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Center for Research in Economics, Management and the Arts

# **Corporate Governance for Crooks? The Case for Corporate Virtue**

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Working Paper No. 2005 – 10

# CORPORATE GOVERNANCE FOR CROOKS? THE CASE FOR CORPORATE VIRTUE

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**Abstract:** Corporate scandals are reflected in excessive top management compensation and fraudulent accounts. These scandals cause an enormous amount of damage, not only to the companies affected, but also to the market economy as a whole. As a solution, conventional wisdom suggests more monitoring and sanctioning of management. We argue that these efforts will create a governance structure for crooks. Instead of solving the problem, they make it worse. Selfish extrinsic motivation is reinforced. We suggest measures which clash with conventional wisdom: selecting employees with pro-social intrinsic preferences, de-emphasizing variable pay for performance and strengthening the participation and self-governance of employees. These measures help to increase intrinsically motivated corporate virtue and honesty.

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**Keywords:** Corporate Virtue, fraud, intrinsic motivation, crowding theory, pay for performance, employee participation.

## **DOUBLE TROUBLE WITH MANAGERIAL BEHAVIOR: EXORBITANT SALARIES AND SCANDALOUS FRAUD**

Recently, the media have been full of accounts of managerial misbehavior. For some considerable time, the often exorbitant salaries of CEOs and other top managers have made the headlines. This is not surprising if one takes into consideration that some managers were able to amass huge incomes in the form of bonuses, stock options and many different forms of fringe benefits and perks. A pertinent example is General Electric's Jack Welch, who in 1998 received 261.5 million US Dollars in stock options, 7.2 million in bonuses and a base salary of 2.8 million. Another example is Disney's Michael Eisner who, in the same year, received 107.2 million, 5.0 million, and 0.8 million US Dollars respectively. On average, the income of the top managers of 10 widely known US companies, such as American Express, Boeing, Coca Cola, Chevron or Merck, amounted to 76 million US Dollars in stock options, 3 million in bonuses and 1.3 million in base salary (The Economist May 8, 1999: 4). As a consequence, the imbalances in income distribution have deteriorated significantly. In 1970, an American CEO earned, on average, 25 times as much as an industrial worker. Twenty-six years later, in 1996, the average CEO earned about 75 times as much, taking only base salaries and bonuses into account. If we look at income including exercised stock options, the income differential reaches an almost incredible level. The ratio rises from a factor of 25 in 1970 to a factor of 210 in 1996 (Murphy 1999: 2553). The prospect of such huge salaries has led some top managers to act in ways which are detrimental to their firms. In particular, they have jacked up short-term profits, instead of focusing on long-term opportunities, and they have neglected paying out dividends to their shareholders (Lambert, Lanen & Larcker 1989). In his authoritative survey on "Executive Compensation" in the *Handbook of Labour Economics*, Kevin Murphy (1999: 2555) has this to say:

"Although there is ample evidence that CEOs (and other employees) respond predictably to dysfunctional compensation arrangements, it is more difficult to document that the increase in stock-based incentives has led CEOs to work harder, smarter, and more in the interest of shareholders."

Corporate scandals are reflected in fraudulent accounts. Well-known examples are WorldCom, Xerox and Enron. In some cases, the CEOs who fiddle the accounts are the same persons who

receive exorbitant compensations, e.g. Enron's Kenneth Lay and WorldCom's Scott Sullivan (Cassidy 2002). These scandals cause an enormous amount of damage, not only to the companies affected, but also to the market economy as a whole. Many observers argue that the drop in stock prices has gained added impetus as a result of such misbehavior. Investors have lost trust in managers.

However, 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), who state: “. . . 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”. Jensen (The Economist, November 16, 2002: 66) accepts that the existing system of managing compensation, especially by the use of stock options, is seriously deficient; he argues that it has proven to be “managerial heroin”, encouraging a focus on short-term highs, with destructive long-term consequences. But he believes that the system can be salvaged by better-designed share options.

Politicians, and some scholars, reacted in line with this orthodox view of Agency Theory. They suggest more monitoring and sanctioning of management, firstly at the level of the board of directors, and secondly at the level of legal regulations. On the board of directors, a higher number of “independent” directors are expected to curb managerial discretion. In addition, the members of the board themselves should be recompensed with performance-related compensation in order to induce them to exercise more effective control. In the United States, by means of the Sarbanes/Oxley Act, Congress forced the top managers of firms with a turnover exceeding 1.5 billion US dollars to take an oath promising not to fiddle their accounts. If caught breaking the regulations, the CEOs risk serious personal consequences, including imprisonment. Clearly, the public no longer trusts their corporate leaders to be honest without the threat of prison doors slamming behind them.

We argue that these efforts will create a structure encouraging *governance for crooks*. Corporate governance, when based on the principles of monitoring and sanctioning, tends to worsen the very problem it is designed to solve. The apparent remedy raises the incentives by managers and other employees to take advantage of the firm they are supposed to care about.

Instead of stricter monitoring and sanctioning, we suggest that the conditions which led to the breeding of crooks have to be taken into account, as Argyris (1964) already stated forty years ago.

Section 2 argues that the basic problem of corporate governance is the existence of a social dilemma, causing self-interested individuals to neglect the common good of the firm. Corporate virtue is one of the most important common goods in firms. Social dilemmas cannot be solved by still more privatizing, but rather by putting more emphasis on employees' intrinsic motivation to contribute to the common good of the firm. In the third section, we explain the difference between extrinsic and intrinsic motivation and its relevance for mitigating social dilemmas. Section 4 presents theoretical and empirical findings for the crowding-out and crowding-in effect, suggesting that the preferences of the employees are influenced by the way corporate governance is run. Drawing on these insights, the next section explains why traditional Agency Theory does not provide adequate answers to the current problems of corporate governance. Section 6 suggests alternative measures, based on Motivation Crowding theory. The last section concludes.

### **WHAT HAS GONE WRONG?**

It seems that the whole corporate sector has been infiltrated by malpractice, greed and distrust. This happened, despite the fact that most companies were governed by boards composed of outstanding people. Nor has a larger proportion of outside directors had much effect. Some of the most extreme cases of malpractices occurred in corporations with a majority of outside directors, such as Enron (80 percent outside directors), Tyco (65 percent) and WorldCom (45 percent) (Tosi, Shen & Gentry 2003). A meta-analysis of fifty-four studies of board dependence showed no statistical relationship between board independence and firm financial performance (Dalton et al 1998). Moreover, the firms were often audited by well-established lawyers, bankers and accountants. Thus, Enron's auditing committee was chaired by a distinguished accounting professor (The Economist August 17, 2002: 50). How can these facts be explained?

In companies, activities are characterized by a high degree of complex interdependencies (Thompson 1967; Grandori 1997, 2000). Simon (1991: 33) makes this point very clear in his important paper on organizations and markets:

“In general, the greater the interdependence among various members of the organization, the more difficult it is to measure their separate contributions to the achievement of organizational goals. But of course, intense interdependence is precisely what makes it advantageous to organize people instead of depending wholly on market transactions.”

However, particularly intensive interdependencies create a special kind of governance problem. Their outcome cannot be attributed to any particular actor. Therefore, incentives for free riding arise (Osterloh, Frost & Weibel 2002). In this situation, there is immediate danger of a social dilemma.

Thus, social dilemmas are at the heart of a firm's activities, in contrast to competitive markets (Miller 1992; Frey & Osterloh 2002). Social dilemmas arise if the actions of self-interested individuals do not lead to socially desirable outcomes. This kind of conflict between individual and collective rationality is modeled in the prisoners' dilemma game. Dawes defines social dilemmas as situations in which “... a) each individual receives a higher payoff for a socially defecting choice (e.g. using all the energy available, polluting his or her neighbors) than for a socially cooperative choice, no matter what the other individuals in society do, but b) all individuals are better off if all cooperate than if all defect” (Dawes 1980: 169). Self-interested individuals do not consider the externalities their actions impose on others when choosing their course of action, leading to either overuse (in the case of external costs) or undersupply (in the case of external benefits) of the collective goods in question. In firms, social dilemmas arise whenever a group of people jointly use or produce some resources without having the possibility of attributing the value of their consumption or production to the individuals of this group. Such a situation has been called the “tragedy of the commons” (Hardin 1968). Today, the most important “commons” in companies are not only accumulated organizational knowledge or absorptive capacity, corporate culture and common organizational routines, as widely discussed within the knowledge-based theories of the firm (e.g. Grant 1996; Kogut & Zander 1996; Nonaka & Takeuchi 1995). Rather, we argue that a crucial “commons” consists of *corporate virtue*. This entails a generally shared notion of what business honesty is about and behaving honestly, even when not being watched. Corporate virtue, similar to corporate reputation, is a public good within the firm. As is the case with all public goods, the characteristics of non-rivalry and non-excludability cause a problem of undersupply, unless formal sanctions or informal mechanisms such as peer pressure raise costs (Kandel & Lazear 1992) or the common good enters into the

preferences of the employees (Sen 1974). Efforts to solve this social dilemma by offering private incentives are doomed to failure if employee's contributions are not measurable, as is the case with intensive interdependencies. Under such circumstances, market failures are imported into the firm (see e.g. Vining 2003).

The scandals demonstrate that such undermining of corporate virtue has indeed taken place due to individual incentives. In the case of Enron, people were paid like entrepreneurs. Short-term thinking and, at the same time, performance distortion were encouraged (Spector 2003). They were even induced to resort to illegal actions. Dishonest behavior was by no means restricted to top management, but filtered down through many layers within the corporation. With Enron, for instance, it was revealed that the whole board, including its president and vice-president, knew about the malpractice. It was also general knowledge among the firm's employees. In the case of WorldCom, dishonesty was not confined to the accounts' department; the sales staff also falsified the accounts.

What has gone wrong is a general deterioration of *intrinsic motivation* to contribute to the corporate virtue. We refer to a distinction between two kinds of motivation, namely extrinsic and intrinsic motivation.

### **EXTRINSIC AND INTRINSIC MOTIVATION**

In order to distinguish between extrinsic and intrinsic motivation and to study their interdependence, various authors (Deci, Koestner & Ryan 1999; Frey 1997; Osterloh & Frey 2000) offer a new way of mitigating social dilemmas.

*Extrinsic* motivation works through indirect satisfaction of needs, most importantly through monetary compensation. This kind of motivation dominates in conventional economics. The extensive use of pay for performance schemes has focused the attention of both principals and agents in the firm on extrinsic motivation. As a result, employees have been conditioned to perceive the money received as being an overriding incentive.

Extensive research accumulated over recent decades has established the importance of a very different kind of motivation in the firm, namely *intrinsic motivation*. In this case, an activity is



valued for its own sake and is self-sustained. The work content itself provides satisfaction or utility.<sup>1</sup>

*Intrinsic* motivation is indispensable when external incentives cannot solve the problems of social dilemmas, either because behavior is not observable, or because the outcomes are not attributable to individuals. If there is an intrinsic motivation to work and to cooperate, contributing to the common good ceases to become a social dilemma. This is true not only in the case of contributing to common knowledge, but also in the case of incorporating norms of honesty and corporate virtue in firms. Sanctioning of norm-violators in firms is efficient only when there is a certain amount of intrinsic motivation on the part of the one doing the sanctioning, as well as on the part of the norm violator: On the part of the one doing the sanctioning, psychological costs arise while sanctioning the norm violator, because colleagues usually tend to avoid open conflicts. On the norm violator's part, sanctions are more efficient if this person feels shame when it is disclosed that he or she has been free riding. A precondition for feeling shame is at least some minimal intrinsically motivated commitment to the rules. Purely extrinsically motivated persons do not feel any shame (Elster 1999; Orr 2001).

A useful distinction can be made between two types of intrinsic motivation (Lindenberg 2001):

- *Enjoyment-based* or *self-actualization based* intrinsic motivation refers to a satisfying flow of activity (e.g. Csikszentmihalyi 1975), such as playing a game or reading a novel for pleasure. This is the incentive focused on by Deci and his group (Deci, Koestner & Ryan 1999).
- *Obligation-based* or *pro-social* intrinsic motivation was introduced into economics by Frey (1997) as a further important form of incentive. It is crucial in accounting for the existence of corporate virtue.

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<sup>1</sup> In economics, with the exception of Frey (1997), and more recently Benabou & Tirole (2002) and Sliwka (2003), only a few authors deal with intrinsic motivation. Examples are implicit contracts (Akerlof 1982), or norms (Kreps 1997). Some economists admit the existence of intrinsic motivation, but then leave it aside because it is difficult to analyze and control (e.g. Williamson 1975), even if they agree that the assumption of solely extrinsically motivated people is an "extreme caricature" (Milgrom & Roberts 1992: 42). These authors believe that institutions should be designed as if people were entirely selfish. But this has consequences for the crowding-out effect of intrinsic motivation.

A wealth of empirical evidence demonstrates that many people are indeed prepared to contribute to the common good of their company and society. They exhibit *obligation based* or *pro-social intrinsic preferences* (Frey & Meier 2002). Important instances can be found both in the public sphere (tax morale and environmental ethics, see Frey 1997) and in the business sphere. In business, three major instances have been discussed in the literature:

1. According to research in “Organizational Citizenship Behavior”, employees provide voluntary inputs, so-called extra-role behavior, going far beyond the duties stipulated in their employment contracts and the lack of which cannot be punished (Organ 1988; Organ & Ryan 1995). “Organizational Citizenship Behavior” is thought of as a “willingness to cooperate”, and accounts for the relatively low amount of free-riding in organization, compared to what orthodox economists would expect (Simon 1991). Of particular interest with respect to the solution of social dilemmas are helping behavior, organizational compliance and civic virtue, which all include subduing individual interests for the sake of the whole organization.
2. In one of the most innovative industries, software production, a very successful form of so-called open source software production has become a serious competitor to Microsoft. Software, like Linux, is produced voluntarily as a common good. This is done to a large extent without any monetary compensation and private property. Instead, this production is, to a large extent, based on a gift relationship (Raymond 2000; Osterloh, Rota & Kuster 2003).
3. More generally, careful laboratory research in economics and psychology reveals that a large number of people voluntarily contribute to public goods (see the surveys by Rabin 1998 & Ostrom 1998).

These instances show that the social dilemma can be overcome if intrinsically motivated pro-social behavior exists. If the love of work and the good of the community enter into the preferences of the actors, the social dilemma is transformed into a coordination game in which there is no social dilemma.

The reason why corporate virtue – which patently exists in the corporate sector – has weakened, can be located in Motivation Crowding Theory. This is discussed in the next section.

## WHY HAS CORPORATE VIRTUE BEEN UNDERMINED? MOTIVATION CROWDING EFFECTS

Intrinsic and extrinsic motivation are not additive. Rather, there is a dynamic relationship between the two. This dependence has been proved to exist in a large number of experiments (Deci 1975; Deci, Koestner & Ryan 1999), as well as in field research (e.g. Barkema 1995; Frey & Oberholzer-Gee & Eichenberger 1996; Gneezy & Rustichini 2000a, 2000b). These relationships between intrinsic and extrinsic motivation are called *crowding effects* (Frey 1997). These effects show that preferences are influenced by outside intervention. This relationship has important consequences for corporate governance. In the case of fraudulent accounts and exorbitant pay, external intervention took the form of employees' conditioning on monetary incentives.

The Crowding Theory of Motivation (Frey 1997; Frey & Osterloh 2002) analyzes the systematic dynamic relationship between extrinsic and intrinsic motivation. Crowding effects can be subdivided into a crowding-out- and a crowding-in-effect. We discuss each of these effects in turn.

### **Crowding-out Effect**

According to self-determination theory (Deci & Ryan 1985; Deci & Ryan 2000), crowding out can take place *firstly*, because perceived self-determination suffers from external interventions in the form of monetary incentives. As a result, individuals shift their "locus of causality" from inside to outside. Their attention shifts from the activity itself to the monetary reward. The content of the activity loses its importance. In the case of civic virtue, intrinsically motivated honesty was undermined by the presumption that agents act solely in the interests of the shareholders if they are paid enough. It was overlooked that exactly that conditioning on monetary compensation reduces the voluntary commitment to the firm and its shareholders. Such commitment is necessary when behavior and outcomes cannot be monitored or attributed to a particular individual. A pre-condition for crowding-out to occur is that the individuals concerned have intrinsic motivation, which can then be undermined<sup>2</sup>.

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<sup>2</sup> In situations where no intrinsic motivation exists in the first place, monetary rewards can increase performance, like simple jobs working on an assembly line, see e.g. Lazear (1999).

There is much empirical evidence supporting this conclusion (for a comprehensive overview of empirical evidence, see Frey & Jegen 2001). It is impossible to summarize the results here of the large number of *laboratory experiments* on the crowding effect. Fortunately, no less than five formal meta-empirical studies of crowding theory are available. Rummel and Feinberg (1988) carried out 45 experimental studies from 1971 to 1985; Wiersma (1992) carried out 20 studies from 1971 to 1990; and Tang and Hall (1995) carried out 50 studies from 1972 to 1992. These meta-analyses essentially support the findings that intrinsic motivation is undermined.<sup>3</sup> Deci, Koestner and Ryan (1999) conducted an extensive meta-analysis. The 68 experiments reported in 59 articles span the period from 1971 to 1997 and refer to 97 experimental effects. It turns out that tangible rewards undermine intrinsic motivation for interesting tasks (i.e. tasks in which the experimental subjects show an intrinsic interest) in a highly significant and very reliable way. Such undermining is particularly true for monetary compensation. The crowding-out effect is stronger with monetary than with symbolic rewards. The crowding-out effect is also larger with expected than with unexpected rewards. When the problems in question are complicated, the negative relationship between reward and performance is stronger than when the problems are simple (see Deci & Ryan 1985; Heckhausen 1991, ch. 15). In all cases, the behavior was initially perceived to be interesting and therefore intrinsically rewarding.

These laboratory experiments all consider effects of external interventions on enjoyment-based intrinsic motivation. But there are also experiments which focus on obligation-based norms, such as perceived obligations of reciprocity. The experiments by Fehr & Gächter (2002) and Irlenbusch & Sliwka (2003) produce an unexpected result from the point of view of traditional Agency Theory. A treatment with effort-dependent variable compensation leads to lower effort inputs than a treatment with fixed compensation.

The relevance of the crowding-out effect is also supported by numerous *field studies*. The corresponding econometric results are consistent with circumstantial evidence proposed by McGregor's (1960) theory X and theory Y. Another real-life case of the crowding-out effect is provided by blood donors, as argued by Titmuss (1970). Paying donors for giving blood undermines the intrinsic motivation to do so. Though it is difficult to isolate the many different

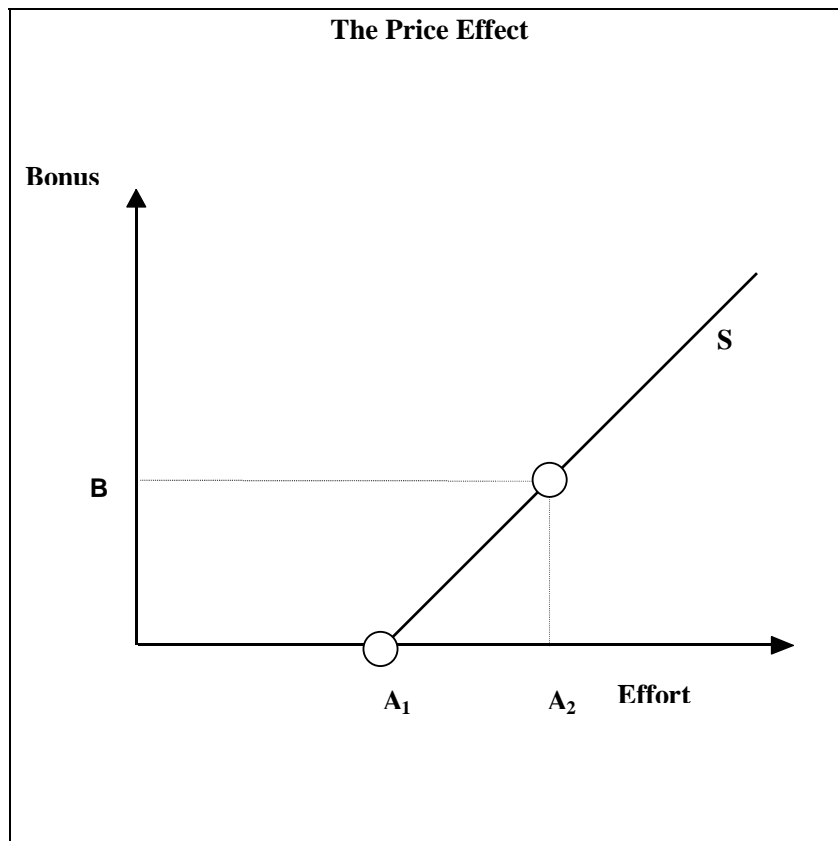
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<sup>3</sup> This view was challenged by Cameron and Pierce (1994) and Eisenberger and Cameron (1996), who concluded that the undermining effect is largely "a myth" on the basis of their own meta-analysis of studies published in the period 1971 to 1991. Deci, Koestner & Ryan (1999) conducted an extensive study to show that these conclusions are unwarranted and that the crowding-out effect is a robust phenomenon under specified conditions.

influences on blood supply, in countries where most of the blood is supplied free of charge, paying for blood is likely to reduce total supply (Upton 1973). The crowding-out effect has also been shown to exist in econometric analyses for the so-called Not-In-My-Back-Yard syndrome, also known as the NIMBY syndrome (Frey & Oberholzer-Gee 1997; Frey, Oberholzer-Gee & Eichenberger 1996). In a carefully designed survey for a community located in central Switzerland, more than half the respondents (50.8 per cent) agreed to have a nuclear waste repository built in their community. When compensation (in monetary terms) was offered, the level of acceptance dropped to 24.6 per cent. Baumol and Oates (1979), Hahn (1989) and Kelman (1981) observed that, under certain conditions, the introduction of environmental charges has little effect. When the penalty for environmental pollution is perceived to be very controlling, people are no longer so motivated to protect the environment for intrinsic reasons. Stukas, Snyder & Clary (1999) show that voluntary contributions to unpaid helping activities are higher when external pressure is low. Gneezy & Rustichini (2000a) found in a field study that fining parents for picking up their children late from a childcare center had an adverse effect. The fine led to a significantly lower level of punctuality. When the fine was discontinued, punctuality remained at the lower level. Obviously the parents' obligation to norms of good conduct was undermined by the external monetary intervention. In a second study, the same authors (Gneezy & Rustichini 2000b) analyzed the behavior of school children collecting money voluntarily, i.e. without monetary compensation (e.g. for cancer research or disabled children). The children reduced their efforts by about 36 percent when they were promised a bonus of one percent of the money collected. Their effort to collect for the good cause could only be significantly raised again when the bonus was increased from one to ten percent of the money collected, but they did not reach the initial collection level again.

This field experiment shows clearly that there are two countervailing forces affecting behavior: the first is the standard *relative price effect*, suggesting that an increase in payment increases effort. This is shown in Figure 1, which illustrates the well-known supply curve of work effort.

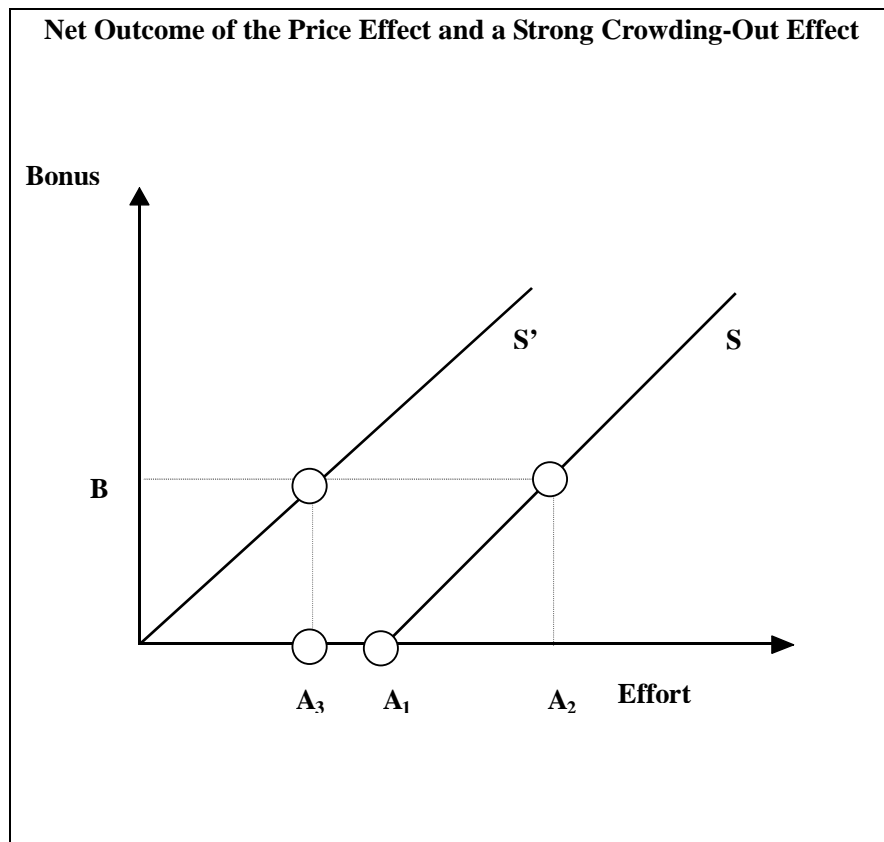
Figure 1



With no bonus, children put in effort  $A_1$ . Provided there is no crowding-out effect, a bonus with the value of  $B$  will increase their effort from  $A_1$  to  $A_2$ . This is the pure price effect.

The second countervailing force affecting behavior is the *crowding-out effect*, suggesting that an increase in payment reduces effort. In our example, both experimental and field studies indicate that children begin to lose interest as a result of the bonus. The supply curve shifts to the left from  $S$  to  $S'$ . As a result, children's efforts fall to  $A_3$ . This is shown in Figure 2.

Figure 2



In this instance, the price effect from  $A_1$  to  $A_2$  is outweighed by the crowding-out effect from  $A_2$  to  $A_3$ . However, this need not necessarily be the case. As illustrated in Figure 3, it very much depends on the intensity of the crowding-out effect. On this occasion, the crowding-out effect shifts the supply curve for effort from  $S$  to  $S''$ . The bonus now increases effort from  $A_1$  to  $A_4$ . Thus, the crowding-out effect can be seen to counteract the price effect. It is difficult to forecast whether the price or crowding-out effect will predominate in any particular case.

There is, however, one essential prerequisite: intrinsic motivation must have been present at the outset, otherwise there would be nothing to undermine. In the case of straightforward activities, for instance, where intrinsic motivation is often scarce, there will be no discernible crowding-out effect.

Figure 3

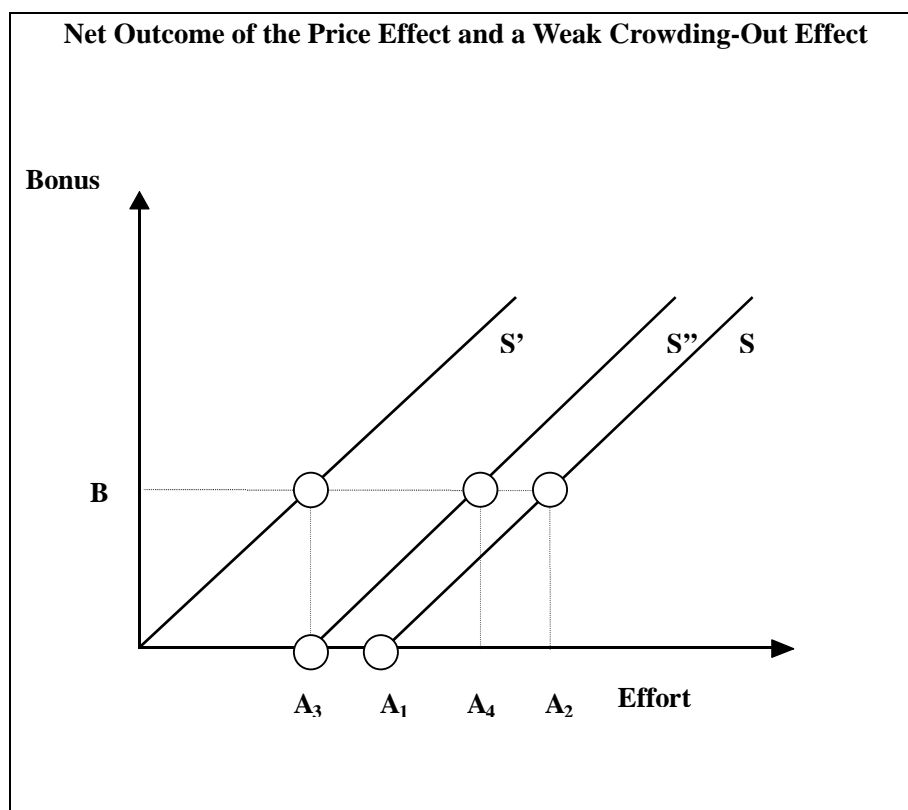


Figure 3 represents the situation which occurred when the children were promised the much higher bonus of 10 percent. While there are no empirical studies so far analyzing the effect of monetary compensation on managerial behavior, one can safely assume that the crowding-out effect carries over to the huge monetary compensations recently administered in firms.

A *second* reason for the decrease in intrinsic motivation is the feeling of being exploited by others. This helps to explain why whole firms, and not only the top management, were subject to all pervading greed and malpractice. Empirical evidence shows that many individuals contribute voluntarily to public goods in social dilemmas, as long as a relevant number of other individuals also contribute. They are conditional cooperators (Levi 1988; Ostrom 2000; Fischbacher, Gächter & Fehr 2001). On the other hand, many people are conditional defectors. As a consequence, intrinsic motivation is crowded out if too many people free ride. Employees' honesty is undermined if they see that their superiors feather their own nests at the expense of their



employees. They are no longer prepared to contribute voluntarily to the common good of honesty and to blame their colleagues if they fail to do so. Therefore, institutional mechanisms must be put in place hindering such exploitation. Corporate governance rules are needed which impose on managers what Hansmann (1980) calls the non-distribution constraint, which is a major precondition for voluntary donations to organizations: voluntary contributions cannot be redistributed among those in charge of the organization.

The exorbitant salaries received by top management thus crowded out intrinsically motivated corporate virtue in two ways. Firstly, the honesty of the managers themselves was damaged in many cases. Secondly, the ensuing malpractices and excessive wages at the top undermined the honesty at lower levels because they felt like suckers. As conditional defectors, they also fell prey to all pervading greed, and were no longer prepared to contribute to the common good. This exacerbates the social dilemma.

### **Crowding-in Effect**

A positive effect on intrinsic motivation of an external intervention or institution is called *crowding-in*. This effect has been investigated much less than the crowding-out effect (but see Deci & Ryan 2000). The most important condition for crowding-in intrinsic motivation is perceived autonomy, but perceived competence and social relatedness also matter. Thus, in Figure 2, the crowding-in effect shifts the supply curve to the right. A pay-rise, accompanied by supportive feedback, reflects appreciation of one's work and thus tends to increase work morale.

The need for *autonomy* refers to the need for personal causation. People, as suggested by DeCharms (1968), have a basic desire to experience themselves as causal agents. They would like to see themselves as initiators of action rather than as "pawns". However, this sense of internal locus of causality can be reduced. In contrast, contextual conditions can support this sense of autonomy if the agent is given choice and if using initiative is encouraged (e.g. Zuckerman, Porac, Lathin, Smith & Deci 1978).

People also share the need for *competence*, i.e. they want to control outcomes and experience efficacy. Each individual seeks to master his or her own way of dealing with the environment. A context, in which feedback is provided, enhances feelings of competence. Being informed influences one's perceived competence and strengthens the feeling of internal control.

Although autonomy and competence have been found to be the most powerful influences on intrinsic motivation, *social relatedness* also plays a role. As this need has only quite recently been incorporated into self-determination theory, not much empirical research has been done so far. However, a promising avenue of research into this area has been the work of Tyler and others (Tyler 1999; Tyler & Blader 2000), who express the need for social relatedness in the so-called group value model. This model tries to explain why people care about fairness and participation. Both aspects convey information on social standing, which in turn defines a person's status in a group and helps shape the person's self-worth (Tyler & Lind 1992). The precise conditions for this to happen are explored in the organizational justice literature, where procedural and interactive fairness have been analyzed for more than twenty years now (e.g. Greenberg 1990; Lind & Tyler 1988).

The next section will show what consequences can be drawn for Corporate Governance.

### **WHY AGENCY THEORY IS INCOMPLETE**

Agency Theory suggests three methods of counteracting the misuse of power by management; intensive monitoring and sanctioning, pay for performance and corporate control by hostile takeovers. All three have proven to be ineffective (Daily, Dalton & Canella 2003; Sundaramurthy & Lewis 2003).

#### **Monitoring and sanctioning**

In an econometric study of 116 managers in medium-sized Dutch firms, Barkema (1995) found that the number of hours worked in the company decreased under intense supervision on the part of the superiors. This study underlines what Argyris (1964) suggests: strict control has a paradoxical effect. It leads to a never-ending and continuously expanding need to increase control. In view of the intensive interdependencies which characterize firms, this is a futile endeavor. Moreover, such an exercise seriously affects the loyalty of employees to their firms. In laboratory experiments, it was shown that negative sanctions crowd out intrinsically motivated trust (Bohnet, Frey & Huck 2001; see Fehr & List 2002, who find similar results). Low levels of legal contract enforcement crowd in trustworthiness. Thus, more order results from less law.

## **Pay for performance**

Pay for performance does not lead to the expected alignment of the interest of managers with those of shareholders. Experience in recent years has shown that performance pay by linking salaries to stock options led to an explosion of compensations 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 more, despite the fact that share prices have plummeted. This suggests that, in reality, 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 amount of money they get<sup>4</sup>. 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 raise their private incomes. Looking back, 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, Bolton & Röell 2002: 47). These shortcomings have not been overcome by the board of directors, which proves unable to effectively control the managers. They would be made worse by the proposal of Agency theorists to compensate board members according to performance. This provides board members with the same incentives as the management to manipulate performance standards. This might explain why equity compensation of board members is not positively associated with firm performance (Daily et al 2003), as Agency theorists have claimed (Jensen 1993).

## **Control by Takeovers**

Corporate control by hostile takeovers has received a great deal of attention from Agency theorists. It has also proven to be far from effective from that point of view.<sup>5</sup> Even in the U.S. and the U.K., it is seldom used and, in most other countries, it is almost non-existent. Managers are obviously able to mobilize anti-takeover defenses, such as super-majority amendments or poison

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<sup>4</sup> See e.g. Benz, Kucher & Stutzer (2002).

<sup>5</sup> From the point of view of directors as mediators of the interests of different residual claimants, anti-takeover provisions make sense. They give directors the leeway to find solutions serving not only the shareholders but also other actors making firm specific investments, in particular employees, see Blair & Stout (2001a: 422).

pills<sup>6</sup>. Moreover, managers successfully supported regulatory interventions, making takeovers more difficult, or preventing them altogether (Romano 1993).

It may be concluded that the fundamental problem of “who watches the watcher” is not solved by existing Agency Theory. In contrast, Crowding Theory provides strong arguments that the measures posed by the Agency Theory *reinforce* the very pro-self extrinsic motivation of managers that it is supposed to defeat. The dynamics between intrinsic and extrinsic motivation must therefore be introduced into an evolving theory to provide a better model of corporate governance and to overcome the problems ensuing from the misuse of management power. Empirical evidence suggests that stricter control and the threat of negative sanctions tend to decrease loyalty to the firm. Therefore, other approaches should be considered.

### WHAT TO DO?

We advance three propositions for the design of corporate governance, taking heed of the insights gained from Crowding Theory:

#### **Selection of Management**

Selection processes should favor employees with pro-social intrinsic preferences. Selection criteria should not be restricted to purely efficiency-oriented aspects, as was the case with many of the scandalous firms. At Enron, with respect to managers, an executive admitted: “I never heard a discussion about a person’s teamwork or integrity or respect” (Spector 2003: 215). This is important, because a higher number of intrinsically motivated, honest organization members increase conditional cooperation. Intrinsic motivation to behave honestly tends to be crowded out all the more if there are a large number of other members of the firm acting in a dishonest way (Blair & Stout 2001b). Human Resources seem to be well aware of the importance of protecting the company from malefactors on the shop floor. In his book on wage rigidity, Bewley (1999) reports many instances where the most important criterion when workers had to be dismissed was weeding out bad characters. But this insight was obviously not applied to management.

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<sup>6</sup> For a description, see Becht, Bolton & Röell 2002.

## More Emphasis on Fixed Salaries

Selecting pro-socially motivated managers does not guarantee that they always act in an appropriate way. According to North (1990: 43), there is a downward sloping demand curve for moral concerns. The more costly it gets, the less people contribute. Conversely, if a low-cost-decision for each individual is at stake, many of them contribute small amounts to the common good so that the total amount of contributions rises considerably. As a consequence, it is important to look for institutions favoring low-cost-decisions (Kirchgässner 1992). An important means to design low-cost situations to overcome the social dilemmas in a firm is to give *fixed salaries* more prominence again. Four empirical results support such a change in policy.

*Firstly*, a recently published review on different types of variable pay suggests that even small percentages of monetary incentives – often as low as three percent of a person’s total pay – increased performance appreciably. It appears that the actual amount of incentive pay as a proportion of fixed pay can be quite small and still be effective (Bucklin & Dickinson 2001). It can be argued that such small monetary rewards are perceived mainly as a feedback which supports crowding in, rather than as an external control.

*Secondly*, public governance teaches us that politicians, public officials and judges receive fixed salaries, because those persons who set the regulations should not be given an incentive to manipulate the corresponding criteria in their own favor (Frey 2003). In management, the exact opposite took place: the top executives were given the opportunity to manipulate the criteria by which they were evaluated and compensated.

*Thirdly*, people behave more cooperatively when they are told to do so. In experiments, subjects behave more pro-socially when the experimenter suggests that they should do so, even without external incentives (Blair & Stout 2001b). Over the last decade, Principal Agency theorists prompted managers and directors to think that performance without incentive pay is irrational. This certainly had an effect on their behavior. As Paul Volker, the former Chairman of the Federal Reserve Board remarked: “Traditional norms didn’t exist. You had this whole culture where the only sign of worth was how much money you made” (Cassidy 2002).

*Fourthly*, there is strong empirical evidence that even honest people are subject to an unconscious “self-serving bias”. In situations characterized by ambiguity or discretion, it is

typical that managerial decision-making judgments of what constitutes fairness conflates with what is beneficial for oneself. Unlike conscious corruption, such conflation cannot be deterred by sanctions (Babcock & Loewenstein 1997; Bazerman, Loewenstein & Moore 2002). Instead, it can be reduced by lowering the incentives to take care of one's own interests. This can be achieved by attributing more importance to fixed wages for managers as well as for board members. With respect to the self-serving bias, it is most important not to compensate the board members according to the same criteria (e.g. stock prices) as the management, because the self-serving bias would unconsciously undermine the willingness to control.

Managers must be paid a fair market wage in exchange for their overall performance, thus reducing the temptations to cheat the firm, consciously or unconsciously. According to Crowding Theory, greater emphasis on fixed salaries reduces crowding out of pro-social intrinsic preferences for two reasons. As we have argued, excessive short-term pay for performance, by means of bonuses and stock options, under identifiable conditions undermines the loyalty voluntarily offered to the company by inducing a switch to a purely calculating mode. As a consequence, a contract including pro-social motives is changed into a purely selfishly motivated contract (Lindenberg, 2003). Moreover, most people only cooperate as long as others do so too. Therefore, when top management lines its pockets, many employees also start maximizing their monetary incomes by whatever means, including fraudulent bookkeeping. Employees are no longer prepared to oppose the wrongdoings of their bosses. They no longer feel obliged to support corporate virtue.

### **Participation and Increased Self-Governance of Employees**

The decision making process of firms must strengthen participation and self-governance as a part of corporate governance. It promotes self-monitoring and sanctioning in an informal way by the corporate community and therewith reduces the breaking of rules. As monitoring and blaming colleagues and superiors carry at least psychic costs (and sometimes ruin one's career), civic virtue is needed. Extensive experimental and field research show that civic virtues are strengthened by procedural utility. Anyone breaking the rules is more easily identified by colleagues than by superiors, and is informally admonished. This has the expressive function of ensuring that others are doing their part in using the common good wisely. Experiments show that sanctions perceived as pro-socially motivated enhance cooperative behavior, whereas sanctions

serving the punisher's self-interest crowd it out (Fehr & Rockenbach 2003). This is important because making people feel shame only works if employees feel at least some minimal intrinsically motivated obligation to follow the rules and to contribute to the common good. Purely rational egoists do not experience any shame (Elster 1999; Orr 2001); this again underlines the importance of intrinsically motivated corporate virtue. This conclusion is empirically supported by evidence in the literature on organizational citizenship behavior (Organ 1988), procedural utility (Frey & Stutzer 2002) and procedural justice (Tyler & Blader 2000).

### CONCLUSIONS

The reactions of Principal Agent theorists and politicians to the malpractices and excessive compensations of top management by intensifying monitoring and sanctioning tend to worsen the very problems they are designed to solve. The apparent remedy raises the incentives of managers and other employees to take advantage of the very firm they are supposed to care about. The conditions leading to "*a governance of crooks*" have to be taken into account. Instead of stricter monitoring and sanctioning, we suggest three alternatives: firstly, the selection of managers should emphasize pro-social intrinsic preferences to ensure the conditional cooperation of other employees. Secondly, care must be taken not to crowd out the corporate virtue based on the intrinsic motivation of managers and employees. We suggest that stronger emphasis should again be placed on fixed salaries to avoid the crowding out effect and to reduce the temptation to cheat. Thirdly, employees' willingness to contribute to corporate virtue by identifying and admonishing anyone resorting to fraudulent accounting must be strengthened by participation possibilities and self-governance.

These proposals clash with conventional wisdom but, based on existing research, they promise to yield better long-term results than governance structures made for crooks.

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