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Introduction

Public institutions rarely serve the needs of informal workers, who encompass as much as 62 percent of global employment (Kok and Berrios, 2019). For instance, informal entrepreneurs often view courts as biased, inefficient, and unequipped to regulate off-the-books transactions, so they do not rely on them for protection. Instead, they must bear the full cost of swindles or errors themselves. The legal system would therefore be of little help to traders who stock up on what they thought were new smartphones, only to discover that they were refurbished and must be sold at a loss. A large body of work maintains that private associations can step in to fill this regulatory gap by enforcing contracts, but this is not always the case. Although informal traders frequently belong to such groups, not all of them promote trade. Indeed, many extort from traders in their own associations. Markets in Lagos, Nigeria, provide examples of both types of associations.

For example, two markets in the center of the city appear to be similar from the outside. Yet the markets are governed very differently. The first is a wine market with about 1,000 traders, and on the surface it looks similar to many other markets in the city. Small shops densely line narrow dirt paths. Shop owners, who might have one employee, sit on white plastic stools, waiting for customers. Like hundreds of other markets in the city, this one is governed by a private traders' association, which is headed by a trader who was elected to serve as the primary leader. Traders in the second market also sell products that are difficult to inspect at the point of sale, in this case cosmetics, food items, and some wine.

The wine market leader's administration is a model of good governance. The leader supports a wide variety of policies that promote trade. For example, the market leader impartially investigates customer complaints and confiscates wine that is substandard or falsely branded, and potentially fines the trader responsible. Similarly, if a supplier sells bad wine to a trader in his or her association, the trader informs the market leader. The market leader will investigate and may organize a market-wide boycott of that supplier.

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By contrast, the leader of the second market extorts from his traders. He collects fees from them that he says will be used to pay ten security guards at a salary of $83/month, when in fact there are only four guards who are paid just $56/month. Similarly, traders report that they pay for waste collection, but the trash is collected only infrequently. "It is obvious [the market leader] doesn't [financially] settle the people who are supposed to carry out dirt in this market," one trader said. "I don't know what [he] is using the money for." If a supplier or customer wrongs a trader in this market, the leader does not intervene.

The underlying dynamics explaining divergent outcomes in these two markets are not obvious. The leaders of both markets are strong in the sense that they are able to control the market's internal affairs. For example, they both have the authority to lock up a trader's shop to sanction rule-breaking. Yet one uses this power to promote trade, such as by punishing traders who cheat, while the other uses it to extort from the traders. This book examines what motivates leaders to carry out trade-promoting policies. Specifically, I investigate the conditions under which market leaders share information about dubious suppliers and customers and impartially mediate disputes, versus when they will be unengaged or predate. I use the term "private governance" to mean the extent to which leaders provide these trade-promoting policies. "Good private governance" indicates that a leader provides many of these services.

A dominant strand of thought suggests that private institutions arise to fill the vacuum left by weak or absent states. These institutions are thought to thrive in the absence of political interference. According to this logic, private good governance thrives in the absence of meddling malevolent politicians. Therefore, the first market's trade-supportive environment should be a function of stereotypically corrupt politicians keeping their hands out of the market's affairs, while the second market's problems must emanate from public interference.

Yet I find that the opposite is true: the wine market faces extensive government intervention, and its leader maintains pro-trade services as a strategy to *respond* to threats of interference. He punishes the sale of substandard wine to reduce the likelihood that disagreements with customers will escalate to the attention of a regulatory agency that uses any dispute as an excuse to extract rents from the market. Unlike the second leader, the first market leader does not extort from traders because he needs their support in order to politically mobilize them to preempt local government extortion. The second market does not face threats from the regulatory agency, and the local government it falls under is far less intrusive. These cases are not the exception. Indeed, I will show that they are the rule: informal institutions perform *better* under the shadow of government, and *worse* in the absence of government interference.

The argument, in short, is that strong leaders – those who are able to control the internal affairs of their group and have the ability to enforce decisions within the group – can use their strength either to predate on group members or to promote trade. Strong leaders will be motivated to engage in the latter strategy when they face the prospect of government intrusion. Threats from the government motivate trade-promoting policies because (1) the leader needs to minimize group disputes to reduce the likelihood of state intervention, and (2) the leader needs the support of group members to mobilize against state threats. In short, strong leaders maintain sophisticated policies to support trade not in the *absence* of government, but rather in response to active government interference.

But the threat of politician intrusion does not always result in private good governance. When traders are in competition with one another, business will feel like a zero-sum game. Markets may be spaces of secrecy, with each man for himself. In these circumstances, market leaders will struggle to unify traders. As a result, I expect that threats of government meddling are more likely to lead to better private governance when traders are selling different products, and are not directly in competition with one another.

1.1 WHY THESE PRIVATE LEADERS MATTER

There are hundreds of other similar markets in Lagos, and virtually all are structured in the same way: they are in physically delimited spaces, governed by a handful of traders who were elected in popular market elections. Societal norms in much of the developing world are such that these market leaders are considered liaisons with government officials. They often exert control over access to shops in a market, even when shops are in privately owned structures. In a place like Lagos where up to 67 percent of residents report working in the informal economy,[1] market leadership matters.

And Lagos is not an exception. In Nigeria as a whole, and indeed in developing countries in general, 41 percent of GDP comes from the informal economy.[2] Moreover, the associational nature of trade is not unique to Nigeria (e.g., Cross, 1998; Hummel, 2017*a*). The world over, retailers, tailors, and shoe shiners are organized and operate under the jurisdiction of private leaders. Similar associations govern slums, informal transportation, and laborers.

For a trader in America, public institutions (in general) impartially enforce contracts and protect property rights. Police arrest suppliers who cheat, mitigating the need for acquiring information about opportunistic individuals. When the rule of law is weak – that is, when laws are unclear and agreements are unevenly and inefficiently enforced – the government cannot be relied upon for these services. This presents a huge barrier to trade. Policies like those the

[1] Author's analysis of the 2012 Lagos State Household Survey ($n = 10,000$). The question asked, "The daily activity of the [respondent] can be categorized into: 1) Formal sector (white collar job), 2) Informal sector (bricklaying, barbing, tailoring, vulcanizer, etc.)." This question likely results in overreporting of the informal sector work, as individuals can work in the formal sector but not consider themselves white-collar workers.

[2] The Nigeria estimate is from the Nigerian National Bureau of Statistics. "Formal and Informal Sector Split of Gross Domestic Product: 2015." 2016. http://nigerianstat.gov.ng/. The developing countries estimate is from Schneider (2005).

wine market leader enforces are critically important for informal traders, who I define as those with businesses that are not registered with all relevant government entities or who conduct transactions that are not formally documented. The wine market leader is doing essentially three things: not predating on his own traders (which includes respecting the validity of shop leases), impartially enforcing contracts, and collecting and sharing information about dishonest suppliers and customers so as to avoid trading with them. For a huge percentage of individuals around the world, whether trade thrives is largely a function of the private policies that govern the space in which trade is conducted.

Moreover, contract enforcement is especially important for capital-constrained traders, who must be able to buy their stock from suppliers on credit. Traders with unregistered businesses may be ineligible for bank loans. Even traders with registered businesses struggle to access bank financing: more than 25 percent of *registered* firms in sub-Saharan Africa report that access to finance is their main obstacle to growth (Beck and Cull, 2014). Indeed, in Africa as a whole, supplier credit finances virtually the same amount of working capital as bank loans (World Bank, 2007). Yet suppliers understand the high risk that traders may not be able to repay them and thus are discerning in deciding to whom to offer products on credit. When market leaders create conditions that encourage repayment – for example, by impartially mediating disputes about repayment – suppliers will feel more comfortable providing credit in that market association.

Likewise, to stay in business, traders often need to give products to customers on credit and assume the risk that they might not be repaid. Here again, market leader policies that encourage repayment – for example, banning a customer from a market until they have repaid – have a huge impact on traders' businesses. These institutions help traders feel secure when extending credit.

In rural contexts, family and social ties can increase cooperation. For example, a supplier may be willing to provide products on credit to a trader who goes to church with her uncle. Similarly, a trader may be willing to sell a phone charger on credit to a customer with children at the same school as hers. These social ties can motivate repayment. City markets, however, rely on one-off impersonal trade: traders do not expect to see each other in other settings. When leaders like the wine market head share information about dishonest suppliers and customers, they provide an immensely valuable service. They are enabling contractual trade that should help traders to grow their businesses.

Property rights protection is another valuable service private group leaders can offer (or not). In dense urban environments, access to land on which to sell products is an important asset. Many urban poor experience insecure property rights, which can make medium- and long-term business planning decisions difficult. The wine market leader respects shop leases and accounts properly for the fees received from traders. In contrast, the other market leader discussed earlier misappropriates fees, and some predatory market leaders will occasionally kick a trader out of a shop before their lease ends. In short, when private market institutions work effectively, they can dramatically improve economic conditions in the informal sector.

1.2 THE ARGUMENT: HOW THREATS OF STATE INTERFERENCE SUSTAIN PRIVATE PRO-TRADE POLICIES

Threats of state interference, I propose, motivate strong group leaders to invest in and sustain policies that will promote trade within the group, particularly when group members are not directly competing with one another. I use the terms "group" and "organization" interchangeably. The group under study in this book is the market association, but the argument could apply to other types of business or resident associations. For simplicity, I conceptualize groups as having a single leader, although many groups are governed by a team of individuals. In the markets studied here, groups might have multiple leaders, but power is typically concentrated in the hands of one person. To avoid confusion about whether "association" references a group or a leader, I avoid this term except in cases where its meaning is unambiguous.

A leader of a group (whether public or private) who is strong enough to protect property rights and enforce contracts also has the power to confiscate the wealth of the members – what Barry Weingast calls "the fundamental political dilemma of an economic system" (1995, p. 1). A large, diverse, and interdisciplinary literature has described the characteristics that define successful self-governing organizations in the absence of impartial public institutions that protect property rights. However, this body of work rarely grapples with when, why, and how some groups succeed in developing these institutions, while others do not. I address this gap in the literature by exploring what motivates leaders to invest in pro-trade policies, when they *could* use their strength to predate.

The existence of pro-trade policies – particularly those related to information sharing and enforcement – is not a foregone conclusion, for a variety of reasons. A novel contribution of my argument is to highlight that such policies entail large short-term costs for a leader. First, what are these policies? Strong information-sharing institutions inform group members about the past behavior of potential trading partners to help them avoid entering into risky transactions with dishonest individuals. Enforcement mechanisms ensure the implementation of agreements, punish dishonest outsiders (through boycotts), and penalize opportunistic insiders through impartial and efficient in-group policing. A number of studies have described groups in which one or more of these institutions are present and support cooperation.[3]

Both types of pro-trade policies entail costs to the leaders, who must either motivate members to share information about people who have cheated them – a difficult endeavor when group members compete with each other and

[3] See Greif (2006) for a discussion of a group with information sharing, Milgrom (1990) for a group with enforcement institutions, and Fearon and Laitin (1996) for groups with in-group policing.

individually have little incentive to share such information – or occasionally make rulings in disputes that go against the short-term interests of group members. Therefore, we will only observe these policies if the benefits to a group leader outweigh the costs. I am building on research by Barak Richman (2017) in theorizing about the role of within-group competition; many studies either claim that group members are not in fact competing with each other (Greif, 2006) or ignore the role of competition and focus only on what happens once collective problems have been overcome.

These costs highlight the importance of group leaders in large groups. Of course, it is possible to imagine these trade-supporting policies being sustained in the absence of leaders. Perhaps in some exceptional cases there are large groups of traders where norms of honesty are strong, social embeddedness induces reputable behavior, and truthful information about traders' reputations spreads quickly. But in general, I expect leaders to be critical, particularly in urban areas where social embeddedness cannot be assumed and there are incentives to keep secrets and spread lies.

While private groups are often viewed as substitutes for state regulations, the reality is far more complex. Groups and the state often coexist as political adversaries. The incentives created by this adversarial relationship determine how group leaders will govern.

My argument focuses on two actors: group leaders and public officials (such as local politicians, the police, and bureaucrats working for regulatory agencies). Traders (group members) play a lesser role in the theory. I assume that group leaders are self-interested and aim to maximize their income by maintaining their position, and thus their power to tax group members. Public officials' incentives vary – some local politicians may hope for higher office, which requires impressing patrons by showing what they can accomplish. Others might wish to avoid rocking the boat and plan to retire after their term. Police and regulatory officials will aim to keep their jobs, which could involve interfering more or less in the affairs of private groups, depending on their supervisors' incentives.

I argue that whether leaders need member support to keep meddling public officials at bay determines the degree to which leaders serve member interests. When public officials (such as politicians) lack a track record of acting in the public interest, groups will perceive the prospect of their intrusion as threatening and contrary to group interests. Where public officials try to interfere, leaders are more likely to support private trade-promoting policies. Under this umbrella concept, I focus on policies that reduce disputes (including information sharing and enforcement policies) and the avoidance of private extortion. A desire to fend off state threats can explain the presence of both. Leaders will work to reduce disputes to avoid them escalating to the attention of a potentially predatory government. Leaders will limit their extortion when they need to mobilize traders in order to collectively deter undesirable government behavior. I outline this logic in Figure 1.1.

What do threats of interference from public officials look like? These threats will vary by group type. In Lagos, local politicians might want to demolish

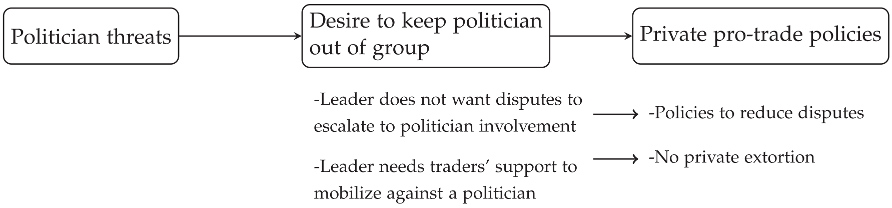

FIGURE 1.1 **How politician threats lead to private pro-trade policies.** The outcome of interest is private trade-promoting policies, including those that reduce disputes (including information sharing and enforcement policies) and private extortion. The presence of both can be explained by a desire to fend off politician threats. Leaders will work to reduce disputes to prevent them from escalating to the attention of a politician. Leaders will limit their extortion when they need to mobilize traders in order to collectively deter undesirable politician behavior

and renovate older markets. Traders are displaced during renovations and are often priced out of shops in the new market. Alternatively, local politicians may try to raise taxes. Regulatory agencies might threaten to lock shops in the market or enter the market with police who scare customers away. Markets on local government land are more vulnerable to these threats, as state officials have more rights to intervene and can collect a wider set of fees. Critically, these threats can vary within a city, and even within a local government. For idiosyncratic reasons, one market might be under threat of demolition, while a neighboring market might not.

Why will these threats limit private extortion? A strong leader wants to keep the government out of the group. The leader's threats against the government, however, are credible only if she can mobilize members to protest or vote as a bloc, or otherwise collectively sanction politicians (Bates and Lien, 1985). Such mobilization requires the sympathies of members. In efforts to maintain this support, the leader will be less likely to extort. This part of the argument has parallels to the state-building literature. For Charles Tilly (1992), a group leader's ability to resist an external threat requires support from group members, which incentivizes negotiation and exchange between the group leader and group members. According to Miguel Centeno (2003), external threats only promote institution building under certain conditions, which involve a certain level of organizational capacity.[4]

Consider the case of a market in the north of Lagos, which falls under a local government that has repeatedly tried to demolish it. The market

[4] My argument has parallels to Oliver Williamson's theory that two actors can provide each other with hostages to facilitate contractual trade (1983), and to arguments that a balance of power between the state and businesses can shape tax rates (Luong and Weinthal, 2004) and constrain corruption (Kang, 2002). There are also parallels to Catherine Duggan (Forthcoming), who argues that private lending markets grow when the state can check their power, primarily by preventing lenders from stealing from their clients. This leads potential borrowers to trust lenders. This argument also builds on work that suggests external threats, such as police repression, can motivate group solidarity (Thachil, 2015).

leader, in response, has mobilized traders against the local government. The association has successfully deterred four renovation attempts and brought the local government to court. In early 2018, the market leader appealed to the Lagos state governor, implicitly threatening the state party with the market's political strength: "We are begging [the governor] to wade into this matter," the market leaders told a reporter. "We know he is not the brain behind the alleged demolition as [the local government] claim[s]. We are all [ruling party] members and we want our governor to win a second term." The local government chairman, in turn, said that the governor "believes the market does not meet up with the megacity status," a common force that motivates local politicians to modernize their communities.[5] If the market leader had been extorting from traders, it is unlikely he would have been able to mobilize them to credibly protest and fend off the demolition.

Why would the threat of politician interference encourage a leader to facilitate information sharing? In short, the prospect of intrusion increases the gains to the leader of keeping her house in order. Disputes provide an opportunity for public officials to intervene, such as the police entering a market to deal with an altercation. If a leader permitted fraudulent behavior, such as allowing a trader to sell substandard products, public officials could exploit a customer complaint as an opportunity to intervene in the market and extract revenue. By policing member actions and eliciting and sharing information about outside swindlers, the leader limits disputes, and thus minimizes opportunities for government extortion, which can threaten the leader's influence. I expect government threats will have these consequences when the leader is strong.

Threats will not always lead to private good governance. I expect that, when group members compete with each other, it will be harder for leaders to elicit information about dishonest trading partners. It will also be harder to promote group cooperation of any sort, including protest efforts. I therefore expect high levels of intragroup competition to frustrate group leaders' efforts to support trade.

Could group leaders and state officials collude, throwing group members under the bus to advance elite interests? I expect such collusion to be uncommon, as the benefits to the group leader will only rarely outweigh the costs of maintaining a collusive arrangement. What we know about collusion in general suggests that it is sustained only when there are very sophisticated institutions to prevent one member of a colluding team from secretly defecting (Marshall and Marx, 2012). I expect these arrangements to be hard to support in low-trust environments. I expect collusion to be possible only when a group leader's autonomy is imminently threatened, and even then it should be rare.

[5] Erewuba, Paul. March 20, 2018. "Lagos traders send SOS to Ambode over planned market demolition." http://sunnewsonline.com/lagos-traders-send-sos-to-ambode-over-planned-market-demolition-2/

1.3 BROADER IMPLICATIONS

The evidence presented in this book has two main implications for our understanding of the role of politics in economic development. First, it suggests a channel for development that does not rely on a developmental state. Second, it updates our understanding of the factors that sustain private pro-trade policies in groups that extend beyond the informal sector.

1.3.1 A New Role for Politics in Economic Development

The notion of state–society struggles promoting trade is distinct from descriptions of partnerships between the state and societal groups that are seen in research on co-production (Mitlin, 2008; Ostrom, 1996) and on how developmental states are effective at promoting economic growth (Doner, 1992; Evans, 1995). Those who argue that under a very specific condition – when the state is developmental – close cooperation between the state and business associations is critical for growth tell us little about the conditions under which we would observe localized growth in non-developmental states.

I am, of course, not the first to argue that a balance of power between the state and society can lead to economic growth.[6] My contribution is to introduce two mechanisms through which this balance of power can shape private governance, shown earlier in Figure 1.1. In contrast to accounts of private governance that suggest private policies substitute for public policies (e.g., McMillan and Woodruff, 1999), I argue that, as the government attempts to intervene in private groups, private governance improves.

1.3.2 How Private Pro-Trade Policies Are Sustained

A vast interdisciplinary literature proposes that self-governance will emerge when it is needed, and focuses on describing the ways in which thriving groups function, but not on the conditions that make well-governed groups more or less likely. Robert Ellickson documents high levels of rancher cooperation in 1970s California, despite little knowledge of relevant legal provisions. “Order often arises spontaneously,” Ellickson asserts (1991, p. 4). Edward Stringham has argued in his series of papers on private contract enforcement in early European stock exchanges (Stringham, 2003, 2002) that trader reputations simply become *known*; he does not explain *how* (e.g., Stringham, 2002, p. 17).

In considering the roots of the rule of law, Gillian Hadfield and Barry Weingast (2014) similarly focus on the role of decentralized collective punishment. While they do not assume that private good governance will emerge when needed, their expectation of what private good governance looks like does

[6] Karl Polanyi, for example, has proposed that untempered market liberalism presents enormous perils (1944). David Kang has argued that a balance of power between the state and businesses can constrain corruption (2002).

not explicitly consider the role of group leaders. My contribution is to highlight that – with the exception of small groups – empirically, the reputational institutions Hadfield and Weingast describe almost always require private leaders. Indeed, even groups with dense social networks, such as the New York Diamond Dealers Club which is comprised primarily of Orthodox Jews, have leaders who enforce policies that sustain cooperation (2001, 2017). When we acknowledge that groups have leaders, we must then ask what motivates these leaders to invest in policies that support trade rather than extort from their members.

I build on research that explores the political factors that make private good governance more likely. Elinor Ostrom (1990) suggests that the government can support private good governance by offsetting the costs of monitoring shared resource usage. Timothy Frye (2000) proposes that the government can lower the risk of information sharing within private groups by keeping tax rates low, as the consequences of a business sharing information with the government about another business's volume of trade would be less severe in terms of tax penalties. My contribution in this book is to show that, even when the government is not offsetting the costs of group governance, politicians can still incentivize the creation of such policies.

In particular, I am introducing an argument for when we will see trade-promoting groups in cities, where traders may not be embedded in each other's lives, nor in the lives of their group leader. In the absence of social embeddedness, traders will be less likely to cooperate with each other, and leaders will feel less socially constrained to act honestly. In so doing, I take up the call from urban politics scholars to consider the unique coordination challenges in cities where there is greater social diversity and population turnover (Auerbach et al., 2018).

1.4 ADDITIONAL FACTORS THAT MAY SHAPE PRIVATE GOOD GOVERNANCE

Why would a trader ever join a market with a predatory leader? And even if they made the mistake of joining a badly governed market, could they not compel the leader to behave better? Moreover, could a leader's time horizon determine how they govern? I now turn to these alternative explanations.

A potential criticism of the argument is that successful traders select into well-governed markets, and that this (rather than the balance of power argument) explains the persistence of different market governance equilibria. However, I expect that traders rarely sort in this way for two reasons. First, group membership is relatively sticky, making it difficult for individuals to frequently switch associational membership. The set of possible groups may be limited. For example, in Lagos, only two big markets sell used car spare parts. Likewise, one can imagine that a member of a badly governed union for hairstylists would not have many other unions to choose from. Second, outsiders have incomplete information about group conditions before joining. In competitive business environments, traders in a market will have no