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CAN PRIVATE LEARN FROM PUBLIC GOVERNANCE?*

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Corporate governance is importantly based on agency theory and relies on extrinsic incentives to align the interests of managers, employees and shareholders. This article argues that in view of recent corporate scandals, private governance can learn from public governance: (1) Goal-oriented intrinsic motivation of agents should be supported by fixed incomes and an extensive selection process of employees; (2) Extrinsic, but non-monetary incentives (e.g. conferring orders and titles) can be used; (3) The power of actors should be restricted by a clear division of power, appropriate rules of succession and institutionalised competition for positions in firms.

The way scholars think of corporate governance today has been importantly shaped by agency theory (Shleifer and Vishny, 1997; Daily *et al.*, 2003). It takes the firm to be a web of voluntary contracts. The major task is to find the most efficient way to align the interests of the managers as the agents to the interests of the stockholders as the principals (Jensen and Meckling, 1976). The market for corporate control is taken to work well, so that this system is self-regulating. There is no reason to assume 'contractual failure'; the collective action problems faced by (dispersed) shareholders are overcome by various processes, the most important being unfriendly stock market takeovers. Agency Theory has sparked a huge literature, which has been very ably surveyed by e.g. Becht *et al.* (2002), Prendergast (1999) or Eisenhardt (1989).

Agency theory not only dominates the academic discipline but has also been accompanied by applications of its major message in business practice. In particular, agency theory's emphasis on the need for managers' interests to be aligned with those of stockholders has been accompanied by, if not been responsible for, a widespread effort to introduce performance incentive plans, in particular pay-for-performance. The idea has even spread to areas outside the market and the capitalist economy. The view that society should be run as if it were a firm has e.g. led to a strong movement called 'New Public Management', urging non-profit firms and public administrations to adopt pay-for-performance programmes; see Pollitt and Bouckaert (2000); Weisbrod (1998).

But there has recently been a sudden sobering up. The stock market has crashed and the corporate sector has been plagued by huge scandals relating to excessive manager compensation and fraudulent bookkeeping. Most importantly for agency theory, performance pay by linking salaries to stock options has led to an explosion of compensation due to the stock market boom and the trend has in

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many cases simply continued, even though economic conditions have changed. Management compensation has often increased still more, even though share prices have plummeted. This suggests that, in actual fact, the compensation of managers has little to do with performance. Rather, the reason for the steady increase in compensation is now widely seen in the fact that managers are able to exert considerable control over how much money they get (Bebchuk and Fried, 2003). Some managers even resorted to unlawfully misrepresenting their firms' accounts in order to raise their private incomes. A particularly troubling aspect is that, in many instances, extended pay-for-performance plans have created the very incentives to commit fraud, by making it attractive to produce short-term increases in share prices (Efendi *et al.*, 2004; Erickson *et al.*, 2003; Johnson *et al.*, 2003). After the event, it can be said that agency theory has obviously neglected the possibility of managers distorting their own standards of performance: '[...] much of agency theory [...] unrealistically assumes that earnings and stock prices cannot be manipulated. That is a major weakness of the theory [...]' (Becht *et al.*, 2002, p. 47).[1]

These weaknesses and failures of actual corporate governance practice, as well as the incompleteness of Agency Theory in predicting them, suggest that it might be useful to approach the issue from a new perspective. This contribution argues that fresh insights for corporate governance can be gained from the way democratic government and public administration are organised. Corporate governance can learn from public governance, in the sense that institutions devised to control and regulate the behaviour of actors in the public sphere can give new insights into how corporate governance practice can be improved. This does not mean that public governance has produced ideal results – far from it. In public choice theory or modern political economy, many inefficiencies of democratic politics and public administration have been documented and analysed, like distortions due to rent seeking activities.[2] These shortcomings, however, do not exclude some institutions of public governance being useful for corporate governance. While the reverse direction of learning from private to public governance has been extensively discussed in the past, leading, for example, to the introduction of New Public Management in at least some parts of public administration, useful insights may also be gained by applying public sector ideas to private governance.

The analysis offered here is rooted in the tradition of constitutional political economy, the economic analysis of political institutions; for surveys, see e.g. Frey (1983); Mueller (1996); Cooter (2000). But is also greatly influenced by developments in psychological economics or behavioural economics; for surveys, see

[1] Other authors, among them major contributors to agency theory, tend to defend the existing corporate governance system, but most of them admit major weaknesses. An example is Holmström and Kaplan (2003, p. 2) stating that: '[...] while parts of the U.S. corporate governance system failed under the exceptional strain of the 1990's, the overall system, which includes oversight by the public and the government, reacted quickly to address the problems'. It should, in particular, be noted that the idea of a self-regulating corporate system based on competitive markets is not seen to be sufficient.

[2] For introductions to public choice theory and modern political economy, see e.g. Persson and Tabellini (2002) and Mueller (1997, 2003). The shortcomings of public bureaucracy are discussed in e.g. Niskanen (1971) or Wintrobe (1997), and rent seeking in Tullock *et al.* (1988) and Tollison and Congleton (1995).

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e.g. Rabin (1998); Frey and Stutzer (2002). The resulting alternative approach does not necessarily contradict classical agency theory, but rather aims at introducing new, forgotten or neglected aspects. As a consequence, however, the ideas for organisational design differ substantially from much of what is suggested by accepted theory. We propose that corporate governance can learn from public governance in three areas:

Section 1 considers the possibilities of using goal-oriented intrinsic motivation in organisations, Section 2 discusses extrinsic, but non-monetary, incentives imposed from outside (e.g. titles and orders) and Section 3 looks at the restriction on power of actors. In each of these Sections, specific public governance institutions are discussed and the possibilities of introducing these institutions into corporate governance outlined. We conclude in Section 4 by discussing limitations of our arguments, and by summing up the main messages.

1. Supporting Goal-oriented Intrinsic Motivation

Traditional Agency Theory builds primarily, or exclusively, on extrinsic motivation.[3] In contrast, intrinsic motivation is attributed a substantial role in public governance. A substantial number of institutions have been designed in the public sector, serving to shape agents' intrinsic motivation in order to produce the desired outcomes. The fact that such institutions exist is an important, but often neglected, aspect of politics and public administration.

Four institutions serve this purpose, the first one relating to politicians, the second one relating to both politicians and public officials, and the two remaining ones relating to public administrators.

1.1. *Popular Participation Rights*

Democracies are defined by giving citizens clearly determined participation rights. In representative democracies, the citizens can determine the parties and often the persons to represent them in parliament. In direct democracies, citizens can also determine substantive issues via initiatives and referenda. Citizens' participation rights have important consequences for the behaviour of the politicians. Above all, participation rights ensure accountability but they also affect identification. The more extensive the rights are to participate politically, the stronger the extent of interaction is between the citizens and the (professional) politicians. The constant tendency for the leaders to establish a 'classe politique' is reduced. A similar positive effect on identification can be expected from co-determination in firms, not least because the managers are induced to interact more intensively with their employees than they otherwise would, e.g., van den Berg (2004). Participation rights also affect feedback. The reaction of the voters to the actions taken by the politicians constitutes an essential part of the democratic political process. In

[3] The extensive surveys by Becht *et al.* (2002) and Prendergast (1999), which adequately represent the state of research in Agency Theory, virtually disregard intrinsic motivation. In contrast, intrinsic motivation has received considerable attention in the business economics literature, see e.g. Frey and Osterloh (2001) or Davis *et al.* (1997).

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referendum democracies, the politicians get direct feedback on how the voters evaluate specific policies. This feedback is of an informative, rather than a controlling nature, and is therefore likely to raise the intrinsic motivation of politicians to pursue policies in the interests of the citizens (Frey, 1997*a*).

1.2. *Fixed Position and Income*

The career path and the income corresponding to the various positions in public administration are governed by formal rules. Advancement is regular and is largely determined by seniority. Promotion does not depend on any specific output performance. The job is guaranteed for fixed terms, and often for life; members of the public administration cannot be simply dismissed by their superiors. Public employees are therefore able to make suggestions for improvement, and to criticise the course of events, even if their superiors do not necessarily agree.

Agency theory has identified such bureaucratic rules as an optimal response to dysfunctional behaviour, due to evaluation procedures occurring in multi-tasking situations (Holmström and Milgrom, 1991, 1994). Agency theory responds by suggesting 'subjective performance evaluation' (Prendergast, 1999, p. 29–33; Gibbons, 1998, p. 120–3). But such subjective evaluation in firms shifts the discretion over employees' pay to the superior. This dependence of employees on the goodwill of their superiors weakens or even totally suppresses any incentives they might have to monitor and criticise the behaviour of their superiors (Prendergast, 1993). Indeed, whistle-blowing has proved to be rarely used under a regime in which the superiors are able to determine the wages of the persons working for them. But such monitoring of the superiors by their inferiors plays an important function, because the inferiors are normally well informed about the tricks played and wrongdoings committed by the management. This problem is to some extent mitigated in the public administration. While there is a well-defined bureaucratic hierarchy, the superiors have to follow well-defined rules and, in principle, have no discretion concerning the pay of their inferiors. This advantage is indeed seen by e.g. Prendergast (1999, p. 37), when he states with respect to bureaucracy: '[...] rules are used to allocate resources rather than allowing individuals' discretion over resource allocation'.

An administrative career according to seniority and with fixed compensation allows its members to concentrate on work content. Fixed incomes have the important advantage of serving as 'redistribution constraints' (Hansmann, 1996). They free employees from fighting over earnings and so contribute to the organisations' common good. In contrast, a system characterised by pay-for-performance strongly induces employees to devote time and effort to influencing their variable income. Employees rationally engage in rent seeking activities in order to manipulate the performance standards and therewith their income. While they can seek higher income by increased effort, it is often easier and less demanding to influence the measuring rod, even to the extent of distorting and falsifying the figures. This has turned out to be of particular importance with

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respect to manager compensation. Several empirical studies have shown that there is a strong relationship between the extent of variable, stock-based executive compensation and the incidence of corporate fraud (Osterloh and Frey, 2005*a*). Johnson *et al.* (2003), for example, show that managers involved in accounting frauds between 1992–2001 had a 69% higher pay-for-performance sensitivity than managers not involved in frauds, a result of their much higher stock and stock option compensation, approximately US$ 4.4 million more at the median (for similar findings see Efendi *et al.*, 2004; Erickson *et al.*, 2003). Agency theory has, to a large extent, failed to see this rational reaction of managers subjected to pay-for-performance, an observation that is now largely acknowledged (Becht *et al.*, 2002, p. 47; Jensen *et al.*, 2004, p. 98).

The administrative approach to the allocation of career advancement and pay avoids fundamental problems connected with pay-for-performance (for on overview, see e.g. Osterloh and Frey (2000)), some of them well known in agency theory:

(1) performance is rarely easily defined, but is often subject to interpretation and influence;[4]
(2) in many cases, only some aspects of performance are measurable, leading to the multi-tasking problem;
(3) employees must constantly be monitored in order to be able to pay them, which can lead to a perception of being controlled and tends to crowd-out any existing intrinsic motivation; and
(4) the work content as such is of less interest to employees, but is regarded as instrumental to pay.

Fixed incomes as used in public governance can avoid these fundamental problems of performance pay. In addition, the public sector approach to compensation seeks to guide agents' behaviour by enabling and shaping intrinsic motivation to work in the organisation's interest.

1.3. *Extensive Selection Process of Agents*

To become a member of the classical public bureaucracy, as it used to exist in Germany and has been described by Weber (1978), is a formalised and arduous process. It takes many years. Before a person can become a full member ('ein Beamter'), he or she has to pass through many, clearly regulated stages, similar to being accepted into a religious order. The prospective members must have passed exams specifically designed as initiations into this select profession. In many cases, these exams have little or nothing to do with the task to be later performed as a member of the public administration. The famous Chinese bureaucracy required people to be able to prepare poems (Tullock, 1964); in

[4] Most of the existing empirical studies analysing the effect of pay on performance, e.g. Lazear (2000), Paarsch and Shearer (1999) or Fehr and Goette (2002), relate to very simple jobs, like windscreen fitting, planting trees or bicycle courier services. Exceptions are Lavy (2002), in his analysis of performance wages for schoolteachers, and certainly also the large literature on performance pay for managers, e.g. Murphy (1999).

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Germany a public official had to have, and to some extent still has to have, an education in law, while France puts more emphasis on formal (mathematical) education in the 'Grandes Ecoles'.

The long and arduous process promotes a specific self-selection for anyone wanting to become a member of public bureaucracy. Because of the 'deferred compensation', persons with very highly developed intrinsic motivation to work in the public sector are attracted, while short-term materialists have no incentive to engage themselves. The difficult and long drawn out process strongly socialises the persons according to the specific culture of the public sector. The goals of the organisation are at least partly internalised. The members develop a distinct and often marked sense of loyalty, and intrinsic motivation is crowded in (Frey, 1997*b*). The long formal selection process, moreover, provides the successful applicants with confidence in their own abilities. This sense of competence is not so much based on outcome related performance (it already exists before the applicants take up their position) but on having got through the process. This feeling can sometimes also result in arrogance, a trait often attributed, for instance, to top-level French public officials coming from the ENA ('Ecole Nacionale d'Administration') or 'Enarques'.

The democratic process also leads to a particular selection of traits in politicians. Voters have a strong tendency to evaluate contenders for political office in terms of their presumed characters (Brennan and Hamlin, 2000; Cooter, 2003). Decentralised democracies allow voters to select the characters of the politicians they want better, because there are a large number of elections in which the contenders have to present themselves to the citizens. The same holds for elections of specific persons, rather than closed lists prepared by the parties. It has been argued that firms should pay more attention to selecting the appropriate characters for the tasks at hand, rather than mainly or exclusively relying on external incentive systems (Cooter and Eisenberg, 2000–2001).

1.4. *Autonomy Within Rules*

Bureaucratic rules provide directions but within them public employees enjoy a clearly defined measure of autonomy. They have the opportunity to evaluate and make decisions based on what they see to be correct and appropriate for the long-term goals of the organisation. As long as public employees adhere to the rules, they are ideally protected from intervention on the part of their superiors. Such autonomy contributes to intrinsic motivation, as an innate need in individuals (Deci and Ryan, 1985; Ryan and Deci, 2000).

Employees in capitalist firms do not enjoy such autonomy based on well-defined rules. As long as superiors do not violate the law, they can, to a large extent, instruct an employee to do anything they like. The only option open to a dissenting employee is to leave the firm, an action that often involves substantial costs. The recent bookkeeping scandals have made clear that, in practice, CEOs are sometimes even able to instruct their employees to commit illegal actions. Employees in private firms thus have to accept a considerable 'zone of indifference'.

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1.5. *Evaluation*

Public governance uses a completely different system to align agents' behaviour with principals' goals. It relies on fixed compensation, self-selection, socialisation and rules to bring about an internalised intrinsic behaviour of agents consistent with the goals of the public organisation. Traditional agency theory has predominantly focused on how this alignment can be reached, by setting the right extrinsic (most importantly monetary) incentives. Bureaucratic rules may appear inefficient *ex post*, but are not necessarily *ex ante*. This point has been noted in accepted agency theory, but is only related to an effort to avoid inefficient rent seeking activities (Prendergast, 1999, p. 38; Milgrom and Roberts, 1988; Tirole, 1992). The approach on which public governance is based places more emphasis on guiding agents' behaviour by intrinsic motivation, which has the considerable advantage that the problems arising from having to measure performance standards appropriately and fully (among which multi-tasking has received most attention in agency theory) are avoided.

There are several obvious drawbacks connected with the public sector approach of relying on intrinsic motivation. Most importantly, fixed compensations and careers fail to provide strong extrinsic incentives for agents to exert effort, which often leads to the impression that the public sector is lacking in effectiveness and innovativeness. Moreover, the intrinsic motivation of politicians and public administrators does not necessarily serve the interests of the citizens, e.g. if behaviour is predominantly directed towards rent-seeking. It is important, however, to see that the public sector approach points out a useful role that intrinsic motivation can, in principle, play in organisations, an aspect largely neglected in agency theory. In addition, the intrinsic motivation of politicians and public administrators will further the interests of citizens or rather harm them, depending largely on the political system and political institutions under which they act.

2. Extrinsic Incentives through Outside Recognition

Public governance also relies on externally mediated incentives to align agents' behaviour with the goals of the organisation. While agency theory focuses mainly on monetary incentives, because they are the most fungible and therefore seem to be the most efficient, public governance uses various kinds of awards as extrinsic motivations; see, more generally, Frey (2005). Two types of specific institutions are used in public governance as extrinsic motivators:

2.1. *Titles*

People like titles to indicate their place in a hierarchy clearly (Frank, 1985, pp. 99–102; Gould, 2002). They have added value when they can be transferred to life outside of the organisation they work in, especially in the context of their social life with family and friends, but also with complete strangers. In former times, this condition was met by conferring such titles as e.g. 'Geheimrat' in Germany and Austria. Titles are transferable if persons outside the organisation have a sense of

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the distinction conferred. They do not necessarily have to know exactly what they mean, but they have to be impressed. Therefore awards must be conferred in a restricted way.

In recent years, most leading private corporations have given up conferring transferable titles. Instead, they use 'functional' titles, which are of little or no use outside of the organisation. Corporations have also shifted to conferring titles in a rather unrestricted way. If, for example, a considerable percentage of managers are 'vice-presidents', the title is no longer worth as much (it must then be amended by adding 'senior', 'executive' etc.). A similar inflation can be observed with the title 'Chief Executive Officer', which is nowadays used by many firms for several people within management heading a division.

2.2. *Orders*

Public governance confers orders, medals and other decorations on people extensively as an incentive device. They are often awarded at the end of bureaucratic careers as a tribute to life-long devotion to one's tasks, and not for specific performance.[5] Orders are not contractible when entering a public career but they are given on the basis of clear rules. They can be transferred to one's social life, as they are virtually worn outside, on the dinner jacket and even on normal suits (e.g. the French 'Légion d'Honneur').

Corporations use a similar incentive when they appoint 'The employee of the month'. But these awards are designed to relate directly to specific performance. They are therefore likely to be understood as solely instrumental. Moreover, they are difficult to transfer outside of the organisations (and are often considered to be rather ridiculous). They have the added disadvantage that they tend to be handed out in a rather inflationary way, so that those not receiving them can be demotivated.

2.3. *Evaluation*

The extrinsic incentives by awards conferred by public governance represent an overall evaluation, and are of an *ex post* non-contractual nature. Care is taken not to make them appear directly instrumental. The incentive structure applied by public governance skilfully combines outside recognition and status with crowding-in goal oriented intrinsic motivation. It might be argued that titles and orders have lost importance. This may be true but revealed preference suggests that they are still highly appreciated today. Thus, many leading economists were, and still are, delighted to have titles bestowed on them, Lord Keynes and Sir Tony Atkinson being just two such examples.

There are major differences between conferring awards and giving money as compensation for performance. First, conferring awards is intended to honour long-term, even life-long performance, while, almost of necessity, performance pay relates to short-term achievements. Second, awards are mainly given in a process-oriented

[5] Exceptions are the few orders conferred on the battlefield but they are small in number.

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way, serving as a reliable feedback for performance, which is likely to raise intrinsic motivation (Deci and Ryan, 1985; Frey, 1997*b*). In contrast, performance pay relies on outcomes that are subject to many other systematic and random effects outside the influence of the recipient. The feedback is thus less reliable, and may not contribute to crowding-in intrinsic motivation. Third, the value of awards is less easy and less straightforward to compare than monetary income. Awards are therefore less prone to being devalued by processes of social comparison and hedonic adaptation, which have been found to decrease the utility from monetary income considerably (Frank, 1985, 2000; Easterlin, 2001; Stutzer, 2004).

The discussion suggests that awards have quite different motivational implications than monetary compensation, in particular pay-for-performance. In many cases, the incentives produced by conferring awards, especially the increase in intrinsic motivation induced, is of great value to an organisation and should therefore be considered a part of management.

3. Restriction of Power

Public governance aims at producing intrinsic motivation in agents but at the same time it has devised many institutions that serve to discipline and control the behaviour of public officials. 'Disciplining agents' is a core task of democratic government. Corporate governance shares the same goal with respect to 'disciplining management' (Becht *et al.*, 2002, pp. 21–2). In the case of public governance, not only the government politicians, but also the members of parliament and administration must be constrained from abusing their power. The major reason for the accumulation of uncontrolled discretion in both areas of governance is the strongly asymmetric state of information of the persons occupying leading positions. This accumulation of power threatens the interests of citizens, as well as shareholders, and leads to authoritarian, or even dictatorial, forms of governance.

For centuries, democracies have developed various efficient institutions to restrict the accumulation of power. Three institutions are of particular importance and provide new insights as to how corporate governance can be improved.

3.1. *Division of Power*

Democratic states distribute the right to act among the three classical decision-making bodies: the executive, legislative and judicial branches. The constitutions actively promote the principle of checks and balances. This does not prevent one branch from dominating for a period of time, but it does ensure that the other branches can reassert themselves in due time. This principle is clearly visible in, among others, the American constitution.

A close analogy has often been drawn between private corporations and the public sector: the CEO corresponds to the head of government; the shareholder meeting to parliament. A more appropriate analogy would, however, be to see the shareholder meeting as a town council meeting, in which the citizens themselves convene and no representatives are needed. The company board may be seen to correspond to the members of the cabinet.

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In corporate governance, the principle of division of power is applied much less strictly than in public governance. In many countries, for example in the US, France and Switzerland, it is common practice that the CEO of the firm is, at the same time, the chairman of the board and therewith of the shareholder meeting. This blurs the division between the top agents (CEOs) and the principals (shareholders). In the same vein, until recently, not much attention has been paid to a clear division of control over core aspects of the firm, like the independence of compensation and audit committees.

Division of power is an area where corporate governance can learn from public governance and, indeed, it already has to some extent. In public governance, there is an independent institution controlling the executives, the 'court of accounts'. In many countries, their competencies are quite restricted. These courts of accounts derive their independence from being part of the judicial branch. In Switzerland, by contrast, an interesting kind of court of accounts exists, which derives its independence from being directly elected by the citizens. Empirical evidence shows that such directly elected courts of accounts have a considerable impact on the quality of government (Schelker and Eichenberger, 2003, 2004). It seems that they successfully restrain local governments from abusing their power and induce them to act more in the citizens' interests.

The corporate sector has often not clearly separated the executive and external auditing functions, at least until recently. In many cases, CEOs determined the auditing firms that were supposed to control them. At the same time, the auditing firms were, and still are, paid for advising jobs for the CEO and general management (*The Economist*, 2004). As a result of the huge scandals produced by this system, there are now government-imposed rules in many countries, more clearly separating the executive from the auditing branch, like the Sarbanes-Oxley Act in the US (Securities and Exchange Commission, 2003). This is obviously an area where corporate governance has incorporated insights from public governance, but only after having incurred huge costs.

The public governance perspective suggests, however, that learning from the public sector could go a step further. The independence of the auditing process could be further improved by relying on the democratic mechanism of direct elections for

(*a*) the members of the audit committee and
(*b*) the auditing firm by the shareholders.

This reflects the basic democratic idea that the independence of a committee cannot be judged by abstract formal criteria alone,[6] but ultimately has to be based on the fact that it has been freely chosen by the people who have an interest in it being independent – in this case the shareholders. The reasoning can also be applied to compensation committees and the choice of the auditing firm; we discuss the idea of competitive elections in more detail in Section 3.3. Evidence from the public sector shows that the direct election of independent bodies leads

[6] This is the current approach, e.g. embodied in the Sarbanes-Oxley Act, where the term 'independent director' is legally defined (Securities and Exchange Commission, 2003).

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them to take the citizens' interests into account better than when they are simply appointed (and are more likely to be 'captured' by those they are supposed to control); for the case of public regulators, see Besley and Coate (2003), and for courts of accounts, see Schelker and Eichenberger (2003, 2004).

The most important area where corporate governance violates the principle of division of power is CEO duality, i.e. when the CEO of the firm is at the same time the chairman of the board. From a public governance perspective, this seriously blurs the distinction between the management and the board who is supposed to control it. In contrast to this view, however, the existing empirical evidence shows that CEO duality does not, in general, lead to disastrous consequences. While researchers have found a weakly positive relationship between CEO duality and the incidence of corporate fraud (Erickson *et al.*, 2003; Uzun *et al.*, 2004; Beasley, 1996; Dechow *et al.*, 1996), a large number of empirical studies document that firm performance is essentially unaffected by the combination of the chairman and CEO positions (Dalton *et al.*, 1998). According to this evidence, one might be led to conclude that the public governance approach overstates the importance of division of power in firms. However, the existing empirical literature simply assumes independence of the CEO and chairman positions if they are held by different persons (Dalton *et al.*, 1998, pp. 271–2). This empirical strategy is likely to seriously underestimate the importance of division of power for firms, because a large majority of the presumably 'independent' chairmen are actually former CEOs of the same firm, as well as former or current executives (The Corporate Library, 2004). Such arrangements can hardly be considered a true division of power, given, among other factors, the important role that outgoing CEOs play in the determination of their successors (Shen and Cannella, 2002) and the fact that current executives are supposed to monitor their own bosses.

3.2 *Succession in Top Positions*

Democratic constitutions constrain their agents not only by division of power but also by extensive rules of law that regulate the succession and the rotation in leading positions. Three rules are of particular importance:

(*a*) *Restricted terms of office.* The members of parliament and directly elected presidents are (normally) elected for four years. At the end of this period, their term in office ends automatically; no further decision is needed.

(*b*) *Re-election restrictions.* Many constitutions know the provision that a president may only be re-elected for one additional term. This is a very strong constraint; it can safely be assumed that many, if not most, presidents would have been re-elected for more terms.

(*c*) *Rotation of positions.* Some parties (the German Green party is an example) instituted an automatic change in positions between those inside and those outside parliament and government. The Japanese MITI, a regulatory authority, automatically rotates its leading members in order to make corruption more difficult.

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The basic idea behind these rules is that they are able to restrict the power of public agents effectively. Moreover, they also open positions to newcomers and, therefore, to fresh ideas. Of the three rules, the one relating to restricted terms in office is the most commonly used in public governance; it is a part of essentially all existing democratic constitutions. But also the requirement of re-election restrictions is common, most notably in the form of the two-term limit for the US President.

Corporate governance also knows either self-imposed or government-imposed rules but they are much less far reaching than those used in public governance, mainly because the market is supposed to control firms. In principle, the terms of office of agents in private corporations are limited but in practice, this is just a formal provision of no real consequence.[7] Formal term limits can therefore play a useful role in corporate governance. Their main advantage is that they entail an automatic end of office, where no further discussion and decision is needed, and that they bring about a binding re-election constraint. Term limits can be envisaged for board members but also for the top executive function of the CEO, e.g. in the form of a two or four-year term in office. Naturally, such term limits, in particualar for CEOs, would lead to certain advantages as well as disadvantages.

One the one hand, four-year term limits would probably lead CEOs to manipulate company fundamentals in such a way that the firm can be presented in a favourable light at re-election time. In the political realm, politicians have been found to produce 'political business cycles' in a similar way; for an overview, see e.g. Frey and Benz (2003). On the other hand, the current pay-for-performance systems arguably give CEOs incentives to act in an even more short-sighted way, as the recent corporate scandals have made clear (see Section 1). Seen from this perspective, well-defined terms in office of four years have several advantages. First, they reinstall an incentive to develop a long-term view on business, as CEOs are basically granted a four-year period to achieve their goals. If CEOs perform well, they can be confident of being re-elected for a second or subsequent term, based on a long-term assessment of their performance. Second, the increased job security can lead top managers to invest more in firm-specific human capital, which cannot be sold to other firms and thus benefits shareholders (Harris, 1990). And third, term-limits create strong incentives for the persons electing a CEO to be very careful when choosing a top manager. Thus, term limits do not need to be an alien element in the corporate world.

3.3. *Competitive Elections*

Probably the most important area where corporate governance can learn from public governance is from the latter's strong emphasis on institutionalised

[7] According to recent empirical evidence, board seats were almost never contested in the US in 1996–2002 (Bebchuk, 2003). Automatic re-election seems to be the rule, despite the fact that board members formally have to stand for re-election every year at the shareholder meeting. Bebchuk (2003) gives several reasons for why board seats are almost never contested. Most importantly, the nomination of director candidates in proxy contests is very costly and subject to a public good problem. Moreover, many boards in the US are 'staggered', i.e. only a fraction of board members stand for re-election every year.

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competition. Democratic governance can be understood to be the competition by parties for votes (Schumpeter, 1942; Downs, 1957). This competition is closely regulated, but it is fundamentally an open competition. There are three main features:

- *Voting rights.* Only citizens may participate, and each citizen has one vote. Elections are individually oriented, as the voters can determine which persons will sit in parliament. In some cases (especially at the local and provincial level), the voters are able to also choose the persons in the executive branch.
- *Competitive process.* Elections must be open and the citizens must have a choice between several different options, i.e. parties and persons.
- *Voting rules.* Various mechanisms for aggregating votes are used, the best known being 'first past the post', leading to strong majorities, but tending to exclude minorities (the system used in the US and the UK), and the proportional system (used in most European countries). The latter sometimes guarantees seats for minorities, or excludes parties with less than a certain percentage of votes (e.g. 5% in Germany).

The voting and representation processes used in the public sector and in stock companies share several similarities. In both spheres, there is a collective action problem related to dispersed 'ownership'. Corporations use elections by shareholders to determine the members of the board, and the board then elects the top management and the external auditing firm. But there is a very big difference in the election process, as we know it, distinguishing the corporate sector from the public sphere: in most corporations, there is generally no choice between various alternatives. As a matter of course, the shareholders are offered one person to be elected for one position on the board, and only one external auditing firm can be chosen, and the CEO cannot be chosen at all.

We suggest that corporate governance can learn from public governance with respect to the following three aspects:

Voting rights. In principle, each share has one vote. However, this principle is often violated by privileged shares or by non-voting shares. Such devices are often used to prevent unfriendly takeovers (Seligman, 1986; Grossman and Hart, 1988). Their abolition would strengthen corporate control and secure truly 'democratic' shareholder representation. Voting rights may, in principle. also be given to non-shareholder groups, giving rise to a considerable theoretical literature on multi-constituency boards (Becht *et al.*, 2002, pp. 48–57). The employees are one group that may be represented. A regime of co-determination can be seen as a formal recognition of 'corporate citizenship' or, more broadly, of 'organisational citizenship'. The literature has recognised that such employee participation is likely to be efficient in firms with considerable firm specific human capital (Furubotn, 1988; Roberts and Van den Steen, 2000; Osterloh and Frey, 2005*b*). Moreover, co-determination seems, in general, not to damage firm performance (Addison *et al.*, 2004). To the extent that employees' firm specific human capital becomes more important in the 'knowledge economy', corporations can be expected to develop an increasing interest in the public sector experience with broad representation

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practices, and also an increasing interest in the experience many European countries have made with co-determination.

Competitive process. Democracy is not well developed within corporations. The essential element of competition, namely that the voters can choose between relevant alternatives, hardly exists. For instance, for a truly democratic process, the persons with voting rights in the firm must have the option to choose between various persons willing to serve as directors. Similarly, they must be able to choose between several competing firms offering external auditing. In both cases, the competitors must be willing to clearly state their interests and programme, and must be able to convince the corporate voters that they are capable of fulfilling the tasks required. It is difficult to see why such a competitive process exists in the political sector but is often assumed to be impossible within corporations. Paradoxically, the way in which capitalist corporations today select their most important representatives brings to mind former communist regimes: there is one option to choose from and it gets chosen by a huge majority.

Corporate governance can learn from public governance by rediscovering the importance and the power of institutionalised competition. Competitive elections seem, at the very least, obvious for positions on the board. Board members are the representatives of shareholders and it is hardly conceivable why shareholders should not have the possibility to exercise their right of free choice; see also Bebchuk (2003, 2004). It is a simple but powerful aspect of public governance that good representation can only be secured if voters have the opportunity to choose their representatives freely. This insight, however, seems to have become completely forgotten in corporate governance.

Competitive elections may not only apply to board members but can be further extended to core areas of the firm. For example, a strengthening of corporate governance can be expected if shareholders are given the right to determine the board members that specifically sit on the auditing and the compensation committees, and to choose between different auditing firms. Such elections would greatly improve the independence of the respective actors. It vests them with a unique, institutionally based legitimacy to take an independent stance; at the same time, it secures their accountability to shareholders in important corporate matters.

To see the potential of competitive elections for corporations, one may even go a step further. Instead of the board members being faced with a choice of top managers chosen by the former CEO, and possibly by a small group of directors aided by headhunters, the selection of a new CEO could take the form of an open competition. Even more extreme, the whole management group could be open to competition from individuals or firms prepared to fill certain positions like the CEO. The electoral competition then serves to select the most efficient group (it may be the former managers), i.e. the group the corporate voters believe to be the most capable relative to the compensation demanded. In difficult situations, the price asked may be high but, unlike in many cases today, such compensation would truly reflect expected performance rather than rent sharing. Naturally, such a far-reaching proposal raises diverse

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issues, like the problem of a reduced confidentiality in the application process, but this should not distract from the potential value the idea has for corporations.

Voting rules. Public governance tends to be rather conservative. It is difficult to extend the area of democratic participation or to introduce new voting rules. The major reason is that the established politicians, parties and interest groups fear losing from such changes. The corporate sector, being proud of being more dynamic than the public sector, should find it easier to consider new voting mechanisms for shareholder votes or for decisions taken by the board. Examples are voting by veto (Mueller, 1978) or storable votes (Casella, 2002), but there are many others. Firms can choose the respective innovative voting rules where they are most appropriate, while sticking to simple majority, qualified majority or unanimity elsewhere.

3.4. *Evaluation*

The many different institutional devices developed in public governance to restrict the power of public agents can serve as a pool of ideas to improve corporate governance. The latter has relied too much on the notion that competitive market forces are quite capable of effectively restricting executives. In view of the recent corporate scandals, it seems reasonable to consider novel approaches to control the behaviour of managers, like an improved division of power, well-defined rules of succession and institutionalised competition in core areas of the corporation. Recent changes in corporate governance rules have indeed co-opted some of the mechanisms of public governance, like the division of power between management and external auditing firms introduced by the Sarbanes-Oxley Act.

4. Conclusions

In this article, it has been argued that fresh insights for corporate governance can be gained from the way democratic government and public administration are organised. Corporate governance can learn from public governance in such areas as goal-oriented intrinsic motivation, extrinsic motivations imposed from outside (like titles and orders), and institutional restrictions of power. Counter-arguments against the very idea of transferring elements of public governance to corporate governance, and even more so against specific institutions, are possible and, in any case, necessary. We have discussed some of these objections in the text. To conclude, we wish to address three more general counter-arguments that are often brought against new ideas, in order to discuss the limitations as well the potential of the proposals in a broader context.

4.1. '*The Ideas are Fundamentally Wrong*'

This view claims that corporate governance has nothing to learn from public governance; the two sectors are fundamentally different and thus it does not make

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sense to transfer institutions. It can be argued that the public sector emphasis on intrinsic motivation is outmoded. Even worse, public governance mechanisms may substantially damage corporate governance, because they are alien to the corporate world, thereby lowering productivity and raising the cost of doing business. There are indeed situations where corporate governance can safely disregard public governance ideas. This is, in particular, the case in a perfectly competitive market in which managers have very little discretionary room, and where the goods, managerial and financial markets align their incentives perfectly with those of the shareholders. In a competitive equilibrium, private firms select efficient governance mechanisms, and any intervention by political and regulatory agencies is supposed to be harmful.

The disciplinary forces of markets, however, are not likely to be enough to effectively discipline corporate agents and institute efficient governance mechanisms. Corporate governance systems all over the world rely not only on self-regulation, but also, most importantly, on corporate law and regulatory measures (such as those imposed by the SEC). Indeed, ideally competitive markets are certainly the exception rather than the rule. Practically all markets allow for substantial discretionary behaviour on the part of executives, which sometimes goes as far as illegal actions, as the recent corporate scandals have made clear. This leads to substantial areas within the firm in which power is wielded and in which politics enters the game. Also, a large number of organisations acting on markets are not purely for profit but take an intermediate position somewhere between shareholder wealth maximisation and pure public ownership. There is thus a broad area where insights and institutional ideas derived from public governance are of interest for corporate governance. We have concentrated mainly on developing our arguments with respect to the classical private corporation; the arguments, however, could be applied to an even larger extent to not-for-profit firms and firms with a varying degree of governmental influence, which may substantially profit from institutions derived from public governance.

4.2. '*The Ideas May (Partly) be Correct but Impossible to Introduce*'

This objection raises the concern that rough and ready devices to overcome the problems faced by corporate governance today cannot easily be derived from public governance. Mechanisms would have to be carefully adapted to the needs of firms, but this would be very difficult, if not impossible. There is indeed substantial merit in this objection. Firms act in a different environment and are dominated by a different social decision-making mechanism from governments; this important distinction has always been a part of Modern Political Economy (Dahl and Lindblom, 1953). We nevertheless think it is not fundamentally impossible to use ideas from the public sphere for more effective corporate governance. Recent regulatory changes embodied in the Sarbanes-Oxley Act, for example, create a division between executives and external auditors that very much embraces the democratic idea of division of power. Also, it is difficult to see why the interests of principals and agents should be almost exclusively aligned by extrinsic incentives,

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especially as intrinsic motivation can be formed by institutions and socialisation in a goal-oriented way.

4.3. '*The Ideas are not New*'

This charge is certainly true. The ideas presented here are based on fundamental insights from the public sector that hardly any scholar of political economics would find particularly novel. Their application to the corporate world, however, may be relatively new, as may the novel approaches to the governance of firms thereby gained. The notion that elements of public governance can be transferred to corporate governance stands in odd contrast to what is taken to be 'modern' today. This holds, in particular, for New Public Management, according to which the public sector should adopt ideas from the corporate sector, or for pay-for-performance, where market ideas are transferred within firms. Our arguments suggest that learning can go in a fruitful reverse direction: private governance can learn from public governance.

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