

# Leadership by Lot

## **Lots of Luck**

How random in management delivers brilliant results

## **Random Selection of Professors**

The historical example of the University of Basel

## **People's Representative by Lot**

Suggestions for lottery in politics

## **Random Selection Today**

Four reasons for the use of lottery

## **CEO by Lot**

A means against hubris of top managers?

## **Female Leader by Lot**

How to appoint more women to top positions

## **Leadership Experiments**

How discoveries by chance enable progress





# CEO by Lot

How focal random selection mitigates hubris

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Hubris is the tendency of overconfident leaders to abuse power to the detriment of other members of the community. The consequences of hubris are often failed investments or excessive bonuses. We argue that in addition to the established recruitment practices, the selection of CEOs should be based on focal random selection. Hubris is mitigated if a candidate is selected after a screening according to conventional criteria. In a laboratory experiment it was shown that focal random selection in fact reduces antisocial behavior in leaders.

Accounting fraud at Enron, software fraud at Volkswagen, corruption at FIFA – the list of misconduct by top managers is long. Another somewhat laudable example is Deutsche Bank, which has taken enormous risks with its tricks on the American real estate market, so that the IMF officially described it as the “most risky bank in the world”. There are plenty of prominent examples of former top performers whose hubris has inflicted great damage on their companies. Nick Leeson, for example, ruined Barings Bank in 1995, Jérôme Kerviel caused a loss of 4.82 billion Euros at the major French bank Société Générale in 2008, Kweku Adoboli inflicted on UBS a loss of 2.3 billion U. S. dollars in 2011.

## Star CEOs and Hubris

How can it happen that former superstars in business sometimes lose all sense of proportion and inflict serious damage on their company with autocratic measures? Extreme overestimation of individuals' abilities and performance might be the reason. It turns managers into gamblers. If the company is successful, CEOs attribute this to their superior ability and bask in its

brilliance. Their ego and their willingness to take risks increase to the point of excess. The extreme personalization of companies and celebrity CEOs convey to the public the idea that the well-being of a company depends solely on top management.

However, a large number of empirical studies of management research come to a different conclusion.<sup>1</sup> The success of a company can be attributed to the abilities of its CEOs only to a small extent. Instead, it can be explained by many other conditions that are not within his or her sphere of influence – for example, an economic boom, political developments, or simply luck. Corporate growth can therefore rarely be attributed to individual CEO stars, but rather to external circumstances. Bill Gates, for example, admits that Microsoft's success depends to a large extent on the luck of having developed the right product at the right time.<sup>2</sup> In general, the probability of error in predicting the success of a product is 50 percent, and even 70 percent in the case of consumer goods such as films, music or books.<sup>3</sup>

This leads to some explosive conclusions: top managers are successful because they happen to be in the right place at the right time. They mostly are not better than those who competed with them for the top position. They also influence the success of



companies much less than it is believed in the financial market. In addition, there are so-called Halo and Matthew Effects, meaning that 'the rich become richer and the poor become poorer'. The lucky ones receive – because they are allegedly so capable – more and better resources, higher promotion and attention. This makes their shine even brighter, and unjustifiably so. They are more and more convinced of themselves and accept to be celebrated as stars. They assign mistakes to others, become unwilling to learn and resistant to advice. And the subordinates do not dare say anything against it. They know that critical advice is perceived as disloyalty by autocratic superiors. As a result, CEO stars increase the pressure on the board to increase their bonuses – also as a safeguard against times when they are out of luck and are no longer able to maintain the appearance of great achievements. The result is growing income inequality between the few top earners and the rest of the population.

The success of companies is often accredited solely to the top management, who subsequently tend to hubris.

As a consequence, hubris of managers arises. Hubris is defined as 'the abuse of power by individuals who are overconfident and, on gaining positions of power, benefit themselves to the detriment of other members of the community'.<sup>4</sup> Hubris reinforces the tendency to enrich oneself at the cost of others. It also reinforces incentives to take excessive risks. Acquisitions are a good example. In at least half of all cases, they prove to be wrong decisions in the long term. An extensive literature on mergers and acquisitions makes it clear that management's overestimation of their own abilities is usually responsible for such failures.<sup>5</sup>

### Focal Random Selection Mitigates Hubris

Admittedly, hubris as a result of success – be it wrongly attributed or earned – is a human characteristic. A certain degree of a CEO's overconfidence or narcissism might even be necessary to foster innovations.<sup>6</sup> But can anything be done against hubris? Corporate governance instruments, in particular board control,

might help.<sup>7</sup> We suggest an additional and provocative solution: returning to an old and successful procedure that has unfortunately fallen into oblivion – focal selection by lot.<sup>8</sup> In classical Athens and medieval Venice, political positions were filled in a mixed procedure of lot procedures and targeted selection. In the Middle Age other Italian city-states, such as Florence or Bologna, also used elements of lotteries to determine their executive during their great period. In the 18th century, chairs at the University of Basel were chosen by lot from a list of three candidates.<sup>9</sup>

Recently, the discussion about random procedures has been revived, for example in politics in the form of a third chamber consisting of randomly selected citizens. It should enable many interests to be represented in the decision-making bodies and counteract concentration of power and the loss of legitimacy of the political and economic elites.<sup>10</sup> This idea could also be transferred to business companies in several ways. Companies could install a second chamber in the supervisory board, which would be formed according to the lottery principle in order to give shareholders a vote.<sup>11</sup> Companies could also apply a certain kind of random selection with the nomination of CEOs.

A chamber consisting of randomly selected citizens is likely to represent many interests.

We suggested on the basis of a laboratory experiment to introduce focal random selection into business companies following the historical example of the University of Basel,<sup>12</sup> called *Wahl zu Dreyen*.<sup>13</sup> We showed that lotteries are an effective remedy to mitigate hubris of leaders. Three kinds of selection methods were compared in the experiment:

- In the *competitive treatment* condition, in each group the participant with the highest test score in a competence task was appointed as a group leader.
- In the *random treatment* condition, one of the six group members was randomly selected as a group leader.
- In the *partly random treatment* condition, the three highest performing individuals were preselected, and then the group leader was randomly selected from these three individuals.

We found that when overconfident leaders were selected partly randomly, they were less prone to misusing their power. They made decisions that are more beneficial to other members of the group, compared to overconfident leaders chosen through the usual competitive selection process.

These results enrich the toolkit of leadership recruitment with a pioneering perspective and a novel instrument to mitigate hubris. We suggest that it helps efficiently to avoid the many problems we have experienced with overconfident managers. Moreover, lotteries offer some additional advantages: they prevent discrimination, for example, according to race, sex, age or origin. They give people a chance who would otherwise have a bad hand. Quotas become superfluous. Creative outsiders gain easier access to influential positions. Women might encourage women to apply leadership positions.<sup>14</sup> Lot-

### Impulses for Practice

- Star CEOs convey to the public the idea that the performance of a company depends only on the top management though, in fact, success only to a small extent can be attributed to the abilities of its CEO.
- As a consequence, hubris of managers may arise, which inflicts serious damage on their companies.
- Focal random selection – that is random selection after a preselection according to conventional criteria – dampens hubris and furthers pro-social behavior of leaders.
- The findings from the laboratory cannot be transferred directly to practice. Nevertheless, it would be worthwhile to make cautious attempts in the selection of leaders.



teries protect against favoritism and 'old boys' networks'. It is not worth investing in lobbying, manipulation or other attempts to gain influence if the lottery decides.

### Disadvantages of Focal Random Selection

Of course, there are also disadvantages of focal random selection. The most common objection is that the lot does not distinguish between capable and incapable candidates. This objection is less relevant when drawing lots from a preselected pool of capable candidates. One can assume that with a careful preselection those who have made it to the 'short list' have a high level of competence. This is the reason why in our experiment we applied focal random selection after a preselection according to conventional criteria. We also demonstrated in a theoretical model that under realistic assumptions with focal random selection there is a tradeoff between the competence of the selected leader and hubris. This is the reason why recruitment consultants will not lose their jobs when focal random selections are applied. The better they work in preselecting a shortlist of candidates, the more important is the advantage of focal random selection.

Another disadvantage refers to the concern of many people that random selection is 'irrational' or 'arbitrary'. However, seemingly rational decisions are often marred by prejudices, cronyism, nepotism, concentration of power, Matthew Effects, or biases.<sup>15</sup> In such cases, the rationality of decision processes is a façade, and an intentionally random decision may be more rational.

### Conclusion

"Power tends to corrupt, and absolute power corrupts absolutely," the historian Lord Acton once said.<sup>16</sup> The idea of 'CEOs by lot' is a bold one to overcome this problem. We expect that it can be applied as successfully as it was in ancient Greece and in the Republic of Venice. We would be glad if we could encourage some innovative companies to integrate the idea of focal random selection in an experimental way into their toolkit of leadership recruitment.

### References

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### Abstract

Hubris is defined as overconfidence combined with a tendency to abuse the power by CEOs or group leaders. Individuals affected with hubris tend to invest money in highly risky projects or claim exorbitant compensations to the detriment of others. A central factor fostering hubris is success in a competitive selection process. The successful applicant tends to attribute success to his or her own competence – a perspective that is usually reinforced by journalists and the public. Drawing on historical examples, we propose to randomly select the winner out of a pool of eligible candidates that were preselected by a conventional screening process. The random component makes sure that a successful candidate cannot attribute the success of a company to his or her competence only. As a consequence, these individuals will be less prone to hubris. In a laboratory experiment we indeed find that group leaders that are selected by a combination of competence selection and lot, compared to those selected by competence selection only, claim less money for themselves.

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