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Upfront

Learning From Government: What the public sector can teach the nonprofit and business sectors

By Alana Conner

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GRADUATE SCHOOL OF BUSINESS
Stanford Social Innovation Review
518 Memorial Way, Stanford, CA 94305-5015
Ph: 650-725-5399. Fax: 650-723-0516
Email: info@ssireview.com, **www.ssireview.com**

Learning From Government

What the public sector can teach the nonprofit and business sectors

As corporations continue to convulse with scandal, the public sector is looking relatively orderly and efficient. Maybe it's time for business to borrow some of government's wisdom, suggest economists Matthias Benz and Bruno S. Frey in their January 2007 *Academy of Management Review* article. The authors, both of the University of Zurich, write that nonprofits could also learn a thing or four from the public sector. Their recommendations for both sectors include:

Give people real choices. Although capitalism and democracy often go hand in hand, corporate governance is remarkably undemocratic. True, shareholders elect board members. But the flavor of corporate elections is decidedly Soviet. "There is one option to choose from, and it gets chosen with a huge majority," write Benz and Frey.

Holding competitive elections for board seats would give elected members the strength and legitimacy to take independent stands. Indeed, unions with competitively elected board members govern better, the authors note. As the democratic revolution catches on in the private sector, corporations might also consider holding competitive elections for auditing committees, compensation committees, auditing firms, and even CEOs. They should also abolish privileged shares, and instead grant one vote per share.

Divide power. Millennia of natural experiments show that democratic governments need checks and balances to control their leaders – hence the stark division of power among executive, legislative, and judicial branches of government; the delicate détente between houses of the legislature; and the careful calculus of voting rules within a governing body.

Yet corporations routinely leave their CEOs unchecked, undermining their ability to serve shareholders. Many companies make the same person both CEO and board chair, or choose former CEOs or current executives as their chairs. Because former CEOs usually have a heavy hand in the appointment of their successors, and current executives are beholden to their bosses, these board chairs are hardly independent of their CEOs. The authors suggest a separation of CEO and board chair, preferably with the board electing the latter.

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Limit leaders' terms. Democratic governments often limit the number and length of their leaders' terms. That way, power doesn't have time to corrupt, and fresh blood can circulate. Yet with a few notable exceptions, such as McKinsey & Company, corporations do not have formal term limits for their top managers, nor do they limit the number of terms board members can serve.

By letting leaders know for certain how long they will be at the helm, preset terms would also encourage longer-range thinking, as leaders would measure their performance in years, rather than in quarters. Knowing that leaders will be on the payroll for several years may also encourage leaders to invest more in their firm's human capital, and board members to think more carefully about whom they select.

Pay fixed compensation. The public sector knows that its leaders should earn a fixed salary, rather than pay based on performance. When leaders can fiddle with their own compensation, the reasoning goes, they may be tempted to fatten their paychecks by fudging the numbers. In other words, performance pay invites cheating.

Corporations have not adopted this philosophy. As a result, although many managers work harder to earn extra money, others "have often found it easier … to influence the measuring rod, even by falsifying figures," the authors write. For example, one study showed that the top executives of firms that cooked their books received higher proportions of stock-based compensation than did the executives of more honest firms. Corporations should offer fixed compensation supplemented with moderate performance incentives. Paying managers 20 percent of their total compensation in restricted stock, the authors suggest, will keep them both honest and entrepreneurial. *–A.C.*