

Private Governance: Creating Order in Economic and Social Life, by Edward Peter Stringham. New York: Oxford University Press, 2015, 296 pp., \$42.75 hardbound.

Governance, Morality, and Markets

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The 2016 presidential race reminds us that there is a chicken-and-egg relationship between government-funded education and public support for socialism.¹ The chicken is government-funded K–12 and higher education; the egg is ideological indoctrination and moral relativism. In a recent email exchange, Angelo Codevilla, professor emeritus of international relations at Boston University, proposed to me that the low quality of K–12 education is a root cause of the low quality of higher education. In turn, the removal of local, parental control from the

¹See, e.g., Angelo M. Codevilla, “America’s Ruling Class—and the Perils of Revolution,” *American Spectator*, July–August 2010, <http://spectator.org/articles/39326/americas-ruling-class-and-perils-revolution>.

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governance of K–12 education has contributed to its decline. The decline of both K–12 and higher education has been accompanied by advocacy of centralizing solutions that in turn reduce the quality of broader economic, social, and educational outcomes. Political correctness, rule books, and speech codes in universities have also supplanted traditional, internally driven morality because state-driven education is increasingly morally vacuous.

The removal of religion from public schools and the institution of secular humanism as a de facto state religion were steps in the centralization of governance. Religion is a key influence on individual self-governance. Perhaps the greater depth and scope of faith in the nineteenth century permitted a degree of economic *laissez faire* and political liberalism that will again be possible if religion and moral belief are strengthened, yet centralized public governance makes that unlikely. Perhaps the reverse is also true: Increasing reliance on private governance might renew interest in morality and in faith as material success once again becomes associated with fair dealing rather than with insider relationships.

Edward P. Stringham, the Kathryn Wasserman Davis Chair in Economic

Organizations and Innovations at Trinity College, challenges twentieth-century assumptions about governance and relationships among the state, the law, and markets. In *Private Governance: Creating Order in Economic and Social Life*, Stringham proposes that regulation and adjudication in an array of fields are most efficacious when arrived at privately, in the marketplace, rather than through administrative centralism. Stringham balances theoretical reasoning with rich historical illustrations of how, since the early modern era, local markets have arrived at governance arrangements without government.

My favorite part of the book is chapter 9, which concerns ethics. Stringham makes a valid point: to the degree that ethics is internalized, governance becomes unnecessary. Stringham cites a behavioral experiment in which, when students were asked to recite the Ten Commandments before grading their own exams, cheating significantly declined.

A stronger sense of ethics results in reduced transaction and enforcement costs. Communities containing members who exhibit a sense of fair play, mutual respect, and reciprocal understanding have less need of governance than ones that contain criminals. Internalization of morality may be more important than police and economic incentives to inducing moral behavior. Thus,

gated communities like Disney's Celebration, Florida, are in high demand. Residents benefit both from association with fellow residents who behave well and from disassociation from a general public who do not behave well because public morality has declined.

Stringham's perspective is Tocquevillian; much of his rationale for private governance arises from the better fit between mores and administrative rules that results from voluntarily chosen as opposed to centrally imposed rules.² Tocqueville saw federalism as one of 1830s America's chief strengths, but Progressivism and the New Deal successively centralized power in the three federal branches, resulting in law and adjudication that are remote from many Americans' values and that rely on centralized administration.

Most classical liberal economists, political scientists, and legal theorists assume that legal centralism is a prerequisite to functioning markets, but Stringham's examples show that private governance markets often evolve locally despite government attempts to quash them. Moreover, governmental regulatory systems are riddled with conflicts of interest, so government employees are often incapable of or uninterested in

²Alexis de Tocqueville, *Democracy in America*, trans. and ed. Harvey C. Mansfield and Delba Winthrop (1838; Chicago: University of Chicago Press, 2000).

enforcement. Police, regulators, courts, and educational administrators may not have the incentives to prevent fraud or theft involving small amounts of money, for the costs of enforcement, prosecution, or litigation may be too high. Educators may have little incentive to deliver basic skills education to students absent market competition. Ideological rationales such as progressive education are ways to explain away the system's ongoing failures.

Stringham's critique of F.A. Hayek toward the end of *Private Governance* offers insight into his own reasoning: Hayek saw parallels among markets, adjudication, and scientific experimentation.³ Markets, judicial procedures, and science all involve discovery: The role of markets is to discover optimal economic and technological procedures; the role of judicial system is to discover rules of law that guide transacting parties; the role of scientific experimentation is to discover scientific principles.

Hayek's model breaks down with respect to the judicial system, Stringham argues, because there is no competitive procedure that restrains the judiciary from doing more than just discovering true or underlying law, that is, from doing

more than it should. Supreme Court decisions such as *Engel v. Vitale*, *Kelo v. New London*, and *Obergefell v. Hodges* have imposed doctrines on government-run schools and private property that do not reflect many, if not most, Americans' values.⁴

The claim that judges can make optimal decisions assumes away the courts' monopoly status and the absence of consumer choice. Without market feedback judges cannot know whether they are inventing new law or accurately discovering underlying mores in accordance with Hayek's model. While markets cannot and should not govern all phases of life, their introduction, when possible, improves a broad range of outcomes because consumer demands signal when institutions are functioning well.

The remedy to ham-handed legal and administrative centralization is, claims Stringham, competitive markets for governance. Stringham paints portraits of various private governance systems, including the earliest stock market in Amsterdam, San Francisco's Patrol Special Police, a private police force that still exists in San Francisco, and PayPal's fraud detection procedures.

Such an institution sounds farfetched, but through the eighteenth century England had competitive courts;

³F.A. Hayek, *Law, Legislation, and Liberty* (Milton Park, Abingdon, Oxon, UK: Routledge, 1998).

⁴*Engel v. Vitale*, 370 US 421 (1962); *Kelo v. City of New London*, 545 US 469 (2005); *Obergefell v. Hodges*, 576 US__ (2015).

among them were local, manorial, county, hundred, ecclesiastical, law merchant, chancery, and common-law courts, and the parties to a dispute could agree on going to one or the other. Simultaneously, Lloyd's of London devised a private arbitration system, and the London Stock Exchange evolved a private regulatory regime. These institutions demonstrated that privately regulated, local markets work. For instance, the London Stock Exchange minimized fraud by excluding perpetrators of fraud from membership and by evicting anyone who defaulted on a contract.

In contrast, federal regulation of securities markets in twentieth- and twenty-first century America has been as unsuccessful as the Department of Education's oversight of the national education system. When the Securities Act and the Securities Exchange Act were implemented in 1933 and 1934, they mandated many of the requirements that the New York Stock Exchange had previously adopted. Imposing the rules applicable to large firms on smaller firms reduced the number of stock issues by the smaller firms. Thus, the establishment of the Securities Exchange Commission reduced the number of new stock issues and did not increase returns on the issues that were made.

A more recent example of private enforcement is PayPal: fraud afflicting PayPal was solved by PayPal, not by any government law

enforcement agency. Early in its existence, PayPal faced a fraud problem that exceeded its total sales volume. In response, PayPal developed sophisticated flags to detect fraud, including techniques such as Captcha, account verification, predictive crime detection, and data mining. PayPal's business has characteristics—technological sophistication, anonymity in transactions, and a large number of customers—that make government enforcement difficult, and PayPal cofounder Peter Thiel has stated that the Internet renders local and national law enforcement ineffective. Another cofounder, Max Levchin, has described PayPal as a security company pretending to be a financial services company. Using similar kinds of technology, CyberSource, now a division of Visa, analyzes sixty billion transactions per year. Private sector security works better than government security in the credit card industry because firms think economically, in terms of costs and benefits, and have a better grasp of technology.

Another example of private governance was the evolution of private law enforcement in San Francisco. The city's population grew rapidly from 1844 to 1850 due to the gold rush, and no municipal law enforcement agency was established. Instead, merchants created a private police force that still exists as a

security guard agency. As of the early 1900s Special Police Officers existed in greater numbers than the municipal police force. In San Francisco today, the police classify a merchant's call about removing unwanted customers a low-priority event and usually will not dispatch an officer, but the Special Police Officers respond rapidly, which is why they are still in business. For a similar reason malls and downtown districts frequently hire private security guards.

Stringham does not outline possible reforms for private governance to revive and energize American society.

The education system seems to be an important starting point for two reasons. First, a privatization model, vouchers, already exists. The creation of local education markets through vouchers might serve as a model for other kinds of privatization. Second, to the extent that decentralization of administration of the public schools and reform of higher education can counteract the political correctness that stimulates support for administrative centralization, perhaps decentralization and market-based thinking can begin to gain public support.