During the siege of Stalingrad in the Second World War, the Nazis bombed the city every night. Despite pleas from his colleagues, a professor of mathematics always refused to go to the bomb shelter. He told his concerned friends that his odds of being hit were too small to inconvenience himself. One night, to their amazement, they found the professor in the deepest recess of the local bomb shelter. When asked why, he told them, “in this city, there are five million people and one elephant. Last night, a bomb hit the elephant.” In Canada, there are approximately 5,000 fair-sized companies. What is the probability that one of them will hire an executive who will single-handedly destroy the company? The odds are a lot higher for an average Canadian company than for that poor elephant.

Companies risk their survival every day. Most risks they cannot do much about. A competitor starts a rumour about a
Companies risk their survival every day

defective product line. A financial analyst issues a “sell” recommendation because of an interest rate hike. A major client thinks they can find a better deal with another company.
Some risks a company can and should be able to manage. The hiring process should be one of them. Yet one often hears of decision makers going with their “gut instinct” in hiring an executive. Some times they’re right and some times they’re wrong—really wrong. Is there a systematic way to understand the hiring process as more than measuring the height of paper credentials, or divining “personal chemistry”? 

The modern study of economics offers a way to understand the hiring process. A basic economic tool in understanding the executive hiring process is scarcity. That sounds strange since there are lots of people out there who describe themselves as executives. If you posted a notice on the Internet—or even on a
lamppost—saying, “Wanted: executive for high-paying position,” you would be inundated with resumes. Yet, the majority of respondents would be inappropriate, despite impressive educational and work histories. Why, then, is there this scarcity?

Adam Smith identified the reason over 200 years ago: the specialization of labour. As economies grow, individuals perform ever-more specific tasks over and over again until they become highly competent and productive at those tasks. Smith’s logic becomes clearer if you look at the software industry. In a 10 person company, would it be efficient for each person to write his or her own program, produce copies, market it, and then provide after-sales service? Of course not. It would be far more efficient if four programmers wrote programs, an engineer produced copies, three marketers marketed it, and two technicians provided after-sales service. The coming of the “knowledge economy” has further specialized labour vertically by creating new industries and careers. At the same time, “globalization” has specialized labour horizontally by providing Canadian companies with access to new markets, each with particular customer preferences.

The specialization of labour is why, when a company seeks to hire an executive, it usually faces difficulties and uncertainties. The company wants someone with experience at making certain kinds of decisions at a certain level of responsibility, whether the specific area of expertise is marketing, accounting, or human resources. They want
someone with experience in their industry or one closely related. They want someone who can align themselves with their corporate values and culture. In a short time, those 500 resumes on file fail to yield the right person. Compromises may have to be made, thus increasing the risk of making a poor decision. In a competitive business environment, poor decisions usually end up as expensive decisions.

The second important economic tool for

In business, poor decisions are expensive decisions
understanding the hiring process is called transaction costs. Bear with me as I try to explain this fundamental but often misunderstood concept in modern economics. It might help to set the stage by saying who came up with this idea, and why.

Ronald Coase, alive today at 102, began his career in the 1930s by asking a very simple yet disarming question: Why do companies exist at all, and if the corporate structure is so efficient, how come there’s not just one big company?

His analysis brought him to investigate a basic building block of economic life, the contract. He argued that every contract is shaped by what he called “transaction costs.” Specifically, these are the costs incurred by defining what is to be exchanged, negotiating the terms, and monitoring and enforcing the performance of the exchange. Coase posited that if transaction costs were lower, companies would negotiate employment and supply contracts every morning, just as markets daily adjust the prices of the goods and services offered by companies. If transactions costs were nil, why would anyone bother to form a company?

In the real world, however, transaction costs are high. What drives up these costs in time and money are asymmetric information and opportunism. Each party to an exchange does not know what the other knows, and people don’t always either tell the whole truth, or do what they say they will. In short, not many meals would be served if, every day, a restaurant chain had to re-negotiate its contracts with its managers and cooks. In order to avoid the market process in the supply of labour—to lower transaction costs—
companies will typically offer an employment contract on fixed terms for an indefinite period. That is why companies as institutions exist.

There are two basic reasons that there is not just one big company. At some level, the additional cost to a company of supervising and managing a new employee will exceed the employee’s marginal contribution to corporate profits. As well, at some point, there will be a loss from hiring permanent employees as opposed to using contract workers. That is, companies will pay marginally more for having hired permanent employees than they pay for contract employees and the transaction cost of negotiating their services.

The relative level of transaction costs leads to arrangements other than permanent employment. In the labour market, just as with other markets, there is a “make or buy” decision. Do we hire this person permanently, or do we buy his or her services for a short time? At the heart of the much-discussed issue of “outsourcing” is simply the comparison of the relative transaction costs incurred by using either permanent or contract employment. For Canadian companies, the tremendous increase in self-employed individuals (from under 10 percent twenty years ago to 25 percent today) has made it easier to find and hire spot-contract employees, particularly those providing technical services.

Still, for the critical leadership positions, companies prefer the certainty and stability of a longer-term contract with their CEO or COO. Such a relationship understandably generates the loyalty which is a prime incentive for high
performance. At the same time, a long-term contract heightens the risk involved in hiring the right person in the first place. Here we meet again the problems of asymmetric information and opportunism.

Every board of directors wonders when interviewing someone for the CEO position, “Is this candidate telling us everything we need to know to make the best decision?” Is he or she taking credit for increased sales at their last company which were the result either of another person’s efforts, or just plain, dumb luck? Is his or her marriage on the rocks? Would he or she still accept a compensation package 10 percent lower than what they are being offered? The questions are endless, and they’re asked on both sides of the table.

To acquire perfect information about a CEO candidate, if not impossible, is, at least, too expensive in time, money, or the distrust engendered by overly intrusive questions. Hiring decisions have to be made under conditions of imperfect information. The risk of a bad decision can only be reduced, not eliminated, whatever the decision maker’s “gut instinct.”

In assisting companies to make critical decisions under conditions of imperfect information, specialized human resources (HR) professionals are increasingly providing value. Their specialized labour goes beyond simply identifying candidates. That’s easily enough done by any number of means, particularly in our age of telecommunications and the Internet. The comparative advantage of HR professionals lies in their experience. Through repeated assignments and assessments, they
have developed an expertise that a company, which may only hire a CEO once every 5 years, simply has not had the opportunity to develop. Nor, one imagines, would a company last very long, if in order to achieve such expertise, it hired a new CEO every year. HR professionals help companies to lower the odds of hiring the wrong person.

Seen another way, specialization helps to save elephants.

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