

## One

### WHAT IS PRIVATE GOVERNANCE?

*When the U.S. real estate bubble burst in 2007 and precipitated a global financial crisis, among the least visible perpetrators were the top three credit-rating agencies, which gave the highest, safest ratings to mortgages that were bundled into extremely risky securities and sold to investors. Credit raters are paid by the companies that issue securities, and those companies shop among the agencies for the best rating. The resulting conflict of interest produced ratings that ill-served the public and investors alike while it enriched those who created, misrated, and sold the garbage investment vehicles.*

*When city of Detroit employees were forced in 2014 to accept severe cuts in their pension payouts to avert the total collapse of their retirement fund, some of the blame should have fallen to the Governmental Accounting Standards Board (GASB), which creates the regulations followed by states and localities for financial statements and was slow to make rules to help ensure that pensions and retiree benefits are adequately funded.*

*Students purchase a microwave oven for their dorm room. They plug it into an electrical outlet anywhere in the United States and it operates perfectly without smoke, fire, or electrical shock. Standards for the sockets and safeguards for the oven are in place thanks to the work of companies such as UL (formerly Underwriters Laboratories), which certifies that products are safe.*

What do credit-rating agencies, the GASB, and UL in the examples above have in common? They are “private governance” institutions: private groups whose decisions become public policy, dramatically affecting people’s lives with little or no public participation or scrutiny. At the same time, they serve important public purposes that governmental bodies may be ill-suited to address. These groups are

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found everywhere—in finance, commerce, industry, and the professions. Among many other public functions, these organizations certify professionals and tradespeople as competent, establish industry regulations, and set technical and professional standards that give them broad reach into people’s lives and have an enormous impact on society.

But because their operations lack the transparency and accountability required of governmental bodies, these groups constitute a policy-making territory that is largely unseen, unreported outside of trade publications, uncharted, and not easily reconciled with democratic principles. As such, that territory demands to be fully explored, documented, and understood. To put the matter even more urgently, private governance should be recognized—and scrutinized—as a distinct and important area in the field of public policy.

## **PUBLIC POLICY, PRIVATELY MADE**

Societies are governed by rules, some of them informal but widely acknowledged such as social norms and professional expectations and some codified as laws and regulations. Most people learn that laws and regulations are enacted by public governmental bodies that, in democracies, derive their authority from a constitutional right to rule and to have their decisions enforced by the courts via governmental intermediaries—for example, the police, the U.S. Department of Justice, and the U.S. Securities and Exchange Commission (SEC). In a democratic society, government institutions operate according to principles that require transparency, public participation, equal justice, and the rule of law, and they maintain publicly available records of their actions and decisions.<sup>1</sup> This boilerplate description of the elements of public policymaking and enforcement is woefully incomplete, however, in that it omits a significant area of formal governance not subject to democratic principles and representative government.

Specifically, private groups also make and enforce rules that function like governments' laws and regulations.

Distinguishing five arenas of policymaking in the United States can help explain why private governance institutions must be included in any map of the American public policy universe. Three of these arenas—legislatures, which enact laws; the executive branch with its administrative agencies, which make and enforce rules to implement the laws; and the judiciary, which enforces and also makes policy through its decisions—are generally well understood. Unfortunately, in much of the political science and policy literature, they are depicted as the entire policy world. They are covered thoroughly in academic literature and discussed widely among the interested or attentive public.

A fourth arena is not as well understood by the public and receives much less academic attention than the first three. This fourth arena consists of hybrid agencies that are created by government but operate with varying degrees of independence from government and its resources and often take on organizational forms unlike those of regular government agencies.

For example, the Federal Reserve, the central bank of the United States, contains some private elements but is a very powerful governmental policymaker that has been intentionally distanced from representative government.<sup>2</sup> The seven-member Federal Reserve Board of Governors, the heart of the system, is today the most significant financial regulator in the country and perhaps in the world, and the Federal Reserve's Federal Open Market Committee is a powerful monetary policymaking body. Other examples of fourth-arena institutions created by the federal government are the Pension Benefit Guarantee Corporation, the Tennessee Valley Authority, Amtrak, and the Federal National Mortgage Association (Fannie Mae), to name only a few.<sup>3</sup> States, too, have their own hybrids in such forms as special authorities and interstate compacts. Some hybrid institutions are significant policymakers, while others are not.<sup>4</sup>

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Least well understood by the public or policy analysts is a largely unseen fifth arena: *private* organizations that make *public* policy. These are the primary focus of this book, along with the policymaking parts of the fourth arena. It is unseen because it is not typically recognized as a distinct arena of public policymaking at all. Some private organizations shape the distribution of resources in society and govern behavior in a fashion similar to that of governmental bodies, with an important exception: the rules under which they operate do not require transparency, equal justice, clearly defined public participation, freely available statements of the standards they set, or other democratic strictures. They are not systematically accountable to a representative assembly of the public, and are even less so to the public directly. Nonetheless, the decisions of private groups in the fifth arena are enforceable by various means and often by government itself, including courts and federal agencies. A very large number and assortment of these private organizations make policies that affect the larger public—their health and safety, their quality of life, and the opportunities and choices available to them. But these private entities' authoritative rulemaking functions are often concealed by the variety of forms they take; they include trade associations, professional societies, and not-for-profit organizations. In fact, even a for-profit enterprise may include private governance as one of its activities.

The federal government has stimulated the development, growth, and authority of private groups and defers to their decisions. In 1996, for example, Congress passed the National Technology Transfer and Advancement Act (NTTAA), which expanded the reach of the fifth arena. The act states, in part, that “all federal agencies and departments shall use standards that are developed or adopted by voluntary consensus standards bodies, using such technical standards as a means to carry out policy objectives.”<sup>5</sup> The word used is *shall*, not *may*, and it requires executive branch agencies to rely on the rulemaking of private bodies. Although the law makes exceptions to this instruction, its main effect is to empower private rulemaking and to tie the work of private organizations to that of government agencies. Not only does the law

convey substantial power to private groups, but it seems to have widened the policymaking activities of private organizations in recent years.

Groups that fall into the fifth arena of policymaking can be difficult to identify. The variety in their organizational types is considerable and their policy work can range from accreditation to certification to standard-setting and regulation, and sometimes enforcement. Another obstacle to recognizing such groups is that their purpose is often much broader than—and often unrelated to—making rules and setting and enforcing standards. For instance, a fifth-arena private governance group might also perform the regular tasks of an industry trade group, such as lobbying governments and holding conferences, but such activities are not part of private governance as we define it in this book. Further, private groups, as self-governing organizations, design regulations for their own operations in the form of bylaws and other wholly internal rules, and those types of self-governance are also not addressed here.<sup>6</sup> Hence, it can be difficult to distinguish between a private group, like a trade association or club, and a private governance group that is also a trade association. Private governance groups do not declare themselves as such, and ordinary language does not direct observers to the existence of such groups.

To summarize, private governance is the public policymaking work of some fourth- and all fifth-arena institutions. Though widespread, private governance and the institutions that engage in it can be difficult to recognize and can be connected to government to one degree or another. In turn, formal public scrutiny of the work of these groups also varies.

### **HOW TO IDENTIFY A PRIVATE GOVERNANCE GROUP**

It is clear that private governance groups take different organizational forms and engage in a variety of policymaking activities. But how exactly is one to identify an organization that is engaged in private governance? To do so, one must pinpoint the specific activity of

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rulemaking, its acceptance, and its impact—in other words, one must define private governance. As noted, it comprises decisions and standards that are made by private groups but function, in effect, as public policy. Specifically, such decisions and standards are characterized by three elements: They are *authoritative*, they affect a *broader public* beyond the group's members, and they have a *substantial impact*.

Rules made by private groups become “authoritative” in one or more of the following ways: first, tacit acceptance of their decisions by the public, as in the case of safety standards set by UL or professional licensing organizations; second, explicit reference to the rules and their acceptance as determinative in court, as in the judiciary's use of privately crafted safety standards to identify industry best practices and to determine the outcome of cases; third, enforcement of privately made rules by a governmental agency, as when the SEC enforces privately created accounting standards; fourth, tacit or explicit legal recognition of the group and its determinations, which is one source of the power of Standard & Poor's and other credit-rating companies; fifth, legal command, as in the case of the NTTAA, discussed above; and last, their incorporation by local, state, or federal government into law, as in the case of privately developed higher education accreditation standards or those of the American Bar Association (ABA). Other examples of authoritative standard-setters include the American Correctional Association, the International Code Council (ICC), the Association of American Railroads, the American Petroleum Institute, the National Association of Home Builders (NAHB), and the American Society of Heating and Air-Conditioning Engineers (ASHRAE).

The phrase “affecting a broader public” indicates that the rules apply to or touch many more people than those who make them and the sectors they represent. For example, oil and gas pipeline safety standards that are privately made concern not only the rulemakers and their industry but also other industries throughout the supply chain, residents near the pipeline, and the environment. Similarly, safety standards for harnesses used to hoist workers at construction sites not only apply to the contractors but also affect the workers who rely on the

standards to protect them and the general public, which pays for the cost of compliance in higher construction costs and rents. Another example is the certification of surgeons: state governments use standards set by private medical associations to determine who can operate on patients; those standards affect not only the professional lives of doctors but also the safety of everyone who undergoes surgery. Similarly, state, local, and federal governments variously mandate Leadership in Energy and Environmental Design (LEED) standards created by the private U.S. Green Building Council. LEED standards, in turn, require use of specific private standards created by other nongovernmental groups.<sup>7</sup>

Private governance rules have a “substantial impact” in that they exert influence across sectors, industries, and territories. Private food safety standards, for example, affect other sectors and industries such as delivery and packaging, the food service industry, U.S. governmental agencies (such as the Food and Drug Administration, the Department of Agriculture’s Food Safety and Inspection Service, and the Environmental Protection Agency), labor unions, and consumer groups, and, at times, food regulations of foreign countries, not to mention the health of the public. One reasonable test of “substantial impact” is to ask whether contemporary society could do without the rules made by private groups. That is, if a private group had not made the rule or set the standard, would government need to make it or set it in the interest of the health, safety, or welfare of the public? At the same time, however, to be *substantially affected*, a broader public need not be aware of the content of specific rules, such as electrical standards, building codes, or credit ratings for corporations and governments.

### **HOW PREVALENT IS PRIVATE GOVERNANCE?**

Because the fifth arena has not been recognized as a significant area of policymaking, no data have been collected on it as a whole. Nevertheless, assembling the fragmentary evidence that does exist provides

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*TABLE 1-1. Estimated Number of Standards  
in the United States, 1967–2014*

<b>Sector</b>	<b>1967</b>	<b>1984</b>	<b>1991</b>	<b>1996</b>	<b>Current (2014)</b>
Government	39,500	49,000	52,500	44,000	Fewer than 50,000
Private	14,000	32,000	41,500	49,000	More than 50,000
Total	53,500	81,000	94,000	93,000	More than 100,000

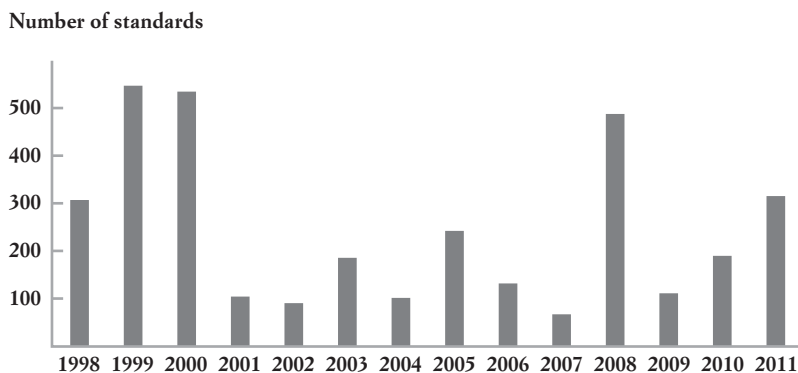
*Sources:* The figures are from several sources: John E. Hartman, *Directory of United States Standardization Activities* (Washington, D.C.: NBS, Department of Commerce, 1967); Robert B. Toth, *Standards Activities of Organizations in the United States* (Washington, D.C.: NIST Special Publication 806, U.S. Department of Commerce, 1996); and ANSI website, at [www.ansi.org/about\\_ansi/introduction/introduction.aspx?menuid=1](http://www.ansi.org/about_ansi/introduction/introduction.aspx?menuid=1).

glimpses into its pervasiveness. The most recognizable form of private governance is standard-setting, and the scope and number of fifth-arena standards in place is surprising. Considering that most discussions of U.S. policymaking ignore private governance, it should also be alarming.

Unfortunately, the most current available data on U.S. standards are found in the 1996 “Standards Activities of Organizations” published by the Department of Commerce’s National Institute of Standards and Technology (NIST). Projecting from this data source, the American National Standards Institute, a private governance group, has estimated that there are more than 100,000 standards in the country today, more than half of them created by the private sector (see table 1-1). However, these figures likely are underestimated since these mostly technical standards are at least twenty years old and do not include state- and local-level standards and activities that “develop . . . ethical/professional standards, or that set standards for judging ani-



FIGURE 1-1. *Number of Private Standards Substituted for Public Standards, 1998–2011*



Sources: *Fifteenth Annual Report on Federal Agency Use of Voluntary Consensus Standards and Conformity Assessment* (Washington, D.C.: National Institute of Standards and Technology, Department of Commerce, 2012).

mals.”<sup>8</sup> Because the excluded standards cover, for example, those set by the American Medical Association (AMA) and the Chartered Financial Analysts Institute (a global association of investment professionals), the actual number of both governmental and private standards is far greater than the published estimates.

As of 1996 nearly 700 U.S. organizations had produced and maintained standards, and an overwhelming majority of these organizations were nongovernmental agencies (604 were nongovernmental and 80 were governmental organizations).<sup>9</sup> Since the passage of the NTTAA, the substitution of private standards for public standards has continued steadily, if unevenly, as illustrated in figure 1-1.

From 1998 (when NIST first began to report on the effect of the 1996 act) to 2011, a total of 3,579 public standards were replaced by private standards. Federal agencies that have adopted private standards include the U.S. Departments of Defense, Commerce, and Health and Human Services. Despite the patchy nature of available data, these reports constitute the best, if greatly underestimated and

*BOX 1-1. Example of the Multiple Sources of  
Private Rules One Industry Must Follow*

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**From Rachel Feinstein, government affairs manager  
of the Hearth, Patio and Barbecue Association,  
for distribution on September 12, 2014.**

Members of the Hearth, Patio and Barbecue Association are affected most by the private International Code Council's International Energy Conservation Codes (IECC) (see <http://reca-codes.org/about-iecc.php>).

These codes are updated every three years and cost about \$44 per code, for people who are not members of the ICC, to purchase.

One controversial update recently made by the ICC is that voting on code changes has been moved from in-person voting to being able to vote online. Members of the public can attend code hearings and submit public comments, but this new online voting system makes the final voting process less transparent.

One thing we deal with is the states adopt the ICC codes, but they can make changes to them, which means this international code is further edited at the state level making it difficult to keep track of. I'm working on developing what we call a State Code Coordinator Program for our members. We would have 2 of our members in each state, familiar with codes and standards, keep track of the code adoption process as well as licensing issues and state legislation and regulations. It is very, very difficult to keep track of everything.

The private National Fire Protection Association (NFPA) also creates codes for builders. Voting members of NFPA are generally builders and installers, but recently, there have been more members with inspector and safety backgrounds. This has made some of the

codes unrealistic and likely not what consumers want. For example, the NFPA 211 Committee on Chimneys, Fireplaces, Vents, and Solid Fuel-Burning Appliances recently proposed that only items that have been tested and listed for use in a specific model fireplace system may be used, both in the original installations and in replacements. This means that if a consumer wanted to change the grate in their fireplace, or change the mantel, an installer would not be able to do this because of the code. The proposal comes from fire safety concerns (accessories/parts not originally tested with a fireplace could cause a fire because it hasn't been tested with the unit). This proposal is available for public comment, but anyone outside of the industry may find it difficult to navigate the page or even know that this issue even exists.

The following private organizations also develop codes and standards that are applicable to our industry:

National Association of Home Builders (NAHB)

American Society of Heating and Air-  
Conditioning Engineers (ASHRAE)

Canadian Standards Association (CSA) makes  
codes that are used in the U.S. too

ASTM International

American Gas Association (AGA)

National Fuel Gas Code of the National Fire  
Protection Association (NFPA)

UL (formerly Underwriters Laboratories)

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hard-to-capture, information on the prevalence of private governance. Internationally, private rulemaking is common but not systematically documented. A partial exception to this dearth of data is provided by Tim Büthe and Walter Mattli in their path-breaking book *The New Global Rulers*, which documents widespread private global governance in financial services.<sup>10</sup>

Taken together, these data strongly suggest that the amount of private standard-setting exceeds that of government in many areas, both in the United States and globally. Yet many policy scholars and the public seem unaware of the existence, much less the consequences, of private regulation. An example of the extensiveness of private governance as applied to a single, relatively small industry is recounted by Rachel Feinstein of the Hearth, Patio and Barbecue Association (see box 1-1).

### WHY DOES PRIVATE GOVERNANCE GO LARGELY UNRECOGNIZED?

Despite its importance and rapid growth, private governance is hiding in plain sight, camouflaged by more familiar categories and the absence of its own recognized niche. What makes private governance difficult to identify is, first, that it is infrequently covered in studies of public policy, with many notable exceptions in the business literature and the international arena.<sup>11</sup> More often, practitioners are likely to know of the groups operating in their areas of expertise. Accountants are keenly aware of the Financial Accounting Standards Board (FASB), engineers of the Institute of Electrical and Electronics Engineers (IEEE), builders of the International Code Council, and so on.

Second, because these groups make decisions largely in private, information about these processes is not readily available in many cases, and, as a consequence, few researchers are able to consider their public impact. Private governance is protected, in the case of commer-

cial enterprises, by the legal right to hold close proprietary data, and, in the case of nonprofit organizations, by the constitutional right to privacy. Often standards are sold by the group creating them, a practice that greatly restricts their availability.

Third, much of private governance, like standard-setting, is seen as “technical,” requiring the direct participation, and even control, of experts who hold commercial or professional rather than governmental positions. It is commonly asserted that if enterprises to which rules apply control the development of those rules, the rules are more likely to be followed and less likely to be circumvented or gamed. Also, it is plausible to believe that most people feel expertise-based rulemaking is beyond their purview and should be left to private actors.

Fourth, private governance in the United States in particular has developed historically in tandem with increased government regulation. In many ways, private governance may seem like “the way we’ve always done it” and thus goes largely unnoticed. Coupled with the respect that private enterprise enjoys in this country, it probably comes as no surprise and causes no concern that, for example, the American National Standards Institute (ANSI), a private organization, represents the United States at the International Organization for Standardization (ISO).

Fifth, although we contend in this book that fifth-arena private governance should not be confused with the fourth arena, hybrid governance, sometimes the difference between the two can be minimal. For example, governments may encourage the use of private standards by public agencies, as in the case of the 1996 NTTAA and Circular A-119 published by the Office of Management and Budget (OMB).<sup>12</sup> They may adopt as law privately developed rules, as in the case of building codes, construction safety standards, licensing requirements to practice crafts, and prerequisites to practice law and medicine. Governments also may enforce privately made standards, as the SEC does in imposing the accounting provisions established by the FASB on publicly traded companies. State and local governments

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may agree to be governed by the rules established by the private Governmental Accounting Standards Board, as most state and local governments are.

Hence, when some states legislate that their Supreme Courts determine who can practice law within their territories, casual observers may think that states, via their courts, control licensing of their lawyers, but underneath this technical direction lies the hegemony of the legal profession itself. In thirty-three states, practicing lawyers must belong to the state bar association, which decides who may practice law in the state.<sup>13</sup> In other states, such as New York, state boards composed of lawyers decide what credentials an individual must have to practice law, such as graduating from an institution accredited by the American Bar Association and passing the state bar exam, a test created by the state bar association and the ABA. In such cases, governments push decisions to private bodies.

In other areas, such as higher education accreditation, the federal government is seizing control of a process that has been privately run since its inception. When a government expropriates for its own purposes a private regulatory process, the private group can lose its independence. At the same time, to the degree that its decisions take on the force of law, the private organization can gain in stature, size, and financial wherewithal. A leading example of this consequence is the reliance the federal government has placed on a commission (the Joint Commission on Accreditation of Health Care Organizations) to determine which health facilities, such as hospitals, are eligible for Medicaid and Medicare funds, without which most of these institutions would be unable to stay afloat financially.<sup>14</sup>

In short, government may use private groups to make its public decisions. Sometimes the groups serve their own professional interests; sometimes the groups are co-opted by government for its purposes and lose some of their independence. Why does that matter? In a democracy, a process with the imprimatur of constitutional government should not be privately controlled. Further, according to the principle of

limited government, public entities should not take over the work of private groups and in so doing subvert pluralistic society. Here lies a critical issue in private governance: when is it simply a part of a pluralistic society, limiting the reach of ever-expanding governments, and when does it undermine citizens' ability to control significant collective decisions in which they have every right to participate?

In sum, private governance comes in so many incarnations that identifying its existence is particularly difficult and perhaps impossible for those who are not already on the alert for it. Before the phenomenon can be identified, the concept of private governance needs to exist in the first place. As Ludwig Wittgenstein famously observed, "The limits of my language mean the limits of my world."<sup>15</sup> However, the concept of private governance is slippery. It does not always operate exclusively of governments. Governments are deeply implicated in private governance, and indeed their agents may participate in it, as staff members of the Environmental Protection Agency do in serving as "public representatives" on private standard-setting bodies.

### **WHY IS PRIVATE GOVERNANCE IMPORTANT?**

With the rapid pace of technological innovation and economic globalization and the concomitant need for common standards and supply-chain consistency across borders, private governance, already widespread, is growing rapidly, filling governmental gaps. Yet the public has little way of knowing about it, much less influencing its decisions. Even though accrediting groups such as ANSI require that standards created under its aegis follow some of the procedures to which government agencies must adhere, such conditions clearly are not a substitute for representative democracy; nor do they have the same effect in private settings that they do in governmental ones.<sup>16</sup> Other groups do not even try to emulate the care ANSI imposes. In any case, operating largely in the shadows to create and sell proprietary standards

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excludes the public.<sup>17</sup> Rather than “of, by, and for the people,” private governance could be described as of, by, and for commercial and privileged interests in the first instance with public interests as a subordinate consideration.<sup>18</sup>

Despite scattered efforts to reserve a place at the decisionmaking table for the “public,” little careful analysis has been undertaken to understand conceptually or operationally who this public is or how officially designated “public representatives” in private groups see and perform their tasks. Most often, the public representative is a surrogate in the form of an official from a labor union or nonprofit organization (such as an environmental group), an academic expert, or a staff representative of a government agency—a far cry from the kind of representation found in legislatures or indirect representation (one step removed from, but still tethered to, legislatures) typical of government rulemaking.

To say that many of the decisions made by private governance bodies are largely technical is a weak defense. As Giandomenico Majone and others have made clear, technical decisions made in the policy realm are likely to be not purely technical but rather trans-scientific, meaning that they require a high degree of expertise and also entail value choices that experts are in no better position—and have less right—to make than do democratic representatives of a broad electorate.<sup>19</sup> In fact, experts are likely to display a high degree of epistemic bias, a form of intellectual blindness created by their specialized professional training. So their strength can also be their weakness.

Perhaps more serious than epistemic bias are the often severe conflicts of interest embedded in private governance. Those with the most to win or lose from a decision made by private groups are the most likely to be the ones doing the deciding, not merely influencing the decision.

Another limitation of private governance, and one that should concern the participants themselves, is that bureaucracies both in and out of government tend to take on a life of their own, as Robert Michels argued almost a century ago.<sup>20</sup> Organizational imperatives tend to



overtake the group's original purposes. These imperatives, such as an organization's funding sources or the aspirations of its managers, can take precedence over members' wishes. Without the equivalent of an independent inspector general, congressional and presidential oversight, an accountability office, or an aware and vigilant public—all of which operate with varying degrees of effectiveness in democratic representative governments—a sharp disjunction between principals (those whom the organization is to serve) and agent (the serving organization) is a predictable result.<sup>21</sup>

That private governance is democratically and even organizationally deficient while significantly affecting the lives of those who are subject to its decisions is sufficient reason for defenders of a free democratic society to be wary of this form of policymaking, even if it is generally accepted and constitutionally protected. Nevertheless, with this book we aim not to condemn private governance but to shine a bright light on it, to recognize it as a category of public policymaking, to advocate that it should be studied on a par with government policymaking, to examine the blemishes that mark private governance, to consider ways to obviate its democratic deficiencies and, where appropriate, to defend it. The goal is to *recognize* private governance, to understand it in its multiple forms, and to make the case that excluding it from the field of public policy diminishes both the understanding of the full policymaking universe and the proper reach of democratic aspirations.

