Does Corporate Governance with the Shareholders in Control Make a Difference?

By

Nils H. Hakansson

Sylvan C. Coleman Professor of Finance and Accounting, Emeritus

University of California, Berkeley

hakansso@haas.berkeley.edu

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Abstract

The Swedish corporate governance model differs from most others in that it makes the owners the company’s ultimate decision-making authority. The Nominating Committee is chosen by the Annual Shareholders Meeting and typically has four members representing the company’s major owners and often one member representing small investors, with the chosen slate of board candidates then voted on by the shareholders. This is in sharp contrast to the situation in the United States, where the Nominating Committee is typically chosen by the current board. The ramifications of this difference are profound, in areas ranging from board and executive compensation, the extent of M&A activity, the opportunity sets available to corporate raiders and for private equity and management buyouts, to the frequency of corporate scandals.

Investment in human capital is viewed as a self-evident good since it provides a dual benefit to the corporation. A case can therefore be made that corporate boards could achieve very large benefits and efficiencies by backing two single-payer, independent, and not-for-profit systems, one for tuition-free education and another for universal health insurance, financed by the investment of relatively small but uniform percentages of revenues; (in health care, the elimination of rents and inefficiencies could reduce the proportion of GDP spent on health care in the US from over 17% at present to near the 10% average for the OECD… and with improved outcomes from its present sub-par performance). In return, the corporate income tax could be eliminated, releasing huge resources to much more productive uses. In view of the rather dismal performance of the firms performing auditing, the paper proposes that the board would be better served if a single, highly professional, not-for-profit corporation, empowered to conduct surprise examinations, took their place. Shareholder-centric boards would also be sensitive to company-generated externalities such as emissions, other pollutants, and obesity, open to having them audited, and willing to back corrective actions.
I. Introduction

What do consumer-investors want? In a few words, they seek useful, safe, and interesting products and services at reasonable prices. And they want to increase their own purchasing power via investments in productive transparent enterprises, either directly or indirectly through efficient intermediaries, and in a manner which reflects their tolerance of risk. The majority of individuals’ investments, whether direct or indirect, are in the shares, bonds, or other debt instruments of corporations. This of course is why the way these companies are operated is a matter of central concern, why corporate governance, whether good or poor, ultimately affects us all.

The separation of management and ownership establishes an agency relationship between the main constituents. This in turn necessitates a web of contracts seeking to ameliorate the information gap between the various parties and to provide appropriate incentives. These questions have in turn generated an extensive literature. Earlier studies, such as the classic works of Barnard (1938) and Fayol (1949), by focusing on the management function, essentially ignored agency issues. The first to seriously tackle the conflict between the shareholders and management were Berle and Means (1967), followed by Jensen and Meckling (1976) and later many others.

This paper will address the corporate governance issue broadly since consumer-investors ultimately have the most at stake. Particular attention will be paid to how reducing the information gap at the various decision centers could help improve not only corporate but overall economic performance. Section II gives a summary of the Swedish system for choosing the nominating committee that selects the board candidates to be voted on by the shareholders, a process consistent with shareholder democracy in that it greatly reduces the information gap. The sharp differences between Sweden and the United States concerning the governing powers of shareholders are then illustrated in Section III. As noted in Section IV, these differences impact virtually all of the key dimensions of corporate governance, including whether the chief financial offer and the chief accounting officer should report only to the board.

Since education and health are the key components of human capital, and provide dual benefits to businesses (as well as other economic entities), Section V argues that corporate boards could achieve substantial benefits and efficiencies by backing two single-payer, independent and not-for-profit systems, one for tuition-free education and another for universal health insurance, financed by the investment of (small ) uniform but separate percentages of revenues. In return, as proposed in Section VI, the corporate income tax could be eliminated, releasing huge resources to much more productive uses. In view of the rather dismal performance of the firms performing auditing, Section VII proposes that the board would be better served if a single, highly professional, not-for-profit corporation, empowered to conduct surprise examinations, took their place. Section VIII suggests that a shareholder-centric board would also be sensitive to company-
generated externalities such as emissions, other pollutants, and obesity, open to having them audited, and willing to back corrective actions. A concluding summary is provided in Section IX.

II. Choosing the Members of the Board

The appointment of board members is an area where practices vary widely. The differences are perhaps best illustrated by comparing the United States and the Nordic countries, Sweden in particular (see e.g. Milne 2013) – most other countries place somewhere in between. In the US, the nominating committee is typically composed of members of the existing board, with the board itself dominated by the chairman and the CEO, often in the form of the same person. Even when shareholders are able to make proposals independently, their votes are typically non-binding. As one observer noted, the American corporate governance system “would seem to look upon shareholders much as landowners looked on peasants in pre-revolutionary Russia” (Hansen 2006, p. 75).

In Sweden, by contrast, the nominating committee (NC) is chosen by the annual shareholders’ meeting (ASM). It typically has four members representing the company’s major owners and often one member representing small investors. The NC must have a majority of members not currently on the board and no one can be from executive management. Thus, if a current board member is chosen to serve on the NC, it is because the shareholders so wish, underlining a sharp contrast to the American system. The slate chosen by the NC is then voted on by the ASM.

This approach has two important and desirable features. First it is highly democratic because the shareholders forming the NC typically represent about a fifth of the ownership and thus have the most at stake. Second, it reduces the information gap between the owners and the company in a simple but efficient manner. The largest shareholders have the biggest incentive to be well informed about who would be most effective as directors. As is well-known, most smaller shareholders have no clue about who to vote for on their own. But they are clearly more willing to trust the bigger owners’ selections via the NC than those put forth by an often self-perpetuating slate offered by an NC selected from the current board. Some Swedish NCs engage professional consultants, carefully chosen so as to have no conflicts of interest, to assist in finding the best candidates to serve on the board.

III. The Decision-making Powers of the ASM and NC

The approach discussed above gives the ASM the ultimate authority over the selection of the members of the board as well as the articles of incorporation. The ASM must also approve the board members’ compensation and select the company’s auditors, areas in which the NC provides recommendations. In addition, the ASM must approve the members to serve on the board’s committee for executive compensation, who must be “independent of the company and its executive management” (Dent Jr. 2012, p. 4). The auditor reports directly to the ASM and must include a review of the performance both of the board and of the CEO, including a
reference to whether “any board member or the CEO has acted in way that may give cause for liability for damages.” The NC also evaluates the performance of the directors, often with the assistance of independent outside professional organizations.

From the above, it is apparent that the Swedish approach gives shareholders a degree of power “that only the most daring corporate governance initiatives in the rest of the world could even imagine” (Hansen 2006, p. 69). It truly makes the owners the company’s ultimate decision-making authority.


A particularly illuminating case was reported by Morgenson (2013c). More than 75% of the votes by shareholders were cast against the re-election of one of the independent directors of CommonWealth Real Estate Investment Trust, causing him to resign as required under the company’s guidelines as well as typical practice. But the board then not only reinstated him, but also placed him on its audit, compensation, and nominating and governance committees. The situation is apparently desperate enough that Harvard Law School has found it necessary to start a Shareholder Rights Project.

The American company Berkshire Hathaway stands as a notable exception to standard US practices. Its directors receive negligible fees for their services but are encouraged to invest substantial amounts of their own money in the company’s stock, which is clearly a very effective way to align their interests with those of the other shareholders.

IV. Responsibilities of the Board

In reviewing the responsibilities of the board, I will for consistency focus on the Swedish system discussed above. Its principal responsibility then becomes to implement the instructions of the ASM and NC. In doing so, the board often consults with the major owners as the fiscal year progresses.

The principal duty of the board of course is to appoint the company’s chief executive officer, to approve or appoint the other members of executive management, and to approve or disapprove significant company decisions. The board of course also has many legal and administrative duties which will not be addressed in this study.
When Should the Chair of the Board Also Be CEO?

In many countries, the chair of the board is precluded by law from serving as CEO. But there appears to be no inherent reason why this should be the case. If, as in the Swedish system, where the NC can have no one from executive management and must have a majority of members not currently on the board, the CEO would clearly have no influence over the board candidates voted on by the shareholders. Thus, if the CEO becomes board chair and keeps the CEO position, it is because the shareholders so wish by their own free will. Thus, it is easy to imagine that Warren Buffett, even though he could not himself serve on the NC despite a 20% share ownership, would still be chosen both CEO and board chair.

In recent years, there has been a mild trend in the United States toward separating the board chair and CEO positions because, as noted, shareholders have attempted to exercise more power over how their companies are being run (see Lublin 2012). But it has been an uphill fight for at least two reasons: shareholder votes are not legally binding and crony capitalism is well entrenched. JPMorgan is a recent case in point. The largest shareholders of American corporations are investment management companies (Craig 2013). But in most of them the chairman of the board is also CEO (Sommer 2013); thus their willingness to vote for separating the two positions in the recent and well-publicized JPMorgan case (see Gapper 2012a, Reilly 2013, Fitzpatrick, Lublin and Steinberg 2013, and Eisinger 2013a) would undermine their own cases and is probably the real reason Jamie Dimon succeeded in keeping both positions, the Wall Street Journal’s editorial to the contrary.¹ Thus, it appears that it is the governance structure of the largest investment management companies, preserved in part via their voting power as shareholders, that is probably the single most powerful reason why the process of separating the board chair and CEO positions, and thereby empowering shareholders, is so slow in the United States.

Entrenched corporate governance and crony capitalism are often, but not necessarily, the result when the CEO essentially controls the board and the existing board chooses the NC. Over time, the consequences of this style of corporate governance become only too visible. Executive and board pay become out of line. The search for even larger compensation drives unwise acquisitions. Poor performance soon invites corporate raiders. Private equity firms start circling. The insiders prepare for a leveraged buyout or management buyout at bargain prices. Evidence of gross mismanagement begins to surface. Most of these consequences are avoided when the Swedish corporate governance model is in place.

Compensation

When the board or its ASM approved executive compensation committee decides to engage external consultants, the Swedish Corporate Governance Code prescribes that it must “ensure that there is no conflict of interest regarding other assignments this consultant may have for the

¹ See May 10, 2013 editorial titled “Targeting Jamie Dimon.”
company and its executive management” (Dent, Jr. 2012 p. 7). This is in sharp contrast to practices in the United States where conflicts of interest are common (see e.g. Cox 2006, Morgenson 2006a, and Fogel and Geier 2007); Morgenson 2006b documented how one consulting firm boosted executive compensation for over 1800 clients. While peer groups are commonly employed in setting executive compensation, Bizjack, Lemmon, and Nguyen (2011), for example, provided evidence that the way they are constructed results in upwardly biased compensation. In 2006, Fernandez, Ferreira, Matos, and Murphy (2012) found both the mean and the median of the compensation of US chief executive officers to be twice that of other advanced nations; in 2003, Michel, Bernstein, and Allegretto (2004) show a ratio between the two pay levels of three to one. Terviö (2009) sees over-compensation as the result of market failure in the discovery of talent that generates a negative effect on productive efficiency.

John Pierpoint Morgan is well known for many accomplishments. One of his statements was that the ratio of compensation between the highest and lowest paid should be 20 to 1. Even recent management guru Peter Drucker promoted a ratio between the top and the rank and file of 25 to 1 or less. This multiple began to get far out of line only in the last three decades, and has recently evoked strong reactions (see e.g. Gapper 2012b, Schwartz 2013, Morgenson 2013d, Thurm 2013, Eisinger 2013b, Morgenson 2013e, and Lublin and Ovide 2013). Bloomberg BusinessWeek recently documented that the pay gap between CEOs and their employees was more than 1,000 for eight companies, including Oracle, Starbucks, and Nike; JC Penney led the list with a 1,795 ratio (Blair Smith and Kuntz 2013). Perhaps not surprisingly, Switzerland recently enacted a law requiring shareholder approval of executive pay at all publicly traded companies, joining several other European nations (Alpert 2013). And as noted by Joshi (2013), highly generous golden parachutes are still common in the United States and difficult to tone down (Monga 2013). Concerns over improper executive trades have also been raised (Siconolfi 2012).

The above observations suggest the presence of rents in US executive compensation. Among the arguments in support of rent extraction presented by Bebchuk and Fried (2004) is that executive pay contracts fail to link performance rewards in relation to that of other firms in the same industry. Others offer evidence that executive incentives may have a negative impact on economic efficiency. Smithers (2013) showed that the ratio of corporate investment over cash distributed to shareholders dropped from 15 in the early 1970’s to under 2 in 2013, linking the decline to management incentives. Asker, Farre-Mensa, and Ljungqvist (2013) found that listed companies with executive compensation linked to the stock market invest substantially less, and are less responsive to changes in investment opportunities, than matched private firms. In a sample of 400 executives, Graham, Harvey, and Rajgopal (2005) found that 78% admitted to sacrificing long-term value in order to smooth earnings.

To gain some perspective, how does executive compensation in Sweden, where shareholders do exercise ultimate control, compare with what executives in other countries are paid? Pollard
(2012) reports that Swedish executives have the second lowest purchasing power in the OECD, yet very few wish to move abroad for better pay. Considering that some of the world’s largest, most global, and most profitable companies are Swedish, this observation would seem to provide overwhelming evidence for the presence of rents in management compensation in many countries, especially the United States, and that these rents can gradually be eliminated via shareholder-selected nominating committees which offer a direct path to shareholder control over board and executive compensation.

Mergers and Acquisitions

Even with less control of his/her compensation, the CEO has other ways to influence it. As noted by for example Weidenbaum and Vogt (1987), executive compensation is increasing in the company’s size. One way to increase CEO pay is via healthy internal growth. Another is through mergers and acquisitions, typically assisted by fee-inspired investment banks. The problem with the second version is that they are driven by incentives which often do not benefit the firm or its shareholders, as the record clearly shows (see e.g. Asquith 1983, Roll 1986, Lippin and Deogun 2000, and Intrisano and Rossi 2012). A genuinely shareholder appointed board is more likely to scrutinize, and when appropriate resist, mergers and acquisitions proposed by management or a fee-driven investment banking firm than a board controlled by an imperial CEO. The relative frequency of spinoffs following mergers and acquisitions in the United States lends further support to the insularity of American corporate governance.

Visualized synergies from M&As often fail to materialize and the subsequent integration of sometimes competing cultures often prove difficult. And even with zero net synergies, shareholders are stuck with holding the merged entities in fixed proportions, thus limiting their prior flexibility, and often their expected utility, as shown by Hakansson (1982).

Too Big to Manage

Returns to scale do not continue indefinitely. Larger and larger enterprises soon run into becoming too large to manage efficiently, or simply too big to manage. Genuinely shareholder-controlled companies tend to be careful to not let this happen, since the board would be aware that the major shareholders would only approve expansions and M&A prospects promising clear-cut benefits. But CEOs and boards unshackled from genuine shareholder control, in their drive for power, recognition, and compensation, often end up with an entity too large to manage effectively. But this outcome is unlikely to escape the notice of well-healed corporate raiders, private equity firms, and hedge funds in search of prey.

Corporations are not the only entities that can become too large to operate efficiently. One could argue that the United States government, as currently constituted, has become too large to manage.
Corporate Raiders

Poor management may of course occur even under an ideal corporate governance structure. But it is more likely to happen when serious shareholder inputs are lacking, as the evidence clearly shows (see e.g. Nutall 2012, Icahn 2013b). Well-capitalized activist investors known as corporate raiders then begin to circle, attempting to replace members of the board as a way to change the target company’s direction, virtually always meeting strong resistance from the current management and board. Carl Icahn’s attempt to take control of computer maker Dell, Inc. offers a current illustration (Ovide 2013), as does Daniel Loeb’s push to get Sony to alter its course by spinning off its movie and music businesses (Soble 2013). Activist investors exist in Sweden also but to be able to achieve success, they must as a first step become elected to the NC by the shareholders (Magnusson 2008).

Private Equity Buyouts

When management performs especially poorly, even large companies become targets of private equity buyouts. A huge chunk of new debt is typically issued to finance the deals, which generates substantial tax savings via very large interest expense deductions. But the new debt load also adds precariousness to the purchased company’s financial position, causing many buyouts to end disastrously. With the goal of taking the acquired company public in a relatively short time, the focus becomes one of cutting expenses, often including retiree benefits, rather than on investments with longer-term benefits. In light of the high fees private equity firms charge (typically 2% of assets and 20% of profits), their return on equity becomes highly sensitive to the timing of the acquisition and its sale. Poorly timed purchases typically backfire.

Under a Swedish style corporate governance system, poor management is unlikely to persist for long, since shareholder pressure would swiftly force replacement. Opportunities for profitable private equity buyouts would then be sharply diminished.

Management Buyouts

When crony capitalism at the top drives the share price to a low level, for whatever reason, management itself will see opportunities for obvious and lucrative managerial actions. A management buyout (possibly in conjunction with private equity) then serves as a vehicle for capturing huge, leveraged gains (see e.g. Stein 1986). But in a shareholder-controlled corporate governance system, such opportunities are likely to become rare since crony capitalism finds it difficult if not impossible to flourish in such an environment.

Gross Mismanagement

Crony capitalism when practiced under the direction of an imperial CEO has on occasion led to gross mismanagement. Tyco under Dennis Kozlowski, Enron, HealthSouth, WorldCom,
Adelphia Communications, and Olympus are just a few examples in which executives are serving, or have been sentenced to, long prison sentences. These events seem inconceivable had the companies in question been operated under a model of shareholder power like the one that exists in Sweden.

**Should the Chief Financial Officer and Chief Accounting Officer Report to the Board?**

One way for the board to get a less biased opinion from the CFO is for that position to be appointed by, and reporting directly to, the board. This way the CFO would not feel pressure, or fear for his job or compensation, from an aggressive CEO determined to have his way. And a full vetting by the board of a company’s financial plans and operations would seem to have zero downside since it would not detract from the CEO’s powers to engage with the CFO in developing productive concepts.

When the Chief Accounting Officer is hired by, and reports to, the chief executive, as is usually the case, he or she may give in to pressure to conceal unfavorable information for fear of being fired or seen as an obstacle. Or the admonitions of the accounting staff may just be ignored by management (as happened near the end of Enron’s presence on our planet). A case can therefore be made that the CAO should operate independently of the CEO and report directly to the board. In addition, one can readily argue that the measurement of the corporation’s performance is of central concern to its owners, should be independent of how it is run, and is almost never within the expertise of the CEO.

**Summary**

To summarize, despite increasing shareholder activism in the United States, CEOs and their boards tend to perpetuate themselves. The principal reason is that the current board chooses the NC and that the CEO is still commonly the board chair. The major voting shareholders are usually investment management companies in which the CEO is more often than not also chair of the board. It is these two components which together are primarily responsible for making the present American system more or less self-perpetuating.

This inbreeding, as noted, has several negative consequences from its perverse incentive structure. It results in excessive compensation, unwise mergers and acquisitions, and companies that are too big to manage efficiently, which in turn attracts corporate raiders seeking to take control. Private equity firms and hedge funds see opportunities for take-overs and even the company’s own executives at times arrange a management buyout at bargain prices.

The employment of independent directors has in recent years become common in the United States. But they typically have very small (or zero) share ownership in the company and their director’s fee is often a substantial part of their income. Being on the board also brings an

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2 At HealthSouth, no fewer than five CFOs participated with CEO Scrushy in that company’s fraudulent activities.
element of prestige. The independent directors’ ability to think as owners, and their willingness to challenge an entrenched management, is therefore essentially inconsequential. A recent study suggests that this was indeed the case during the 2007-08 financial crisis (Ringe 2013). The role of independent directors is therefore essentially symbolic, without adding anything substantive to the inbred American corporate governance structure.

The best way to correct the crony-style corporate governance situation in the United States would be top adopt the Swedish model. In the Swedish system, as noted, the NC is selected by a committee chosen by the largest shareholders and cannot include a majority from the current board nor any member from management but may include an individual representing small shareholders. Since the largest shareholders have the resources and incentive to be well-informed and usually have a longer-term perspective as well, this model appears to bring us as close to genuine shareholder democracy as is practical.

The Berkshire Hathaway corporate governance model is also worthy of praise. Directors receive negligible fees but are encouraged to invest a substantial amount of their own money in the company’s shares. Executive stock options are totally absent from The Berkshire Hathaway corporate structure; compensation is based on salaries and bonuses only.

V. Does Corporate Governance Have a Co-Operative Role in Human Capital Investment?

The quality of human capital has a significant influence on the prosperity and well-being of a nation and its companies and consumer-investor shareholders, for two reasons. First, educated and healthy employees clearly improve the ability of the company to provide competitive products and services. Second, educated and healthy customers have greater purchasing power. The company therefore sees investments in human capital as self-evidently good.³ Such investments have two principal components, education and the care and promotion of health. Many countries leave these tasks to the government with financing provided primarily through taxation. Other nations, the United States included, employ a mixture of taxation and corporate and individual funding. In health care, the US has seen a recent gradual shift of the private financial burden from the corporation to its employees. The quality of a country’s human capital and infrastructure are clearly key ingredients determining that nations’ competiveness.

Investment in Education

Primary and secondary education is generally financed with public funds but private tuition-based schools can be found in many countries. At the university level, there are two basic models: one is tuition-free or nearly so and thus relying on taxation while the other relies heavily on tuition in addition to public and private funds. Most of the world uses the first approach while the second model has become the norm in the United States, with college costs of over $60,000

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³ Of course, companies producing and selling poor quality or junk products or services may disagree.
per year not uncommon and tuition reaching $40,000 even in public universities (Reynolds 2013, Lavelle 2013). One result of the second version, exacerbated by the recent economic downturn, has been to leave Americans with student debt of more than $1 trillion at a time when jobs are somewhat scarce (Lowrey 2013).

A recent OECD study of 37 countries showed the United States in 36th place in government spending on early childhood education (the Czech Republic was the leader) but near the top on late childhood education (Porter 2013a). In international comparisons, students from South Korea, Finland, and Singapore usually top the performance list. More surprising is that the United States, once the leader, now ranks only 14th in the world in the percentage of 25-34-year-olds with higher education degrees; this is most likely in part due to the recent sharp increases in tuition fees (Blow 2013). Not surprisingly, these rankings persist into the adult level, as measures of literacy, numeracy, and problem-solving skills reveal in another comprehensive study (OECD 2013). Gordon (2013), Peterson and Hanushek (2013), and Gates and Boren (2013) have reminded us that education and public colleges are key drivers of economic growth. Sen (2013) has argued that one reason India trails China is because of its failure to invest in the education and health of the poor.

Sweden, in a program to offer choice at the primary and secondary education levels, has provided government financing to private equity firms to essentially compete with the public system. This has not surprisingly generated considerable criticism (see e.g. Löfven and Andersson 2013, especially as a result of operator bankruptcies (see e.g. Schottenius 2013, Jällhage and Lucas 2013, and The Economist 2013).

Investment in Health

The United States spends more than 17% of GDP on health care, far more than any other country. The Netherlands is second with 12% while the average for the OECD is less than 10%. More than half of US expenditures are from private funds (Mitelman 2013); see also Cutler and Scheiner 1999 and Andersen, Reinhardt, Hussey, and Petrosyan 2003). But these huge expenditures are not providing commensurate results. In a study comparing 17 nations commissioned by the National Institutes of Health, the Institute of Medicine (2013) found that American men ranked last, and American women next to last, in life expectancy. Americans also ranked at or near the bottom in infant mortality and low birth weight, heart disease, chronic lung disease, obesity and diabetes, HIV and AIDS, drug-related deaths, adolescent pregnancy and sexually transmitted infections, injuries and homicides, and disability (see also Kearney and Levine 2012). Perhaps the most surprising finding was that white, insured, college-educated or upper income Americans are in worse health than similar individuals in other countries. On the

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4 In Finland, teachers “are considered ‘esteemed professionals similar to medical doctors, engineers, and economists,’ and they are trained accordingly” (Saalbach 2012). For comparison, only a small percentage of American teachers come from the top third of college graduates (Keller 2013).
only positive side, Americans who reach 75 can expect to live longer than people in the peer countries, probably thanks to the Medicare plan for the elderly.

What explains this dismal situation? One is the cost structure which procedure by procedure far exceeds what other nations charge (Rosenthal 2013a, 2013b, 2013c). Another is the wide variation in what different hospitals charge (Meier and McGinty 2013). What Medicare and insurance companies pay generally appears reasonable but the uninsured are billed many multiples of their prices – often leaving them bankrupt (Brill 2013). 120 leading cancer specialists recently joined forces in a protest against drug costs (Collier Cool 2013). Many performed surgeries are questionable (see e. g. Whoriskey and Keating 2013). Medical conflicts of interest also appears to play a role (Carreyrou 2013, Rau 2013, Pearl 2013, Welch 2013) as do medical errors (Southwick 2013) and medical identity theft (Robertson 2012). Many uninsured travel abroad to counties like India for treatment, because the total cost including travel expenses is typically substantially smaller than being treated at home (Gokhale 2013). In sum, it is evident that the cost/results ratio for the American medical system reveals the presence of large rents and inefficiencies.

The Case for Single-Payer Not-for-Profit Education and Health Insurance Plans

For most products and services, the information gap between buyer and seller is not large. In most cases the buyer will have the opportunity to pre-check the item being purchased, test-drive it, or get an implied warranty without charge. In education, the process is lengthy and more difficult to evaluate in advance, especially at the childhood level where program changes are frequent and funding levels are often uncertain. In health care, the information gap between the patient and the doctor is especially large; unnecessary surgery and malpractice are all too common and very difficult to foresee. And if you are severely injured, you are forced to have complete trust in the ambulance service, the hospital, and the attending physicians. Complicating the situation is the patient’s typical ignorance of the financial incentives which affect medical treatment decisions.

When the information gap is large, as it clearly is in health care and education, it is relatively easy for the service provider to take advantage of the situation by either over-charging or providing sub-standard service, both of which are difficult to discover and even more difficult to have remedied. And remedies, even if obtained, are usually very expensive in time and money for both sides.

Since the domestic business community ends up bearing most of the cost of the inefficiencies and rents of the American health care and education structures, it has the largest incentive to restructure them. Of course, the full value of these incentives only becomes visible when viewed in a longer run perspective. And only a unified effort can provide the full payoff so this is where the business community as a whole needs to engage in a joint effort.
Experienced and dedicated educators essentially agree on what constitutes a good education in the sciences, humanities, and the arts. The ancient Greek adage of a sound mind in a sound body still provides a good model. Recent misadventures in foreign policy remind us that a meaningful curriculum should include a comprehensive history of the world and of religion. The best minds in education also subscribe to the Finnish model of teacher training. Similarly, experienced and dedicated medical professionals essentially agree on how to provide sound health care to the ill as well as preventive care and on what constitutes effective professional medical education.

The distinguishing feature of the best educational institutions is their not-for-profit status, whether private or public. The same is true for the top medical centers and hospitals, such as the Mayo Clinic and the Cleveland Clinic; many of the top hospitals are university affiliated.

What is needed then, in order to minimize the information gap and to facilitate operational efficiency, are two single-payer, independent, and not-for-profit administrative structures, the first focused on primary and secondary education and on covering university tuition, and the second serving as a national health insurance institution. For simplicity, I will call the first organization the Education Investment Fund to be run by the Education Investment Board; similarly, the Health Investment Fund would be run by the Health Investment Board. Both boards would preferably be structured based on the Federal Reserve model, with seven members serving staggered 14-year terms.

Thousands of local parent-run school boards are not likely to come up with the best and most efficient way to teach physics, biology, history, or any other subject. Currently, doctors, hospitals, other care givers, and drug stores have to deal with hundreds of insurance plans that are only marginally different, and interact with the bureaucrats in those hundreds of insurance companies, which is hardly an efficient way of utilizing resources. When salary is the compensation form, and other possible conflicts are precluded, only those dedicated to teaching or to healing the ill are attracted to the education and health care professions, minimizing the incentive to exploit the information gap for personal gain.

Which raises the question: How should the Education Investment and Health Investment Funds be financed? Companies commonly allocate a percentage of revenues to research and development. Since investment in education and health care are similar in nature to R&D, and every company receives a dual benefit from such investment, we would expect every business to be agreeable to investing \( x \)% of sales in the Education Investment Fund and \( y \)% of sales in the Health Investment Fund each month. Once these plans are fully operational, companies will easily find the qualified human resources they need and will no longer have the large expense and worry that accompany employer-sponsored health plans and employee training programs. In

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5 In Finland, it is more difficult to be admitted to education school than to medical school or law school (Saalbach 2012).

6 Such as ownership of suppliers of medical equipment and services that could be favored.
equilibrium, we would of course expect the business community to pass on these investment costs to their customers. But this indirect and essentially invisible process is clearly much more efficient than having millions of people and companies, thousands upon thousands of government bureaucrats, and at least hundreds of insurance companies continually fight it out in an environment of great uncertainty.

Since passive index funds beat actively managed investment programs over any longer period, due in part to their lower fees, both the Education Investment Fund and the Health Investment Fund should invest in stock index funds and bond index funds, preferably on a global basis (see e.g. Zweig 2013). When outflows exceed inflows, it is preferable for the funds to borrow short-term, on a roll-over basis, as shown in Hakansson (2013) with reference to his proposal for the Social Security Trust Fund.

No change of this magnitude can happen overnight of course. There will therefore need to be a transition period – in the US from an unsatisfactory educations system at the lower and middle levels and exorbitant tuition levels at the university level, and from a ridiculously expensive health system with sub-standard outcomes to a much improved standard in both education and health care, all to the benefit of the individual, the business community, and the economy as a whole. In particular, we could expect the proportion of GDP spent on health care in the US to decline from over 17% of GDP at present to near the 10% average for the OECD… and with improved outcomes from its present sub-par performance. Part of the improvement would be due to healthy life-style instruction at the lower and middle levels instituted by the Education Investment Fund.

VI. Should Businesses Pay Income Taxes?

The official corporate income tax rate in the United States is 35%. But the effective tax rate was recently 12.6% (McKinnon 2013), and more than half of businesses pay no income taxes. General Electric, with 975 people in its tax department, has been particularly effective in lowering its tax bills (Kocieniewski 2011). A common tax reducing strategy has been to locate subsidiaries in Ireland (Holzer 2013, Rattner 2013). In the United States, corporate income taxes as a share of all federal taxes has dropped to about 10% (Porter 2013c).7

If, as proposed above, businesses essentially cover the costs of education and health care through their human capital investment plans, their contribution to the economy is likely to be much greater than any corporate income taxes in hands of the government could achieve. Since elimination of the corporate income tax would also free up large amounts of human capital both

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7 A recent cartoon suggests that it’s good to be an American at tax time (Bloomberg BusinessWeek 2013). Tax identity theft has also recently become common in the United States (Vance Jr. 2013).
inside and outside the corporation, resources that could then be placed in more productive uses, a strong case could indeed be made for killing the corporate income tax.8

VII. Does Corporate Governance Extend to a Co-Operative Role in Auditing?

In the early part of the second half of the twentieth century, the bulk of corporate auditing was performed by eight firms, referred to as the Big Eight. Through mergers, the number was gradually reduced to the Big Five. Since the big auditing firms also were very active in consulting to the same group of companies, often generating conflicts of interest, and needed to compete against each for their clients, audit performance often ended up suffering. Some of the bigger scandals involved Enron, WorldCom, Tyco, HealthSouth, and Olympus. One of the Big Five, Arthur Andersen, ended in demise, leaving us with the Big Four. But audit scandals have not ended, with two of the most recent involving MF Global (Luchetti and Rapoport 2012) and Peregrine (Dugan and Rothfeld 2012). Dissatisfaction with the auditing profession is a continuing occurrence (Norris 2012, Wyatt 2012, Jones 2013, Rapoport 2013a, Lattman 2013, Catanach 2013, Norris 2013a, Smyth 2013, Bråse and Larsson 2013, Norris 2013b, 2013c). Despite the Sarbanes-Oxley Act, multi-tasking conflicts have apparently not disappeared (Rapoport 2012). Not surprisingly, The Public Company Accounting Oversight Board is feeling compelled to take action (Rapoport 2013b).

Since consumer-investors are the ones who ultimately bear the bulk of the costs associated with audit failures and the shortcomings of the current audit structure, they have an incentive as shareholders to instruct their boards to co-operatively change the audit model to something like the Audex Corporation. Being not-for-profit with a well-paid staff of salaried professional auditors, it would charge fees of x% based on total assets and y% based on total revenues annually for each company. The Audex Corporation, to be fully effective, would also need to have the right to make surprise audits at any time.9 The second element, unannounced visits, is likely to reduce the frequency of accounting misdeeds by keeping the Chief Accountant’s Office on its toes.

VIII. Should Corporate Governance Include a Co-Operative Role in the Economy’s Performance?

Recent economic history has displayed sharply changing trends. The US was once the leading nation in social mobility but has recently fallen behind most of Europe (see e.g. Stiglitz 2013). In the 2012-2013 Global Competitiveness Index of the World Economic Forum, the United States ranked seventh, behind Switzerland, Singapore, Finland, Sweden, Netherlands, and Germany. US corporate profits, for long periods hovering around 6% of GDP, have recently risen to about 10% of GDP while inflation-adjusted average US manufacturing wages have dropped to about

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8 Hedge fund guru Stanley Druckenmiller has argued for eliminating the corporate income tax as well as taxing the dividends and capital gains of individuals at ordinary income rates (Freeman 2013).

9 Surprise audits of the mutual fund industry by the Securities and Exchange Commission have been very effective.
$19 from over $21 in the mid-1970s (see e.g. Kimes 2013). Many of these changes are attributable to a significant deterioration in the relationship between business and government since the late 1970’s.

During the period between World War II and the mid-1970’s, the relations between business and government were mostly constructive, with the business community cooperating with labor and supporting significant government investments in education (such as the GI Bill), infrastructure (e.g. the interstate highway system), R&D, and many social programs (see e.g. Mizruchi 2013). The results have been overwhelmingly positive, with the US government having funded the science behind our most pathbreaking innovations (the internet, GPS, touch screen display, voice activation, nanotechnology, major drugs, even fracking), in effect replacing the private sector where it has been reluctant to risk failure (Mazzucato 2013). The number of commercial spinoffs from DARPA (Defense Advanced Research Projects Agency), NIH, and NASA alone are huge (see also Temple 2013).

Since one of the core economic facts is that the propensity to consume is declining in income, much of the post-1970s trend has provided a negative influence on economic growth. Economic history also shows that economic growth is greatly influenced by what happens to the middle class. A robustly growing middle class provides a strong positive influence on economic growth while a stagnating middle class has a negative effect. Anyone involved in corporate governance would thus be advised to keep these facts in mind in determining which national economic policies to actively support.

Carbon dioxide levels in the atmosphere recently set a new record of 400 parts per million (Borenstein 2013). A comprehensive study based on data from 1981 to 2001 by two Chinese, one Israeli, and one American scholar found that the life-span in Northern China has decreased 5.5 years in part as a result of pollution from coal (Wong 2013, Hook 2013; see also Ma 2013). Other pollution studies record effects on autism (Wang 2013), cadmium levels in food (Chen 2013), algae growth, groundwater contamination (Rodriguez-Lado, Sun, Berg, Zhang, Xue, Zheng, and Johnson 2013), wildlife (Associated Press 2013), and on many other objects. While many companies are ignoring or seem oblivious to these impacts, the insurance industry for one is not – presumably because it will be paying some of the bills (Porter 2013b). Others see climate change as having an impact on markets (see e.g. Leggett 2013). Even some conservative economists have declared themselves in favor of a carbon tax (Schultz and Becker 2013).

Atmospheric emissions are not the only source of pollution. Improper company disposal of waste (Clifford 2013) and some uses of pesticides and waste runoffs also pollute land areas, rivers and streams, and alter the acidity of the oceans.

Companies are also expected to meet certain quality standards for their products and services. Since the quality level in many instances is not readily observable, trade organizations or the government steps in by setting the standard to give the buying public some assurance. But the
standard is not always met (see e.g. Nixon 2013, Harris and Kumar 2013). When it comes to food, the information gap is especially large and the high level of obesity reflects that the sharp conflict of interest between healthy food ingredients and industry profits is far from settled (see e.g. Kessler 2009 and Jack 2013).

**Auditing Emissions and Compliance**

In order to provide a fact-based information set for corporate governance and relevant government agencies as a basis on which to take actions on climate change, other externalities, and their consequences, the current information gap must be reduced. The simplest way to accomplish this would be for businesses to include a summary of emission and disposals in their annual reports\(^{10}\) and for the Audex Corporation described in Section VII to include these externalities as well as various compliance issues in their audit functions. This of course requires the Audex Corporations to have scientists in many specialties on its staff in addition to its accounting professionals. But it would also provide the factual basis that consumer-investors need to make informed investment decisions as well as educated political choices with respect to our health and our environment.

**Changing the Corporate Mind-Set**

As noted by Mizruchi (2013) and others, the current post-1970s inbred structure of corporate governance in the United States, with its strong links to the US Congress, is currently essentially insulated from genuine shareholder control as well as public opinion, climate science, and environmental studies. The world’s largest emitters in particular show no signs of readiness to adapt to climate change (see e.g. Vitelli 2013). But a number of influential current and former executives like Ian Dunlop (Clark and Wilson 2013), Tom Steyer, Henry Paulson, and Michael Bloomberg (Cohan 2013) understand what’s at stake and are becoming engaged. Patchell and Hayter (2013) offer a glimmer of hope by reminding us how the Montreal Protocol of 1987 caused the producing companies to virtually eliminate the production of CFCs (chlorofluorocarbons) and other dangerous chemicals by developing alternative methods. Sweden, where corporate governance is genuinely controlled by the shareholders, has instituted some of the sharpest environmental control measures on the planet.

**IX. Concluding Summary**

The Swedish corporate governance model differs from most others in that it makes the owners the company’s ultimate decision-making authority. The NC is chosen by the ASM and typically has four members representing the company’s major owners and often one member representing small investors, with the chosen slate then voted on by the ASM. Since the NC must have a majority of members not currently on the board and no one can be from executive management, the shareholders are clearly in control. This is in sharp contrast to the situation in the United

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\(^{10}\) Swedish companies carbon emission reports are currently viewed as unsatisfactory (Tuvhag 2013).
States, where the NC is typically chosen from the current board which tends to make it self-perpetuating. The ramifications of this difference are profound, in areas ranging from board and executive compensation, the extent of M&A activity, the opportunity sets available to corporate raiders and for private equity and management buyouts, to the frequency of corporate scandals. Corporate governance at Berkshire Hathaway stands out as a notable exception.

Since educated and healthy individuals improve the company’s ability to provide competitive products and services, and also possess greater purchasing power toward what corporations sell, investment in human capital is a self-evident good. A case can therefore be made that corporate boards could achieve very large benefits and efficiencies by backing two single-payer, independent, and not-for-profit systems, one for tuition-free education and another for universal health insurance, financed by the investment of relatively small but uniform percentages of revenues. In return, the corporate income tax could be eliminated, releasing huge resources to much more productive uses. In view of the rather dismal performance of the firms performing auditing, the paper proposes that the board would be better served if a single, highly professional, not-for-profit corporation, empowered to conduct surprise examinations, took their place. A shareholder-centric board would also be sensitive to company-generated externalities such as emissions, other pollutants, and obesity, open to having them audited, and willing to back corrective actions.

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