Photograph by Steve Cohen

Recent Studies

On tournament theory, global competitiveness, corporate whistleblowing, and other topics of interest.

Research Notes by Des Dearlove and Stuart Crainer

Winning by Losing

Beck A. Taylor (beck_taylor@baylor.edu) and Justin G. Trogdon (justin.trogdon@duke.edu), "Losing to Win: Tournament Incentives in the National Basketball Association," *Journal of Labor Economics*, January 2002. www.journals.uchicago.edu/JOLE

Executives throughout the world know that their performance often is gauged relative to the performance of their colleagues or competitors. Indeed, organizations spare no effort in creating competitive high-performance cultures. But what if there were a system and an environment that actually encouraged losing?

This may seem bizarre, but the situation exists in the American National Basketball Association. Toward the end of the 82-game regular season, teams that have won playoff places are identified. With a number of games remaining, some teams realize that they have no chance of reaching the playoffs. Their seasons are over, and they apparently have little left to play for. But there is one important twist: The bottom-ranked NBA team at the end of the regular season has the first pick of the year's most talented

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college players. The objective of this rule is to encourage the best distribution of talent for the teams and the league. The trouble is, as Beck A. Taylor, an associate professor of economics at Baylor University, and Justin G. Trogdon, a researcher at Duke University, explain, the NBA teams are, in effect, rewarded for losing. Tournament theory — reward structures based on relative, rather than absolute, performance — suggests that as the rewards for losing increase, so does the motivation to lose.

And so it proves in the NBA. Analyzing three seasons, the authors conclude that "NBA teams eliminated from the playoffs lose in order to secure higher draft choices." During the 1983–84 season, Professor Taylor and Mr. Trogdon calculate that teams that were eliminated from the playoffs were about 2.5 times more likely to lose than those that qualified (even considering the effects of the quality of the team and the venue of the games).

Such research, of course, is mainly of interest for the broader management questions it raises. In the public sector, for example, the "poverty trap" means welfare benefits are available only to those whose income is below a certain level. People are rewarded for being below the threshold. Similarly, when it comes to international pollution, heavily polluting nations are more likely to attract foreign investment.

In a corporate environment, tournament theory has been applied to executive remuneration and incentive programs. For example, the Danish academic Tor Eriksson (www.hha.dk/eok/nat/staff/tor_form.htm) of the Aarhus School of Business has researched tournament theory as the basis for executive compensation in more than 200 Danish companies. He concluded that tournament models did apply in that the greater the number of managers involved in the "tournament," the greater the prize in terms of compensation. Further, there is some evidence, he says, that companies with a larger spread of managerial salaries perform better.

Measuring Competitiveness

Jean-Claude Larréché (jean-claude.larreche@insead.edu), *Measuring the Competitive Fitness of Global Firms 2002*, Financial Times Prentice Hall, 2002. www.corvaltec.com/2002report/index.html

Stéphane Garelli (Stephane.Garelli@imd.ch), *IMD World Competitiveness Yearbook 2002*, IMD. www.imd.ch/wcy

Comparing competitive prowess is an increasingly popular academic pastime. Judging by the output of two of the leading business schools, Europe, in particular, is preoccupied with measures of economic virility.

The *Measuring the Competitive Fitness of Global Firms 2002* report, produced by the business school INSEAD, ranks the competitive readiness of leading multinational corporations. No less ambitious is The *IMD World Competitiveness Yearbook 2002*, published by the Swiss business school IMD, which calculates the competitive pecking order of entire countries.

The INSEAD report, produced by INSEAD professor Jean-Claude Larréché, has been published annually since 1998; it ranks the competitive capabilities of companies drawn from among the 500 largest in North America and Europe. The 2002 findings suggest that European companies currently lead the competitiveness parade. Among the 326 companies evaluated, mobile phone giant the Nokia Corporation and car manufacturer BMW are tied for first place, the U.S.-based pharmaceuticals company Pfizer Inc. is a close third, and IBM is in fourth position.

The report's laudable aim is to "provide a balance to the predominantly short term and financial nature of the information generally available on business corporations." Firms are evaluated on 13 business capabilities: market strategy; innovation; mission and vision; corporate culture; performance; customer orientation; organization and systems; human resources; planning and intelligence; technical resources; marketing operations; international capability; and e-business capability (a new category this year). In combination, these give a rating for Overall Market Effectiveness Capability (OMEC).

The data on which the ranking is based is obtained from questionnaire responses; multiple employees from each firm respond to the 182-item questionnaire. The average respondent is a 43-year-old manager, three levels from the CEO, with 17 years of business experience. The obvious weakness in this approach is the subjective nature of the data, which means that the line between competitive fitness and corporate complacency may be a fine one. The fact that companies whose data is insufficient are excluded also makes comparisons between years problematic. BMW is a newcomer this year, for example, whereas General Electric Company, rated third in 2001, is absent in 2002.

The IMD's alternative competitive benchmark comes from Stéphane Garelli, a professor at Lausanne University and IMD. The *IMD World Competitiveness Yearbook* ranks the competitiveness of entire nations. (Professor Garelli is a former managing director of the World Economic Forum, which also publishes an annual Global Competitiveness report.)

Published annually since 1989, the IMD yearbook examines the relationship between a country's national environment and the wealth-creation process, ranking "the ability of nations to provide an environment that sustains the competitiveness of enterprises."

The interactions of four competitive factors are analyzed: economic performance, government efficiency, business efficiency, and infrastructure. Each category is broken down into five subcategories, which are evaluated with multiple measures. In all, data is collated across more than 300 competitiveness criteria. These cover a multitude of measures as varied as GDP per capita, levels of tax evasion, Nobel prizes per capita, and how open the national culture is to foreign ideas.

Here, the news for Americans is more reassuring. The United States continues to top the ranking, as it has since 1992, when it usurped Japan. Its nearest challengers are Finland, Luxembourg, and the Netherlands. Meanwhile, Germany languishes in 15th place, down three places from its 2001 position, and Japan drops another four places to 30th — just one place above China. Nations in the ascendancy include Denmark (up nine places to sixth), the Czech Republic (from 35th to 29th), and South Africa (from 42nd to 39th).

The main story the IMD's 2002 report tells is of the more-painful-than-expected economic hangover that followed the exuberance of 1999 and 2000. In terms of competitive performance, the report suggests, 2001 is a year to forget. Market corrections were more severe than expected, and uncertainty was accentuated by the events of September 11. The global downturn hit some countries harder than others. Denmark's improved position, for example, reflects the fact that it has better withstood the volatility of the global economy (as has the U.K.). Singapore and Mexico are suffering from a cyclical recession. Japan, while still the second largest economy in the world, remains blighted by a structural recession, and is unlikely to see its fortunes reversed in the short term. The full economic impact of September 11 remains "difficult to quantify," the report says.

The Ethical MNC

Terry Morehead Dworkin (dworkint@indiana.edu), "Whistleblowing, MNCs and Peace," William Davidson Institute Working Paper Number 437, February 2002. www.wdi.bus.umich.edu

Peace is a universal objective for which we have traditionally turned to governments and nation-states.

By setting the bar high themselves, MNCs can influence ethical norms in the countries where they operate.

But today, multinational corporations (MNCs) are, in many ways, more powerful than nations. How the power of MNCs can best be harnessed to support the factors that contribute to peace in society — in particular, the linkage between stability and political social justice — is the weighty topic discussed by Terry Morehead Dworkin, a professor of business law at Indiana University's Kelley School of Business.

Professor Dworkin highlights the role of whistleblowing in enforcing ethical standards. Timely as the paper is in light of recent events at the Enron Corporation and other companies, its link with world peace might seem tenuous. However, her argument rests on the notion that global corporations can set an example. The growing influence of MNCs, she says, places them beyond the effective control of many countries. By setting the bar high themselves, multinationals can influence ethical norms, which in turn can help to promote political and economic stability in the countries where they operate.

Efforts to foster "peace through commerce," Professor Dworkin argues, rely on MNCs' upholding such fundamental principles as justice, good governance, information transparency, and giving individuals a voice. In this study, whistleblowing involves "the disclosure by organization members of illegal, immoral, or illegitimate practices under the control of their employers to persons or organizations that may be able to effect action," Professor Dworkin writes.

In many developed countries, whistleblowing is an established, legally codified practice. During the Civil War, the U.S. Congress passed a whistleblowing law to fight fraud among government contractors. In 1971, interest was reignited by consumer advocate Ralph Nader and his call for whistleblowing to stem corporate wrongdoing. Disasters such as the explosion of the *Challenger* space shuttle further highlighted the issue. But it was the introduction of the Corporate Sentencing Guidelines in 1991 (which provided for reduced fines for companies that introduced measures to detect wrongdoing) that spurred American companies to establish internal whistleblowing procedures.

Other countries, including the U.K., New Zealand, and Australia, have also enshrined whistleblowing in legislation. In these countries, as in the U.S., whistleblowing has played a role in supporting social justice; for example, helping to enforce the equal treatment of minority groups and addressing such issues as sexual harassment.

The question is whether whistleblowing can be used as a governance tool in countries where it is a part of neither the culture nor the legal system. In these countries, Professor Dworkin says, three factors are essential. Corporate reporting procedures must be clear, easy to access, and strongly supported by senior management. Ethical codes should concern relatively few issues and be widely understood and accepted. And allowances must be made for cultural adaptation. The latter point is important because such issues as bribery and cronyism are subject to cultural interpretation.

Professor Dworkin concludes that if these conditions are met, then whistleblowing procedures can provide a valuable spur to ethical behavior. "Exporting the idea of whistleblowing helps promote transparency and good government in the larger society," she notes. "Organizational norms matter most when law is the weakest." By establishing formal whistleblowing policies in all countries where they operate, multinationals can help move transitional economies away from reliance on corrupt practices, which are divisive and which ferment instability and a sense of injustice.

Identity in Alliances

Lin Lerpold (lin.lerpold@hhs.se), "Identity by Association: The BP and Statoil Case," Submitted to Academy of Management, International Management Division, August 2002. Unpublished paper.

The rationales for corporate alliances between competing companies usually center on economies of scale and knowledge sharing. Although these are attractive and worthwhile objectives, Lin Lerpold, a researcher at the Institute of International Business at the Stockholm School of Economics, suggests that there can be more to alliances. They may also be used to change the way an organization perceives itself. Her insights are based on analysis of the eight-year-long alliance between two oil companies, Statoil and BP.

The basis of Ms. Lerpold's view is the notion that organizations have an "identity." This is not another word for corporate culture. Instead, she suggests that an organization's identity is made up of how people within the organization perceive it, and of how they believe it is perceived by people outside the organization.

The alliance between the Norwegian company Statoil and the U.K.-based multinational BP began in 1990. It covered R&D, natural gas marketing, and international exploration and production. The unwritten subtext, however, was that Statoil, a much smaller company than BP, saw the alliance as a means by which it could assert a new identity as an international company. "They [Statoil] wanted to become a really international company, and they knew they had to change their mind-set and reputation. Everyone knows that Statoil is using BP in the alliance to do just that," observed a BP manager at the time of the alliance.

The startling thing is that Statoil's driving motivation for entering into the alliance was left informal and unarticulated — in public, at least. Statoil was keen to absorb the tacit knowledge of how to run a global business through its alliance with BP. But no systems, plans, or initiatives were apparently put in place to convert BP's tacit knowledge into explicit knowledge that could be acquired by Statoil.

Ms. Lerpold concludes from this that alliances are often concerned with the unconscious and unsystematic sharing and acquisition of tacit knowledge. In the case of Statoil and BP, this was clearly the situation. But the knowledge was regarded as accessible only through the practice of working together, rather than through a clearly delineated program and process.

An interesting question raised by the paper is the link between what we learn and our sense of identity. If Statoil learned to "become international" in perspective and practice, did the learning acquired by individual employees — by whatever means — change their view of their company?

Also unanswered in this research is what motivated BP to enter into this alliance. The presumption is that having a much smaller company as an alliance partner offers something valuable to BP's sense of identity, too. Alternatively, BP may have entered into the alliance precisely for the standard business reasons — R&D, marketing, etc. — expressed at the time.

CEO Matchmaking

Sam Allgood (sallgood@unl.edu) and Kathleen A. Farrell (kfarrell2@unl.edu), "Is Your Firm a Good Match for the CEO?" *Journal of Business*, forthcoming. www.journals.uchicago.edu

The speed with which many CEOs now arrive at and depart from their jobs is a cause of growing concern. A study of Fortune 200 companies published in 1996 by Harvard professors Rakesh Khurana and Nitin Nohria found that CEOs appointed after 1985 were three times more likely to be fired than those appointed before that date. The apparent acceleration in the turnover of CEOs is focusing attention on the factors that lead to premature exits. Adding to the debate are Sam Allgood and Kathleen A. Farrell, assistant professors of economics and finance, respectively, at the University of Nebraska–Lincoln.

Much of the literature on CEO

turnover has examined monitoring mechanisms after an appointment has been made, especially the quality of the CEO and the role of the board and major stockholders in removing poor performers. But, according to Professor Allgood and Professor Farrell, job match theory — an approach used by labor economists — provides an alternative perspective on CEO churn.

Job match theory emphasizes the fit between the firm and the individual. It assumes that there are no good workers or good employers, only good matches, which are more productive than bad matches. This suggests that the outcome of a CEO succession depends on the quality of the match between the appointee and the firm rather than simply the quality of the individual. For example, a CEO with an outstanding track record as a turnaround specialist may not be a good match with a firm that is financially sound, and this mismatch is more likely to cause an early CEO exit.

The authors analyzed 392 CEO job matches in U.S. companies between 1981 and 1993 (the average firm in the sample had sales of approximately $5.5 billion). Although they do not claim that all CEO turnover can be accounted for by job match theory, the theory does explain the empirical regularities in the CEO labor market. In particular, the researchers argue that the theory provides an explanation for the vulnerability of CEOs in the first few years in the job, as the quality of the match is tested. They found that the risk of a CEO exit increases until the fifth year of tenure and then decreases — a pattern predicted by job match theory, but not by other theories of labor market turnover.

Job match theory also provides an alternative explanation for a widely accepted finding in CEO turnover literature. Studies have consistently shown that firm performance is inversely related to the likelihood of a CEO exit. Previous interpretations of this result were that the board dismisses poorly performing CEOs. Job match theory asserts that an early departure is a natural consequence of a poor CEO–firm match, rather than shareholder pressure. Job match theory then shifts attention from monitoring CEO performance to a wider view of the succession process.

At first sight, these findings may seem obvious. But, on closer inspection, job match theory offers other interesting insights. It questions the notion that a good CEO will succeed in any firm at any time, and focuses attention on what precedes the appointment. Rather than viewing the arrival of a new CEO and the exit of the previous CEO as separate events, it points to a link between them. This has implications for appointing inside versus outside CEO replacements.

In their research, Professor Allgood and Professor Farrell suggest that the best matches arise when insiders follow CEOs who quit, and when outsiders replace CEOs who are fired. In other words, CEOs appointed from within are more likely to be fired if the previous CEO was fired, and more likely to last if their predecessors quit. Moreover, if job match theory applies to the CEO labor market, then it is possible to predict the factors likely to lead to a good match.

None of this makes monitoring or motivating CEOs any less crucial. But it does indicate that a better understanding of the factors affecting the fit between a CEO and a firm could increase the probability of choosing a CEO who will endure. Given the number of bungled CEO successions, that would be a welcome development.

Will Wal-Mart Stumble?
Eleanor O'Higgins (eleanor.ohiggins@ucd.ie) and John R. Weigel (weigel@chapman.edu), "Has Wal-Mart's Magic Formula Expired?" Unpublished paper.

The retail chain Wal-Mart Stores Inc. exerts an increasingly global presence, with more than 1,700 discount stores across the United States and 612 foreign stores as of 2001. Its strategy is built around launching hypermarkets and superstores,

“Job match theory” may explain the vulnerability of CEOs during their first few years on the job.

expanding internationally, establishing a discount club, and, less significantly, introducing local neighborhood markets and online retailing.

Execution of this strategy has relied on some consistently applied practices — low prices, effective implementation of technology (Wal-Mart’s computer system receives 8.4 million updates per minute), use of the company’s growing purchasing power, and a culture geared toward customer service that can be traced back to the “aggressive hospitality” originated by company founder Sam Walton. The result is retailing nirvana: extremely low costs combined with high turnover to maximize profitability.

Although Wal-Mart would appear to have squared the retailing circle, Eleanor O’Higgins, of the Michael Smurfit Graduate School of Business at University College Dublin, and John R. Weigel, of Chapman University’s George L. Argyros School of Business and Economics, in Orange, Calif., sound a few warning bells. Central to the points raised in their paper is the assumption that companies, however large and well established, always seem to decline. The more concrete evidence lies in the changes in the retail marketplace now under way. The authors identify key worldwide retailing trends — changes in consumer markets and store formats, international consolidation, new pricing and branding strategies, and applications of technology.

According to the authors, these trends are already having an impact on Wal-Mart. Their analysis of Wal-Mart’s value chain processes over the past 15 years suggests that its performance in terms of revenue generation, gross margins, and operating return on assets is declining. In the United States, their research shows that Wal-Mart’s operating return on assets fell from 23.69 percent in 1987 to 12.9 percent in 2000 (even more, say the authors, than the ailing Kmart Corporation’s).

Professor O’Higgins and Professor Weigel’s conclusions are based on a model that breaks down the return-on-equity ratio as it relates to individual value chain processes. The components of return on equity are operating return on assets (made up of total asset turnover, gross margin ratio, and organizational infrastructure ratio) and the financial effects multiplier (the interest-management ratio, tax-management ratio, and assets-to-equity ratio).

At the heart of the argument is the need for a company to change, especially while it is apparently ahead of the game. After all, Wal-Mart has managed to generate a total return to shareholders at a compound annual rate of nearly 23 percent over the period examined. But even Wal-Mart cannot assume that what has succeeded before will continue to succeed in the future.

For example, the authors believe that Wal-Mart’s technological edge has long since been blunted because it is easily emulated by competitors. They also suggest that the company’s values and culture need to evolve and broaden from its roots with Sam Walton and Bentonville, Ark., if the company is to thrive globally.

The reality is that Wal-Mart does not have a monopoly on retailing wisdom. Other companies have viable and innovative strategies of their own, which may ultimately prove better suited to international success than Wal-Mart’s. ✚