Since the status, the insignificant capital, the low reputation, and the limited trustworthiness of such people are well known, they do not dare attempt to carry on any considerable business.” Word of mouth enabled traders to find who was reliable and with whom they should deal. When traders knew that someone was untrustworthy it would be in their incentive to boycott that party. (Caplan and Stringham, 2002) The Dutch stock market had an informal reputational network, which emerged with no assistance from the government whatsoever. In this case, the political approach to self-governance gives the inaccurate prediction: the Amsterdam market should not have been successful but it was. The existing economic and sociological literatures at least have a chance at explaining the success of the Dutch market, but Frye’s political approach to self-governance has none.

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9 As one passage of the text states, the descriptions are offered “so that knowledge of the stock exchange, about which nobody has written so far, might become more general.” (De la Vega, 1688:168)
10 See also De la Vega (1688:150, 172, 176, 201).
11 It may be important to note that the Dutch stock market started to decline in importance towards the end of the seventeenth century, which was a time when the Dutch government raised taxes on financial transactions. (Barbour, 1976:77-8) This would fit with Frye’s prediction that the government can take actions that hamper markets but not his conjecture that they can play a role assisting them.
12 A sociologist could maintain that it was dense social ties that enabled the Amsterdam stock market to function and a traditional economist could maintain that it was a small enough group, with homogenous
LONDON

Still it is possible that Amsterdam was an outlier. For this reason it will be useful to examine another market. After Amsterdam the one that leaps out is the stock market of London, which developed slightly before the turn of and throughout the eighteenth century. It was it this time where secondary markets matured and began taking a shape more familiar to modern observers. It was also the first major market to have a stock exchange organized that created and enforced rules.

Since this is a natural experiment it will be telling to see if government played a useful role assisting stock markets. Perhaps Frye’s approach will yield more accurate predictions for London. We have already seen in the case of Amsterdam, market participants had an incentive to share information, but was this an anomaly? In London we see many parallels with Amsterdam; the Brits adopted many of the practices of the Dutch, notably the recounter dates where trades would be settled once every three months. (Dickson, 1993: 491,507-510) These quarterly settlement dates exposed traders members who had low discount rates. Still it is not clear whether these explanations are accurate. First it is questionable how dense the social ties were. Although many of the stockbrokers were of sephardic origin it does not appear that constituted the vast majority of the profession. Vega has no apparent references to religious or social sanctions and the only reference to Judaism’s influence is that on Saturdays less people attend the market. Later estimates put the percentage of Jewish shareholders at twenty-five (Bloom, 1937:190) so it may be the case that Jewish investors used Jewish stockbrokers, but of the other three quarters it seems unlikely that native Dutchmen had close religious or ethnic ties with their brokers. By 1688 the population of Amsterdam was two hundred thousand, which included residents of various religions originating from places such as Germany, Portugal, and Scandinavia (Israel, 1995:621-7). This seems too diverse to depend on close-knit ties or religious bonds for cooperation.

These facts also bring into question whether the market worked because it was a small group with homogenous agents. The Amsterdam Bourse was by no means a closed club, and although there was a brokers guild, common for brokers to be unlicensed and conduct business anyway. For example, De la Vega (185) wrote, “There exists an infinite number of these free brokers. This occupation is [in many cases] the only recourse for impoverished [businessmen], and the best place of refuge for many ruined careers.” De la Vega (1688:190) talks about how there were many sorts of brokers with disparate income levels, so it does not seem likely that they were able to self-govern because of a small numbers situation where everyone was alike. Still it might be claimed that there was a small enough group of traders, so this potential explanation cannot be ruled out completely. This, however, would not be able to address the large number of people who made trades related to the stock market, which according to De la Vega was quite large and included “old men, women, and children.” (De la Vega, 1688:185-8; Israel, 1995:346)
to all of the above risks of default and we can see this danger mentioned in early accounts of the stock market. For example in, *Every man his own broker; or, A guide to the Stock Exchange*, a book reprinted throughout the four decades at the end of the eighteenth century, Thomas Mortimer remarked: “problems arise if the person making the trade does not have the ability (cash) to settle, for in many cases a broker and his customer had no money.” (Mortimer, 1801:53-4)

The political approach to self-governance suggests that if there were a solution, the state would be at its heart, but in this market too, this is not the case. (Stringham, 2002b) Looking into the development of secondary markets in London one is hard pressed to find ways of attributing its success to the state. Frye assigns two positive roles to government for promoting self-governance. The first is enacting policies that encourage the sharing of information. Although we believe he is correct that self-governance rests on the ability of market participants to share information, nowhere does he demonstrate that the state must play a positive role for this to happen. What if government simply does nothing?

Looking into the history we can see English brokers, just like their Dutch counterparts, were actively sharing information about the reliability of others. One of the more prominent pieces of evidence is the use of the term lame duck. In 1761 Thomas Mortimer described a lame duck as: “A name given in ’Change Alley to those who refuse to fulfil their engagements…There are some at almost every rescounter.” (quoted in Morgan and Thomas, 1969:61) Although lame ducks posed problems to trustworthy brokers, just like in Amsterdam, the economic incentives were the same: it paid to investigate the reliability of one’s trading partners and to boycott the untrustworthy. We
can see evidence of this in various sources such as Mortimer (1761) and Adam Smith’s (1766) *Lectures on Jurisprudence*: “They who do not keep their credit will be turned out, and in the language of Change Alley be called lame duck.” (Smith, 1766/1982:538) The system of sharing information went beyond a few brokers gossiping over coffee; eventually the system advanced where brokers would write the names of unreliable brokers on a chalkboard in one of the main places of trading. (Morgan and Thomas, 1969:61). In contrast to the Frye’s assertions about this need for government, we can see brokers readily sharing information without any direction from the state.

The second role that Frye would have us assign to the public sector is selecting the brokers to form a self-regulating organization. In Frye’s NAUFOR example in Russia, the government actively selected the brokers that should be in control of the market. Again he implies that the market would have been unable to successfully organize without government assistance. The question is whether government needs to play this role. Did the Crown play such a role in London? Once more, we see that the Political Approach to Self-Governance does not fit with the facts. In London, the first self-regulating organization emerged not because of government but in spite of it.

Through the end of the eighteenth century there was no formal stock exchange, so brokers made use of coffeehouses, the most popular of which being Jonathan’s. As the market grew, unfortunately there were more traders with less than stellar reliability and it was costly to keep track of everyone. Not surprisingly the more reputable brokers did not want to be exposed to such elements so they devised a strategy. In 1761 Thomas Mortimer wrote, “The gentlemen at this very period of time…have taken it into their heads that some of the fraternity are not so good as themselves…and have entered into an
association to exclude them from [Jonathan’s] coffee-house.” (quoted in Smith, 1929:215) They decided that they would rent out Jonathan’s Coffee-House to use it as their exclusive venue. By having the ability to preselect who could enter the club it would free brokers from always having to be on their guard.

Was it the case, as the Political Approach to Self-Governance would have us believe, that the government was behind such an organization? To the contrary: the government actually acted as a roadblock in this case. Rather than allowing and encouraging the London brokers to police themselves, the courts intervened and declared that the stockbrokers did not have a right to exclude anyone from Jonathan’s. (Morgan and Thomas, 1969:68; Jenkins, 1973:45) The government acted a cause of disruption, but with economic incentives as strong as they were, the brokers did not give up. They ended up constructing their own building, referred to as New Jonathan’s and later renamed to The Stock Exchange, which could create and enforce rules.\(^\text{13}\) Members who were unruly could be fined or kicked out of the club, which would create significant incentives for cooperation. This is an example of a self-regulating organization that enforced rules in a non-coercive way. The London Stock Exchange seems to be the archetypal example of successful self-governance and by all accounts we can see that Frye’s predictions about the political origins of social order are just wrong.\(^\text{14}\)

\(^{13}\) After the completion of New Jonathan’s brokers who were excluded attempted to use the government to break open this private club, but in this second case the government did not intervene. (Morgan and Thomas, 1969:72).

\(^{14}\) The existing economic and sociological approaches, again, at least have a chance at explaining the successful self-governance in London but in the end they also seem deficient. The London Stock Market clearly was not a close-knit community where each person knew everyone else and their business. Were this the case there would have been no reason to write down the names of the untrustworthy or exclude them from the Coffeehouse since such measures would be redundant.

As for the old economic approach, the London stockbrokers clearly had heterogeneous interests and it was not limited to a small number of traders. This was, after all, why the more reputable brokers desired to set up a self-regulating organization because there were too many people who could not be
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**CONCLUSION**

We have argued that the existing literatures on self-governance are too pessimistic about the ability of individuals to form self-governing organizations that provide the framework within which complicated economic relationships can be forged. In addition, we have argued that the political approach to self-governance, specifically, is either redundant or contradictory. Market participants find creative ways to self-police their interactions beyond the limited scope predicted by the standard economic and sociological approaches. Self-interest can work as a powerful mechanism for social cooperation without a government enforcer, even in situation of anonymous dealings. Moreover, in the historical examples of the emergence of financial markets, economic actors found ways to share information between market participants and discipline deviants. We have argued that with regard to the emergence of complicated financial
arrangements the evidence suggests that when government does nothing self-organization of markets work. It could also be argued that the systemic instability of financial markets results when government intervenes in the market and distorts the signals that economic actors follow in trying to realize the gains from trade. In short, governments aid markets most effectively by getting out of their way, allowing economic actors to pursue their plans as they see fit, and allowing the market to develop its own rules and mechanisms for dealing with cheaters and opportunistic behavior.

Frye’s political approach to self-governance, despite the advance his book represents in terms of previous discussions of the emergence of financial markets in post-communist economies, fails to improve upon the existing economic and sociological approaches. Improvement in our understanding of self-governance will come not from incorporating the political element into the analysis, but instead through clarifying with theoretical and empirical work the various mechanisms through which heterogeneous agents in large group settings actually produce cooperation without command.

creating a self-policing club they were able to overcome these problems.
REFERENCES


