Article

WHAT MAKES BUREAUCRACIES SO RISKY?

How asymmetric skin-in-the-game leads to risk

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We often sustain or even enhance bureaucracy to avoid risk and failure. But is this the best way to protect our organisations and make them viable? We claim that there is a superior substitute to bureaucratic processes – that is, aligning skin-in-the-game.

Bureaucracy is often the result of trying to avoid risk. We see the potential benefits of some level of standardisation and tight control in areas where failure is not an option. However, we also see that bureaucracy often distances people from the purpose of their organisation and from having something at stake – having so-called skin-in-the-game.

We argue that asymmetric skin-in-the-game, a lack of knowledge in the positions where decisions are made as well as low autonomy and ownership make bureaucracies much riskier in many cases. Here, we will mainly examine the risk factor of asymmetric skin-in-the-game.

Human decision-making is based on skin-in-the-game and then knowledge

In 2017, a young Danish doctor was found personally responsible and fined for the death of a patient on her shift. The court found that she had not adequately journalised her treatment of the patient. The verdict has had major implications for the Danish healthcare system. Doctors have always had their professional pride and personal engagement on the line when treating patients. This provided aligned interests between doctors and patients. But the verdict has changed the symmetry of interests to some degree, and the focus is now on controlling, rather than trusting doctors. Doctors now have a stronger interest in documenting their process – not with the purpose of improving the quality of treatment, but with the purpose of avoiding criticism and penalties.

In another, less tragic story, a kindergarten was challenged by parents picking up their children after closing time. As a response, they introduced a fine for late pickups. The result was that the number of late parents skyrocketed. Their incentive to pick their children up on time had changed from a moral incentive to a financial incentive. There was now a price on late pickups – a price that was too low – and parents could decide whether it was worth paying.

Both stories demonstrate the importance of incentives in human behaviour and decision-making. And more importantly, it shows the impact of asymmetrical interests and when decision-makers have no – or a different – skin-in-the-game than the people who are affected by the decisions.

"Skin-in-the-game" asymmetry

The idea behind skin-in-the-game asymmetry builds on the theory of principal-agent problems. The classic principal-agent problem primarily focusses on the potential financial conflict of interest between the owners of a company (the principal) and the top management of the company (the agent). We broaden this scope to the multiple asymmetries in an organisation at all levels and to more than just financial interests.

In the metaphor "skin-in-the-game", the term "skin" refers to the person involved, and the skin can be defined as "what can you win or lose?" This could be on a financial level, i.e. the amount of money that is at stake, but also on a personal level, i.e. the amount of meaningfulness, professional or personal pride, joy, sadness or suffering that is at stake.

The 'game' is about how your actions affect the overall success of the organisation and how all the pieces of the organisational puzzle work together and as a whole contribute to value creation.

Bureaucracies combine asymmetric skin-in-the-game and knowledge

In start-ups, skin-in-the-game is likely to be more transparent and aligned, and decision-makers are more likely to be in touch with their main stakeholders – customers, employees and owners. In bureaucracies, on the contrary, we argue that asymmetry of skin-in-the-game is larger – mainly because of the hierarchical factor that distance-makers from the decision-impact.

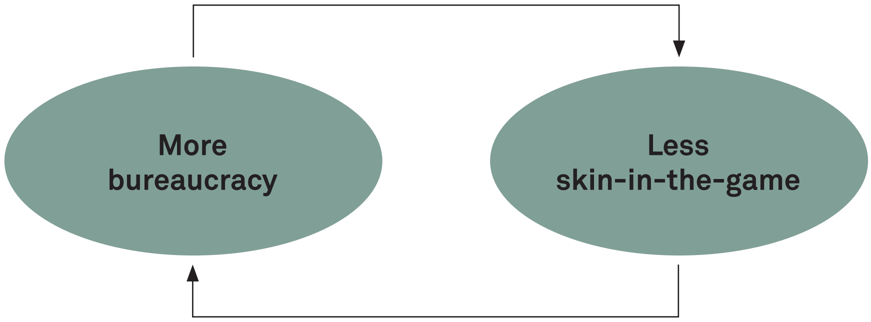
The challenge bites its own tail

People, who are being distanced from the impact of their decisions, have less skin-in-the-game. And a lack of skin-in-the-game leads to more bureaucracy, which then again leads to less skin-in-the-game.

When there is not enough skin-in-the-game, solutions become more complicated, as people are not judged on the true impact of their work, but more on the appearance of it (Taleb, 2017). More meetings, more PowerPoints, more reporting, more decision gates, more meaningless projects.

The consequential bureaucratic escalation removes decision-makers even further away from the impact of their decisions. They don't bear the long-term physical, emotional and financial consequences and they don't have to use their own solutions.

This is where bureaucratic organisations become very risky. They become exposed to high strategic risk due to a lack of innovation and agile adaption to a changing world. And they become exposed to high financial risk due to sub-optimal decisions, i.e. risky tactical bets as a result of people playing with "other people's money".



Examples of how asymmetric skin-in-the-game and knowledge make bureaucracies risky

In our view, a lack of skin-in-the-game leads to poor decisions and lots of risk for the organisation. Danish professor Bent Flyvbjerg has demonstrated this through his research on megaprojects. He shows that the massive and systematic budget overruns on megaprojects can be attributed to "strategic misrepresentation". This basically means deliberate over-optimism in business cases, driven by personal interests in getting projects accepted.

The financial sector's role in the global financial crisis is also an example of asymmetric skin-in-the-game. Traders and financial institutions lost symmetry between the long-term impact on owners, customers and society by taking extreme risks to gain short-term earnings.

In general, our experience from working with organisations shows us that bad, slow and overcomplicated decisions are made because of no alignment of the skin-in-the-game. Here are a couple of concrete examples of bureaucratic processes that we often see in large organisations, which result in substantial risk for companies:

Procurement bureaucracy

In major procurement decisions, it often takes a very long time to make decisions. Templates have to be filled out, lots of meetings are held and there are many differing views that have to be consolidated. It is all done in order to make the right decision. It is not easy to avoid bureaucracy when you have to live up to tender, competition, anti-money laundering and GDPR rules. But over time, the compliance processes often become obsolete and are not removed. Instead, layers of compliance and bureaucracy are built on top of each other. This results in overcomplex processes that reduce autonomy and personal accountability. No skin-in-the-game. Bad decisions.

We see great potential in simplifying the processes, appointing clear responsibility for the procurement decision and offering this person all the necessary help. You can define the few areas where the risk is beyond your tolerance and give the decision-maker autonomy in all other areas. Let him or her decide to what degree consultation with the legal department, co-ordination with the treasury and support from management is needed. If he or she is not able to make a prudent decision, don't see it as a need for more bureaucracy – the same decision would still have been made if we had rolled him or her up in a bureaucracy. The only difference would have been the existence of a pile of reverse engineered templates to support the bad decisions. Instead, the bad decision should be seen as a lack of skin-in-the-game, skills, training and/or culture.

Enterprise risk management bureaucracy

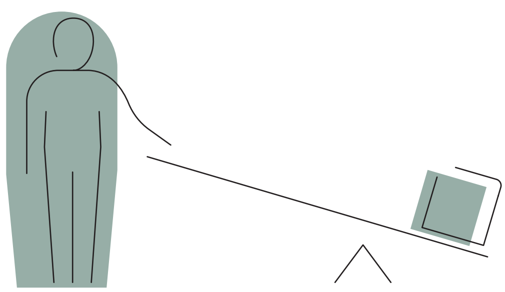
Since the turn of the century, centralised risk management has been established in most medium-to-large organisations. Driven by the experience from 9/11, corporate scandals like Enron, WorldCom and Parmalat and the global financial crisis, boards became very interested in enterprise risk management (ERM) and wanted to follow recommendations from guidelines such as COSO and ISO.

Unfortunately, the good intentions of systematic risk management have, in many cases, been implemented very poorly. We see many examples of companies where ERM has become a reporting discipline with no impact. They follow the same recipe: the whole organisation does bottom-up reporting each quarter. The corporate risk management function then consolidates the input which is often a messy load of non-risks, personal interests and inferior work just before the deadline. They then compile a report to a risk committee or a leadership team with a “heat map” of risks and a list of “mitigation actions” which have already been decided. The report speaks “risk language” and not the language of the business. To no surprise, the report ends up in the reporting trap: where reports – at best – are read and spark a discussion, but rarely promote new decisions that lead to actual changes and real impact.

The amount of resources that go into this nonsense process is staggering in some organisations. But the fix is quite simple: remove most of the reporting and maintain only what is needed for compliance purposes. And instead, then spend resources on supporting the organisation in taking risk and reward adequately into account when making decisions, e.g. in proposal and procurement processes. Train the organisation in the effect of cognitive biases on human decision-making. Make sure knowledge about risks gets directed to the right places. Have the analytical skills to reflect risk and opportunities in business cases and strategies.

How do we align skin-in-the-game?

In the two examples highlighted above, we claim that aligning skin-in-the-game is a superior substitute to the bureaucratic processes. But how do we align skin-in-the-game?



Traditionally, aligning skin-in-the-game is considered difficult. How can we align financial exposures? What do we do when the success of a decision is only clear in the distant future? What do we do when the success of the decision is affected by a complex combination of several factors outside of our control?

There are many elements to aligning skin-in-the-game and the details of this are beyond the scope of this article. But let us provide some key considerations to start with:

Determining what “skin” is at stake for stakeholders?

When you look at the “players” and their possible up or downsides on a personal and financial level, are there then differing interests at stake? Meaningfulness? Professional pride? Financial security? Comfort? What stakes are the highest and who has the most to lose? Short-term or long-term? What other interests than the ones attached to the concrete situation could there be?

You can take a fantastic starting point for this kind of stakeholder analysis by spending sufficient time on conversations, listening and exercising empathy with your stakeholders. When you truly understand who has what at stake, you need to consider and mitigate any asymmetries.

Examples of levers to align “skins”

1. Getting the right people on board

2. Substantial financial ownership of the business available to all employees and leaders

3. Autonomy, accountability and clear ownership of decisions

4. Performance measurement to promote cross-organisational thinking and be less concerned about free riding

5. Decentralisation of decisions

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Create coherency between individual actions and the overall value creation
This is the classical leadership challenge of creating transparency on how each individual contribute to the overall success of the organisation. That everybody knows what to do to serve the interest and purpose of the company. E.g. that Procurement knows not only how alternative suppliers affect direct costs but also has a view on how the alternative suppliers will affect long term earnings through indirect effects on quality, customer satisfaction, risks etc.

Levers to align "games"

1. A shared purpose throughout the organisation
2. Transparency in numbers, decisions, contribution and pay
3. An ethics and value-driven culture

Conclusion

We recognise the potential benefits of some level of bureaucracy – primarily, efficiencies through standardisation and tight control in areas where failure is not an option. This is not a question of "Trust vs. Control". It is about recognising that control & bureaucracy has negative side effects and should be disposed with care and never become corporate theatre without impact.

In our view, however, bureaucracies have grown out of hand in many places, resulting in high risk for organisations.

The bureaucracy distances people from the purpose of the organisation and from having skin-in-the-game. This results in more bad decisions and organisational inefficiencies. Hence, we argue that bureaucracy is riskier than the opposite.

The fix is not easy. But at least we should stop the bleeding and have an honest dialogue about the challenge. No new bureaucratic elements should be implemented. On the contrary, our examples show that we should remove the obsolete and redundant compliance processes that no longer address significant risks.

About the authors

Bjørn Rothaus is an economist and director at Implement Consulting Group. For 20 years, Bjørn has helped public and private companies gain more value from their work with risk management. Bjørn is a specialist in enterprise, strategic and project risk management and has worked with companies such as General Motors, Vestas, A.P. Møller - Maersk, Rockwool, Copenhagen Airport and Thai Airways.

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