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PUBLIC GOVERNANCE AND PRIVATE GOVERNANCE: EXCHANGING IDEAS

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I. A RIDICULOUS IDEA?

To many economists it may appear a strange, if not queer idea, to even consider what can be learned from the public sector. Have we not, after all, a lot of negative experience with the public sector? It is often considered synonymous with large-scale inefficiency, waste, scandals and corruption. As a result, have there not been many efforts to overcome these shortcomings of the public sector by moving towards more market-oriented institutions and policies? For this reason, the 'New Public Management' was introduced in many countries. Its main message was that the public sector should imitate the market as fully as possible. In particular, the dependence of individuals on governmental services, characterised by long waiting queues and bad quality[1] was to be replaced by a service corresponding to consumer needs. Public sector wages should not be determined by seniority, but by performance. A similar movement in the United States referred to 'Reinventing Government', in the sense of introducing market mechanisms (see, for instance, Stiglitz 2002: 351).

The serious shortcomings of the public sector were also the subject of a great deal of academic writing. My own field, Public Choice or Modern Political Economy[2] can, in many ways, be characterised as the study of 'government failures' (see, for instance, Tullock et al., 2002). From the very start,[3] it concentrated on the irrationalities, inconsistencies and inefficiencies of the public sector. The 'Comparative Institutional Analysis' (see, for instance, Eggertson 1990) concluded quite generally that government failures were far more important than market failures. As a consequence, aca-

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1 Even in a country with a relatively small public sector, like Switzerland, it is only a few years back that one had to wait for weeks to get a telephone installation and the only choice was an unattractive phone in one color only, black.

2 E.g. Frey (1978), Persson and Tabellini (2002), Mueller (1997, 2003). The shortcomings of public bureaucracy are discussed in e.g. Wintrobe (1996), and rent seeking in Tollison (1982), Tullock et al. (1988) and Tollison and Congleton (1995).

3 Arrow (1951), Black (1958), Buchanan and Tullock (1962), Sen (1970), Niskanen (1971).

P. de Gijsel and H. Schenk (eds.), Multidisciplinary Economics, 167–186.

demic literature has been keen on transferring ideas from the market (normally understood to be perfectly competitive) to the public sector. Most importantly, introducing competition and the market via privatisation and deregulation has been the major advice offered by economists to improve the working of society in general, and the public sector in particular. An example is competitive federalism, where various jurisdictions undertaking the same activity is not seen as a waste but, given the right conditions, as an incentive to raise efficiency (see, for instance, Frey and Eichenberger 1999). On a more microeconomic level, the introduction of market elements into the public sector was hailed as one of the great achievements in economics in the last century (Faulhaber and Baumol, 1988). According to Stern (2002: 337), this approach can be fairly summarised in the following manner: 'Privatise, get the government out of the economy, and let markets determine allocation and make decisions wherever possible'. Auctioning systems for allocating scarce resources, road pricing and tradable permits for pollution control are well-known examples.

There is no doubt, in my opinion, that transferring ideas and mechanisms from the private into the public sector provided fresh and valuable insights, and in many cases strongly increased the efficiency of the public sector. But in this paper I wish to do exactly the reverse: *I argue that the private sector can learn from the public sector.* I claim that, throughout its long existence, the public sector, and in particular democracy, has generated worthwhile institutions, some of which may be of great use to private governance. In order to substantiate this claim, I want to be concrete. I direct my attention to the core of the private sector, namely the management of firms. I thus wish to defend the proposition: '*Corporate Governance should learn from Public Governance*'. It will be argued that the recent large-scale scandals, fraud, inefficiencies and corruption among firms (see Osterloh and Frey, 2003) could have been reduced, and perhaps avoided, if rules and institutions existing in the public sector had been in place in private corporations. But I have to warn the reader that, in order to appreciate this approach, a change in outlook is required, i.e. it is necessary to go beyond conventional economic reasoning. Most importantly, one must depart from the view that there is one, and only one, motivation – namely extrinsic incentives – guiding human behaviour. Rather, it has to be acknowledged that intrinsic motivation also matters.

The approach followed here is mainly based on Constitutional Political Economy[4] and is also greatly influenced by Psychological Economics or Behavioural Economics.[5] The results of our alternative approach[6] suggest a very different organisation of the capitalist firm from that which traditional agency theory argues. More generally, it argues for a broader understanding of human behaviour and motivation in organisations. The approach does not contradict classical agency theory, but rather introduces new, forgotten or neglected aspects. As a consequence, however, the ideas on organisational design differ substantially from much of what is suggested by conventional economic theory.

Corporate governance is discussed from the point of view of agency theory in section II. The following section analyses the multiple ways in which the power of actors in the public sector is restricted. Section IV argues that extrinsic incentives can be created by outside recognition and not only by monetary rewards. Section V shows how goal-oriented motivation is supported in the public sector. The last section offers conclusions. The paper, of course, does *not* argue that public governance produces ideal results – far from it. It has already been stressed that *democratic politics* and *public administration* are subject to many inefficiencies and scandals, and that distortions due to rent seeking activities are prevalent. But this does not exclude that *some* institutions of public governance may be useful for corporate governance.

II. CORPORATE GOVERNANCE AS AGENCY THEORY

Modern scholars think of corporate governance in terms of agency theory. This approach 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 very ably and extensively been surveyed by e.g. Becht et al. (2002), Prendergast (1999) and Gibbons (1998). While agency theory is not a unified whole, and different opinions do exist, as in any other vigorous discipline, I take these surveys to adequately represent the state of research.

The general adoption of agency theory as the essence of corporate governance is in line with the development of the American economy which, since 1995, has grown significantly more quickly than the European and the Japanese economies. It may also be seen to correspond to the stock market boom of the 1990s and, more generally, to the adoption of the American way of life.

Agency theory has not only dominated the academic discipline, but has been accompanied by applications of its major message in business practice. Agency theory's emphasis that managers' interests must be aligned with those of stockholders has arguably been responsible for the effort to introduce performance incentive plans, in particular pay-for-performance. The idea has even spread to areas outside the market: society should be run as if it were a firm. 'New Public Management' urges nonprofit organisations and public administrations and, of course, profit-oriented firms, to adopt pay-for-performance programmes.

4 See Buchanan and Tullock (1962), Frey (1983), Mueller (1995), Cooter (2000), Frey and Kirchgässner (2002).

5 See e.g. Kahneman, Slovic and Tversky (1982), Simon (1982), Dawes (1988), Lane (1991), Thaler (1992), Rabin (1998), Fehr and Schmidt (1999), Mullainathan and Thaler (2000), Fehr and List (2002), Frey and Stutzer (2001/2, 2002).

6 I thus seek to follow Gibbons' (1998: 130) evaluation: '...I think that the best economics on this subject (incentives in organisations, BSF) ... will exhibit stronger connections both to the broader literature on organizational economics and to other disciplines that study organizations'.

But there has recently been a sudden *sobering up*. The stock market has crashed, the greatest losses being experienced by the new market stocks (NASDAQ and the New Market Index). More importantly for agency theory, the corporate sector has been plagued by huge scandals relating to excessive manager compensation and fraudulent bookkeeping.[7] Performance pay, linking salaries to stock options, has led to an explosion of compensation due to the stock market boom. This trend has, in many cases, simply continued, even under changed economic conditions. Management compensation has often increased even further, 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 due to the fact that managers are able to exert considerable control over the money they get. Most importantly, they can do so by producing short-term increases in share prices, or by re-pricing their stock options. Some managers even resorted to unlawfully misrepresenting their firms' accounts in order to increase their private incomes.[8] After the event, it is possible to state 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: 47).[9]

These weaknesses and failures of both agency theory and actual practice suggest that it might be useful to approach the issue from a *new perspective*, namely the way democratic government and public administration are organised.

III. RESTRICTIONS ON POWER[10]

'Disciplining agents' is a central task of democratic government. The same goal is shared by corporate governance with respect to 'disciplining management' (Becht et al., 2002: 21-22). In the case of public governance, not only the government politicians, but also the members of parliament and administration, must be constrained from misusing 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 of shareholders, and leads to authoritarian, or even dictatorial, forms of governance.

7 Corporate Scandals were e.g. discussed at an Academy of Management special presidential panel entitled 'The Crisis in Corporate Confidence', see Bartunek (2002), Kochan (2002), Gioia (2002), Child (2002), Adler (2002).

8 See e.g. Benz and Stutzer (2003), Müller (2003) and, more generally, Lutter (2001).

9 Other authors, not surprisingly among them major contributors to agency theory, tend to defend the existing corporate governance system. But most of them admit major weaknesses in the approach. An example is Holmstrom and Kaplan (2003: 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 suffice.

10 This section is based on joint work with Reiner Eichenberger.

For centuries, democracies have developed various efficient institutions to restrict the accumulation of power. Three are most important:

1. *Division of Power*

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

A close analogy has often been seen between private corporations and the public sector: the CEO corresponds to the head of government; the shareholder meeting to parliament.[11] A more appropriate analogy would be to look at 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. In corporate governance, the division of power between the top agents (CEOs) and the principles (shareholders) is much less strict than in democratic public governance. It is often the case that, in many countries (for instance in the USA, France and Switzerland), the CEO of the firm is at the same time the president of the board and therewith of the shareholder meeting. This has arguably often led to catastrophic consequences. There are many cases of CEOs, either with particularly strong personalities, or who have been in office a long time, who then started to dominate their firms in an almost dictatorial way. Absolute power also corrupts in the corporate sector.

There is another important division of power in public governance. There is an independent institution controlling the executives: the court of accounts, Rechnungshof or Rechnungsführungskommissionen. Unfortunately, in many countries, their competencies are quite restricted. In Germany, for instance, the Rechnungshöfe may only inform the parliament and the public about the way the executive performs his or her task, but may not interfere. The courts of accounts derive their independence from being part of the jurisdictive branch, while the Rechnungsprüfungskommissionen in Switzerland derive their independence from being directly elected by the citizens.[12] The corporate sector often does not clearly separate the executive and external auditing functions. In most cases, the CEO determines the auditing firm, which is supposed to control him or her. At the same time, the auditing firms are paid for advising jobs for the CEO and general management. 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. This is an area where corporate governance learned directly from public governance – but only after having incurred huge costs.

11 This analogy stood indeed at the beginning of the Corporate Governance literature (see Mead 1922, for a survey Becht et al., 2002: 6-10), but has largely been forgotten.

12 See more fully Schelker and Eichenberger (2003), who empirically show that directly elected Rechnungsprüfungskommissionen induce governments to misuse their power less, and to act more strongly in the citizens' interests.

2. Rules

Democratic constitutions constrain their agents by extensive rules of law. Suffice it to mention three:

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 (again 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.

These rules are not only able to effectively restrict the power of public agents. They also open positions to newcomers, and therefore to fresh ideas.

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. These rules may, to some extent, be used by 'shareholder suits' (see Becht et al., 2002: 92-93). The term of office of all agents in private corporations is limited. But this is very often just a formal provision, of no real consequence. Automatic reelection is the rule, as long as the agents work well and, if they don't, dismissal within terms is undertaken.[13] Indeed, today, CEOs are in office less than four years on average. An effective term limit of four years, with the possibility of one re-election, would therefore not constrain corporate life[14] much.

3. Institutionalised Competition

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

a) Voting rights.
Only citizens may participate, and each citizen has one vote.[15] 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 also able to choose the persons in the executive branch. In contrast, pay-for-performance is more collectively oriented, because the performance measures (company profits, share prices) are not the product of a particular individual.

b) Competitive process.
It must be open and the citizens must have a choice between several different options, i.e. parties and persons.

c) 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 UK system) 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).

There are similar vote and representation processes in stock companies. There is also a collective action problem with dispersed share ownership (see Becht et al., 2002: 6-7, 20-21). The board is elected by the shareholder meeting, and the top management and the external auditing firm are elected by the board. But there is a very big difference to the election process, as we know it, in democratic countries: in most corporations, the voting processes are opaque (to say the least) and 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.

Corporate governance could learn from public governance with respect to the following aspects:

a) Voting rights

In principle, each share has one vote. However, this principle is often violated by privileged shares or by nonvoting shares. Such devices are often used to prevent unfriendly takeovers. Recently, much emphasis was placed on *'independent' directors* (members of the board), who are supposed to protect the interests of minority shareholders from actions by both the CEO and blockholders. Empirical research has, however, found that independent directors have little influence on firm performance (Becht et al., 2002: 42-3). An important reason may be that they have less information at their disposal than 'inside' directors.

Voting rights may also be given to *nonshareholder groups,* giving rise to a considerable theoretical literature on multiconstituency boards (Becht et al., 2002: 48-57). One group which may be represented are the *employees*. This could be seen as a formal recognition of 'corporate citizenship' or, more broadly, of 'organisational citizenship'. Agency theory (e.g. Roberts and Van den Stehen, 2000) has recognised that such employee participation may be efficient in firms with much job specific human capital. It has also recognised (e.g. Holmström, 1999) that such codetermination may be an effective way of reducing costly strikes. As seems to be the rule, the many contribu-

13 For a discussion of CEO succession, see Hambrick and Fukutomi (1991), Ocasio (1999), Westphal and Zajac 1995).
14 They are indeed enforced in some well-known firms, such as McKinsey. Mandatory rotation of external auditors is discussed in Arrunada and Paz-Ares (1997) and Summer (1998).
15 But the concept may be generalised, see Frey (2003).

tions to the topic stemming from German-speaking countries are totally neglected in surveys on agency theory.[16]

Another group, which may be given a formal voting right for corporate decisions, are the creditors and customers. Even more broadly, environmentalists and other action groups may be accorded participation rights in firms, thus formally integrating 'stakeholders'.

So far, corporate governance theory has not provided any systematic analysis of these issues. 'What is worse, this literature mostly considers highly stylised models of multiple constituencies' and there is, at best, sketchy empirical evidence on the role of boards (Becht et al., 2002: 48, 97). This is no doubt an area where closer collaboration between agency theorists and political economists would be fruitful. The various interests have some analogy to political parties and distinguish themselves, for instance, with respect to the time frame or the role attributed to profits.

b) 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 of choosing between several competing firms offering external auditing. Similarly, they must be able to choose between various persons willing to serve as directors. 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 required tasks. It is difficult to see why such a competitive process exists in the political sphere, but is often taken to be impossible within corporations.

A further step can be imagined. Instead of the board members being faced with a choice of managers chosen by the CEO, and possibly a small group of directors aided by head hunters, the selection could be made in an open competition. Anybody who is reasonably competent as a manager should be able to participate. Even more extreme, the whole management group may be opened to competition by individuals or firms prepared to fill certain positions (for instance the CEO). Already now, there are firms competing to manage a particular corporation for a fixed number of years and for a specific price. In Germany, for instance, firms are hired from outside to manage hospitals and other organisations in the health sector. 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 today, such compensation truly reflects expected performance rather than rent sharing.

16 At least in Becht et al. 2002, Prendergast 1999, Gibbons 1998. It should be noted that formal codetermination is not only a German phenomenon, but is also important in Austria, the Netherlands, Denmark, Sweden and Finland. A recent empirical analysis of codetermination in German firms is, for example, Schank et al. (2002).

c) New Voting rules

Public governance tends to be rather conservative. It is difficult to extend the area of democratic participation[17] or to introduce new voting rules. The major reason is that the established politicians, parties and interest groups fear to lose from such changes. The corporate sector is proud of being more dynamic. It should therefore be willing to consider new voting mechanisms. 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.

Evaluation

The many different institutional devices developed in democratic public governance to restrict the power of managers 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. This belief is difficult to maintain in the face of the huge management scandals recently observed. Many corporate actors, and certainly public decision-makers, have grasped the lesson to be learned. They have indeed already co-opted some of the mechanisms of public governance, including the division of power between management and external auditing firms, and also between the CEO and the president of the board.

IV. EXTRINSIC INCENTIVES BY OUTSIDE RECOGNITION

Public governance also relies on externally mediated incentives to align agents' behaviour with the goals of the organisation. Unlike traditional agency theory, it is not committed to only one motivational force. While agency theory favours monetary incentives, because they are the most fungible, and therefore seem to be the most efficient, public governance uses *various different kinds* of extrinsic motivations.

Three types of institutions are used in public governance as extrinsic motivators:

1. Titles

People like titles to clearly indicate their place in the hierarchy.[18] They have much added value when they are transferable to life outside of the organisation they work in, especially in their social life with family and friends, as well as with strangers. In former times, this condition was perfectly met by conferring such titles as 'Geheimrat'

17 See, for instance, the great difficulties of introducing elements of direct voter participation via initiatives and referenda. Compare Kirchgässner et al. (1999).

18 The importance of positional competition for individuals has been empirically shown by many scholars, e.g. Frank (1985).

in Germany and Austria, or 'Sir' or 'Lord' in Britain.[19] Titles are transferable if persons outside the organisation have a sense of the distinction conferred. They do not necessarily have to know exactly what they mean, but they have to be impressed.[20] Therefore they must be conferred in a restricted way.[21]

In recent years, most leading private corporations have given up conferring transferable titles. Instead, they use 'functional' titles of little or no use outside of the organisation. It is difficult to brag in social circles about the title 'group leader' when nobody has a clue whether this means that one is in charge of ten people, or ten thousand people, as both can be, and are, called 'groups'.

2. Orders

Public governance confers 'orders' on people extensively as an incentive device. They are often given at the end of bureaucratic careers as a tribute to the life-long devotion to one's tasks, and not for specific performance.[22] Orders are not contractible when one enters a public career, but they are given on the basis of clear rules. They are transferable to social life, as they are virtually worn outside, on the dinner jacket and even on normal suits (e.g. the French Legion d'Honneur).

Corporations know a similar institution when they choose 'The manager of the year', 'The employee of the month' or 'The dishwasher of the day'. But these 'orders' are designed to relate directly to specific performance. They are therefore understood to be solely instrumental. Moreover, they are difficult to transfer outside of the organisations (and often are considered to be rather ridiculous). Finally, they tend to be handed out in such an inflationary way that those not receiving them are demotivated.

3. Ceremonies

Titles and orders are almost invariably handed out in a ceremony. Public governance knows of many other occasions when agents in the public sector participate in publicly visible ceremonies. Examples are the reception of foreign dignitaries, parading the troops or coronations. They provide the agents working in the public administration, or politicians, with prestige and visibility in the public sector, which is an important extrinsic reward.

Such ceremonies are much more rare in the private sector.[23] They tend to be considered a waste of time for all the people concerned. They do not correspond to the

19 Note that banks in German speaking countries until recently used the title 'Bankdirektor' or even 'Bankbeamter', therewith adopting a title belonging to the public administration.

20 Thus, it is not important for outsiders to know whether a 'Ministerialdirektor' is more or less than a 'Ministerialdirigent', or a 'Major General' more or less than a 'Lieutenant General'.

21 Corporations do not seem to be good at that. When a considerable percentage of managers are 'vice-presidents', the title is no longer worth as much (it must be amended by adding 'senior', 'executive' etc.). A similar inflation can be observed even with the title 'Chief Executive Officer'. Today, many firms have several CEOs, for instance one for each division.

22 Exceptions are the few orders conferred on the battlefield, but they are small in number.

23 For a discussion of ceremonies in organisations, see Dandridge et al. (1980).

image of an 'efficient' manager. It therefore can happen that a new CEO takes over a firm without the employees ever having seen him or her. To some extent, corporations seek to imitate public ceremonies, but they tend to be instrumental and nontransferable outside of the firm. As a consequence, they are of limited use in bolstering motivation.

Evaluation

The extrinsic incentives[24] provided by public governance are directed to lifelong devotion to one's tasks and achievements. They represent an overall evaluation, and are of an ex post noncontractual nature. They do not relate to any specific performance, and are therefore designed not to be (directly) instrumental. The incentive structure applied by public governance skilfully combines the production of outside recognition and status with crowding-in goal oriented intrinsic motivation. It might be argued that titles and orders have lost importance. This is certainly true, but may be attributed to the fact that they have partly been abolished. It is interesting to note how many leading economic economists were, and still are, obviously delighted to have titles bestowed on them, Lord Keynes and Sir Tony (Atkinson) being just two such examples.

There are major differences between conferring titles and orders and giving money as compensation for performance:

- Conferring titles and orders are intended to honour long-term, even lifelong performance, while almost all of necessity performance pay relates to short-term achievements. As employees have to earn their living by getting paid, if this money is given in relation to performance, it must be adjusted according to short-term considerations.
- Titles and orders are mainly given in a process-oriented way, serving as a reliable feedback for performance. This feedback tends to raise intrinsic motivation (see Deci and Ryan 1985, Frey 1997). Performance pay is outcome-oriented. But outcomes are subject to many other systematic and random effects beyond the influence of the recipient. The feedback is therefore less reliable, and does not contribute to crowding-in intrinsic motivation.
- Titles and orders tend to be more absolute than monetary income which is easy and straightforward to compare. When monetary pay is explicitly given to reward performance, employees are inclined to compare the amount they get with the total profits of the firm. They easily see that their share is normally only a tiny fraction of the total profits, a comparison which decreases their dedication to their firm.

This discussion suggests that conferring titles and orders, as well as honouring employees by holding specific ceremonies, has quite different motivational implications from monetary compensation, in particular to pay-for-performance. In many cases, the incentives produced by conferring titles and orders, especially the increase in intrinsic

24 For the terms intrinsic and extrinsic, see Frey and Osterloh (2001), Osterloh et al. (2002). An application of an extrinsically oriented 'public choice' theory to bureaucratic organisations has been undertaken in business economics e.g. by Spicer (1985). However, intrinsic motivation of managers and employees is traditionally emphasised by such approaches as 'stewardship theory' (Davis et al., 1997).

motivation induced, is most valuable for an organisation and should therefore be part of management.

V. SUPPORTING GOAL-ORIENTED INTRINSIC MOTIVATION

Traditional agency theory builds primarily, or exclusively,[25] on extrinsic motivation. 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 so as 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. 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, represented in parliament. In direct democracies, citizens can also determine substantive issues via initiatives and referenda. The citizens' participation rights have important consequences for the behaviour of the politicians:

a) Identification

The more extensive the right to participate politically is, the stronger the extent of interaction between the citizens and the (professional) politicians. The constant tendency for the leaders to establish a 'classe politique' is reduced.[26] Codetermination in firms also raises identification, not least because the managers are induced to interact more intensively with their employees than they otherwise would.

25 Becht et al.'s survey (2002) and Gibbons (1998) virtually disregard intrinsic motivation, not to mention the interaction between extrinsic and intrinsic motivation. Prendergast (1999) devotes half a page (on p.18) of his 56 page survey to intrinsic motivation, but dismisses it with the remark: '... there is little empirical evidence'. He seems to overlook the fact that the situation is not better for agency theory, according to his own evaluation: 'All in all, the available empirical evidence on contracts does not yet provide a ringing endorsement of the theory' (p. 56). Moreover, today there is substantial empirical evidence on the relationship between intrinsic and extrinsic motivation, see the survey by Frey and Jegen (2001).

26 See e.g. Frey (1997), Bohnet and Frey (1999), Eichenberger and Oberholzer (1998).

b) Feedback

The reaction of the voters to the actions of the politicians constitutes an essential part of the democratic political process. In referendum democracies, the politicians get a direct feedback on how the voters evaluate specific policies. This feedback is of an informative, rather than a controlling nature, and therefore[27] tends to raise the intrinsic motivation of politicians to pursue policies in the interests of the citizens.

2. Fixed Position and Income

The career path and the income corresponding to the various positions are governed by formal rules. Advancement is regular and mostly by seniority. Promotion does not depend on any *specific* output performance. The job is guaranteed for life; the members of the public administration cannot be 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.[28]

Tournament theory has identified such bureaucratic rules as an optimal response to the dysfunctional behaviour, due to evaluation procedures occurring in multitasking situations (Holmström and Milgrom 1991, 1994). Agency theory responds by suggesting 'subjective performance evaluation' (see Prendergast 1999: 29-33, Gibbons 1998: 120-123). But such subjective evaluation in firms shifts the discretion over employees' pay to the superior. This dependence of employees on the goodwill of their superior weakens or even totally suppresses their incentives to monitor and criticise the behaviour of their superiors. 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 mitigated in public administration. While there is a well-defined bureaucratic hierarchy, the superiors have to follow well-defined rules and have, in principle, no discretion concerning the pay of their inferiors. This advantage is indeed seen by Prendergast (1999: 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 serve as 'redistribution constraints' (Hansmann 1996, Osterloh and Rota 2003). They free employees from fighting over earnings and so contribute to the organisations' common good. In contrast, the system characterised by pay-for-performance strongly induces employees to devote time and effort to influencing their variable income. The employees rationally engage

27 Deci and Ryan 1985, Thomas and Velthouse 1990.

28 This is, of course, the reason for life tenure of professors, who are given a position independent of government.

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 by distorting and falsifying the figures. Agency theory has, to a large extent, failed to see this rational reaction by employees subjected to pay-for-performance (Becht et al., 2002: 47). Corporate governance also seems to have neglected a more aggregate response to performance wages, again diverting the efforts of employees in unproductive directions. Pay-for-performance systems concentrate the attention, especially of managers, on compensation rather than on effort. It aligns the interests of all employees to one specific goal, namely to jack up profits, or share prices, as much as possible. No manager or other employee has any incentive to inform the shareholders or the public whether these goals are reached by illegitimate, or even illegal means, because they all benefit from the system. The result of this arrangement is an explosion of managers' compensation, which is consistent with what we have observed ever since pay-for-performance was widely introduced.

The administrative approach to the allocation of career and pay avoids the fundamental problems connected with pay-for-performance. It suffices to list them (see also Osterloh and Frey 2000): (1) Performance is rarely easily defined, but is subject to interpretation and influence;[29] (2) In many cases, only some aspects of performance are measurable, leading to the multitasking problem; (3) The employees must constantly be monitored in order to be able to pay them, leading to a perception of being controlled. This tends to crowd out any existing intrinsic motivation; and (4) The work content as such is no longer of interest to employees, but is regarded as instrumental to pay. This induces distributional fights and negative sum games.

3. *Extensive Selection Process of Agents*

To become a member of the classical public bureaucracy 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

29 The few existing empirical studies analysing the effect of pay on performance, Lazear (1999, 2000) and Paarsch and Shearer (1999), relate to very simple jobs, like windshield fitting and tree planting. The same holds for the recent study by Fehr and Goette (2002), relating to bicycle couriers. But Prendergast (1999: 57) rightly criticises '... the excessive focus on the contracts of workers for whose output measures are easily available ... to put it simply, most people don't work in jobs like these'. An exception is Lavy (2002), in his analysis of performance wages for schoolteachers.
Obviously, because it is generally taken to be impossible to measure the performance of political executives in a reasonable way, the proponents of pay-for-performance do not advocate that the president of the United States is paid according to the increase in real GNP, or the rise in the Dow Jones Share Index produced during his administration, but it has recently been proposed by a proponent of the Deutsche Gewerkschaftsbund in Saxony, see Leipziger Volkszeitung (2003). But why is it taken to make sense for CEOs, who often command larger 'realms' than nations? This is only possible if the share value is taken to be the only criterion. But such a measure is hotly debated by all persons taking a broader view of the role of corporations in society.

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 public administration. The famous Chinese bureaucracy required people to be able to prepare poems (see Tullock, 1964); in Germany a public official had to have, and still to some extent 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.[30] The difficult and long-drawn out process strongly *socialises* the persons 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.[31] The process thus tends to *crowd in* intrinsic motivation.

The long formal selection process, moreover, provides the successful applicants with self-confidence in their own abilities.[32] 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 sometimes results in arrogance, a trait often attributed, for instance, to top-level French public officials coming from 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 (see Brennan and Hamlin 2000, Cooter 2003). Decentralised democracies allow voters to better select the characters of politicians they want, 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. Firms should pay more attention to selecting the appropriate characters for the tasks at hand, rather than to mainly or exclusively relying on external incentive systems (Cooter and Eisenberg, 2000-2001).

4. *Autonomy Within Rules*

Bureaucratic rules provide directions, but *within* them public employees enjoy a clearly defined measure of autonomy. They have room to evaluate and to 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 ideally are protected from

30 Agency theory has noted the important function of deferred compensation for the selection of desired workers (already Salop and Salop 1976). But, in the empirical study by Lazear (1999, 2000), the opposite effect is studied: the offer of introducing incentive wages to workers induces persons with above-average productivity in fitting windshields to join the firm, i.e. the more extrinsically oriented materialists tend to newly enter the firm.

31 The third part of Hirschman's *Exit, Voice and Loyalty* (1970) reappears.

32 Social psychology emphasises competence as an important innate need. See Deci and Ryan's (1985) self-determination theory.