By Johan Fourie

MANAGEMENT

Why the wrong people often get promoted

Let's say a managerial position needs to be filled. Who should get the job? A lower-level employee who is outperforming, or the 'correctly-qualified' candidate?

Sechaba is a salesman in a car dealership. He is incredibly good at his job. Each month, he outsells all his colleagues. The reason for his success is that he can assess the needs of his clients as they walk through the door, and he has a Schalk Brits-smile that fosters confidence in him and in the cars he sells. Sechaba is the Tony Robbins of car salesmen.

Then the position of manager of the car dealership opens up. What to do? Should Sechaba be promoted, given his excellent performance at the lower level? Or should his colleague Whitney be offered the role of manager? Whitney has a financial degree and is a conscientious and hardworking team player. She has all the attributes that would make her a better manager. But what will it do to team morale (and incentives for future salespeople) if Sechaba isn't promoted? Would it not seem unfair?

Usually, the theory suggests, that is why Sechaba will be promoted over Whitney, even though Whitney would be the better manager. The Peter principle, a hypothesis developed by Laurence Peter, states that an employee is promoted based on their success in their previous job until they reach a level at which they are no longer competent.

The problem with the Peter principle is that it's been difficult to find real-world evidence that such promotions are actually bad for firms. One argument could be that such promotions are in fact good for firms: It's the incentive of promotion that inspires salespeople to work as hard as possible. There might be costs involved in not appointing the best managers, but if one would remove promotion incentives, sales will collapse.

The counter argument is that salespeople could easily be incentivised through other channels, like rewarding them for each sale.

A new paper in the *Quarterly Journal of Economics* solves this conundrum. Alan Benson, Danielle Li and Kelly Shue trawled through a massive dataset of sales transactions for a panel of 38 843 workers, 1 553 of whom were promoted into managerial positions across 131 US firms, to search for evidence of the Peter principle. They found much evidence: Frequently, those staff members with the best managerial skills are overlooked for promotion; instead, those with the best sales records get the better job.

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This evidence could, of course, be interpreted in two ways. Either firms make mistakes and promote the wrong people, or it could imply that the incentive benefits of promoting based on sales performance justify the costs of promoting workers with lower managerial potential.

The evidence, according to the authors, seems to suggest that firms are not so foolish as to just be making mistakes – firms carefully consider the costs of the Peter principle.

In settings where salespeople are rewarded with strong pay for performance and where managerial roles entail greater responsibility, firms place less emphasis on the sales performance of new promotions. But often firms just appoint the best salespeople, without considering the other qualities applicable to managerial positions.

This seems somewhat surprising because of the significant costs in appointing the 'wrong' people.

To assess the magnitude of the costs associated with firms' existing promotion policies, the authors compare the managerial performance of promoted workers with the predicted managerial performance of workers who would have been promoted under a counterfactual promotion policy that maximises expected managerial quality. "We find that average managerial quality, measured by value added to subordinate sales, is 30% higher under this counterfactual policy."

Yet these costs should be weighed against the costs of lower morale and sales performance of promoting poorer performers. Returning to our example, if Whitney is promoted, Sechaba may simply find a different firm. And, indeed, this is exactly what the authors find: "Workers are much more likely to leave the firm if a teammate with worse sales performance is promoted."

The evidence suggests that firms are largely aware of the difficult trade-offs in appointments. If this were true, one would expect managers that have important roles to be more carefully selected than managers that aren't that important.

This is precisely the authors' finding: In one test, they compare firms where managers oversee larger teams versus those with small teams. If firms do indeed carefully consider the costs on both sides, then firms with larger teams should value better managers more than firms with smaller teams. And it is so: "[Our] findings suggest that when the costs of managerial mismatch are particularly high, firms are more willing to sacrifice the incentive benefits of performance-based promotion tournaments to promote better managers."

It would seem that the decision to promote managers is a careful trade-off between having the right skills for the job and rewarding good performance at a lower level. Sometimes it's best to promote the best person for the job; at other times, though, you'd rather promote Sechaba because failure to do so would come at the even greater cost of low morale and poor incentives.

These lessons apply not only to sales firms, of course. In any hierarchy where skills vary at different levels, the question of promotion based on capacity or performance depends on many factors. Yet one thing is true: In the competitive market, a firm that repeatedly miscalculates the trade-offs, will quickly be replaced by firms that make better decisions. The decision to promote either Sechaba or Whitney to manager is, ultimately, a profit-maximising (or cost-minimising) decision. ■

editorial@finweek.co.za

Johan Fourie is associate professor in economics at Stellenbosch University.

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