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, 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 can, in many ways, be characterised as the study of ‘government failures’ (see, for instance, Tullock et al., 2002). From the very start, 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-
Academic 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 Economy4 and is also greatly influenced by Psychological Economics or Behavioural Economics.5 The results of our alternative approach6 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 organisa-

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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’.