Organizational Structures and Their Effect on Productivity

In the 1980s, Jack Welch, then-Chief Executive Officer of General Electric, created the forced distribution system, also known as the vitality curve, the forced ranking system, or the stack ranking system. In a forced distribution system, managers must rate their subordinates along a normal distribution, where only the “top twenty” percent are seen as producing outstanding work, the “vital seventy” percent produce adequate work, and the “bottom ten” percent produce inadequate work. The bottom ten percent, Welch states, should then be removed from the organization, helping to reduce costs and improve productivity, with the ultimate goal of increasing profits and company value. In theory, this practice helps managers make effective termination decisions, since they can see which of their employees are lagging behind.

In practice, this system can cause productive, beneficial employees to be filed into the bottom ten when compared to their coworkers, causing the productive employee to be reprimanded or fired. In turn, this makes employees to work against one another and the organization. Star employees, for fear of being fired when compared to other high-performers, choose instead to work in teams filled with the vital seventy or bottom ten percent to avoid being at the bottom of the distribution. The organization loses the opportunity for effective and innovative production since the star employees choose not to collaborate. Other employees, knowing they may be terminated when compared to the top twenty, even if they contribute positively to the organization, have decreased levels of job performance and organizational commitment.

Even with the issues that stem from the use of a forced distribution system, it still remains popular. As of 2012, sixty percent of the Fortune 500 companies still use some form of the system (Kwoh, 1). The most infamous example in the consumer technology industry is Microsoft, which was known for implementing practices like the forced distribution system under CEO Steve Ballmer that appeared to make its large, hierarchical organization more efficient, but ultimately created tribalism and rivalry between different divisions of the organization. While Microsoft remained a hugely profitable company due to its Office and Windows brands, its bureaucratic practices slowed its pace of innovation and lost the company consumer mindshare.

Alternatively, competitors like Apple approached their hierarchal organization in a different way: similar to a start-up, all major projects in the company flowed through former CEO Steve Jobs (Lee, 1). With a simplified focus on its products, Apple was able to increase innovation and mindshare at the same time that Microsoft was losing theirs. In February of 2014, Steve Ballmer retired as CEO of Microsoft and was succeeded by Satya Nadella. With Nadella's new position came an organizational restructuring and an executive management shuffle, the norm for when a new CEO is assigned.

While Satya Nadella's leadership at the head of Microsoft shows promise, the changes he has implemented in the company have yet to bear fruit. Microsoft's mobile division, which oversees the development of Windows-powered smartphones, maintains third place in market share behind Google's Android platform and Apple's iPhone devices (Ong, 1). Its operating systems division has received middling response from its most recent release of Windows 8. The Xbox division's Xbox One video game console has been playing catch up with Sony's PlayStation 4 since their release in Fall 2013, selling only 10 million units compared to the PlayStation 4’s 13.5 million units sold, with most of those occurring after Microsoft reduced the price of the price of the Xbox One by one hundred dollars (Warren, 1). However, many of these products are slowly seeing improvement after several iterations due to Microsoft evaluating feedback received from customers about their products and removing the archaic systems that guided management and product development during the Ballmer era.

Rigidly hierarchal organizations are largely ineffective in industries where being innovative is key. However, newly appointed CEOs of giant firms attempt to reinvigorate the company’s innovative capabilities by reorganizing divisions and reshuffling executives. Unfortunately, even if a new individual now holds the title of vice president of some invented division, the underlying hierarchal structure usually stays the same. Gabe Newell, who left Microsoft in 1996 to cofound video game developer and digital distributor Valve Corporation, talks about how disadvantageous a hierarchal organization is:

> “We realized that here, our job was to create things that hadn’t existed before. Managers are good at institutionalizing procedures, but in our line of work that’s not always good. Sometimes the skills in one generation of product are irrelevant to the skills in another generation. Our industry is in such technological, design, and artistic flux that we need [employees] who can recognize that. (Suddath, 1)”

As Newell states, the video game industry, similar to the consumer technology industry, is constantly changing in an attempt to create the next great innovation. One way to help create consumer-facing innovation is to limit the time it takes a message to travel from employees to consumers, usually those who are lower in the organizational chain, to decision makers, who tend to be the executives and managers. Another way to increase a firm's ability to innovate is to give each employee more autonomy and decision making ability. This is Valve's key differentiator, and it's one of the reasons that they are so successful.

At Valve, not even Newell has the ability to single-handedly fire someone. Hirings, firings, and projects are all done through temporary, multidisciplinary teams of employees, all of whom have equal amounts of power within the organization. In Valve's employee handbook, new hires are told that they can work on anything they like; picking a project to work on is done at their discretion.

When a project team is formed, the temporary project leader is chosen, and a team organization structure may form to suit the needs of the project. When the project is finished, the leadership and structure dissipate. A leader for one project may choose not to lead the next one. The fluidity and autonomy of the company's employees is given such importance that each work desk is equipped with wheels, encouraging them to unplug from where they are currently working to move to a new group to get new ideas.

Giving employees complete autonomy looks like it would create a great potential for failure. Valve acknowledges this risk in a section of their handbook titled *But what if we ALL screw up?*:

> "When everyone is sharing the steering wheel, it seems natural to fear that one of us is going to veer Valve's car off the road.
>
> Over time, we have learned that our collective ability to meet challenges, take advantage of opportunity, and respond to threats is far greater when the

responsibility for doing so is distributed as widely as possible. Namely, to every individual at the company.

> We are all stewards of our long-term relationship with our customers. They watch us, sometimes very publicly, make mistakes. Sometimes they get angry with us. But because we always have their best interests at heart, there's faith that we're going to make things better, and that if we've screwed up today, it wasn't because we were trying to take advantage of anyone. (20)"

This investment in each individual employee has paid dividends to the company. As of 2012, the private company has been valued at $2.5 billion (Wingfield, 1). They have several extremely successful products, such as the video games *Team Fortress 2* and *Dota 2* as well as the online video game marketplace Steam. While $2.5 billion may pale in comparison to Microsoft's almost $90 billion valuation, Valve has something just as valuable: mind share. Microsoft has sometimes been seen as stodgy, bureaucratic, and greedy by its customers, while Valve is seen as creative, innovative, and consumer-focused. Valve's popularity and success starts with hiring only the highest quality workers and then ensuring that they are all given a voice within the company. The employees, surrounded by other high performers, then produce higher quality work. As Valve's handbook states, they have a higher profitability per employee than Microsoft, Google, and Amazon (27). This performance is then reinvested in the employees.

Interestingly enough, Valve also uses a version of forced distribution, referred to as stack ranking within their handbook. However, where Microsoft's forced distribution was used by management to determine which employees should be terminated, Valve's stack ranking is used by an employee's peers to determine their proper compensation.

The employee being ranked also participates in the system, determining their contribution along the same four criteria used by their peers: Skill Level/Technical Ability, Productivity/Output, Group Contribution, and Product Contribution.

Valve transformed the system from an individual managerial decision to a democratic process, and it only works because of Valve's strict hiring standards. Everyone in the company can be trusted to hire and compensate the best employees, because star employees want to be surrounded by other star employees. The reason General Electric and Microsoft used the system to remove underperforming employees was because they had underperforming employees to begin with. Lackluster employees can be hired in hierarchical organizations because they were vetted only by a relatively small number of people: a human resource representative, a hiring manager, and possibly a direct supervisor, but not their coworkers or their potential project members. Because so few people can make decisions in hierarchical organizations, the margin of error can be high.

This practice of limited management and allowing people to choose the projects they wish to pursue is known as open allocation, and it is used at other organizations like GitHub, an open-source web platform that allows programmers to collaborate on building software. GitHub is extremely popular, with a global Alexa rank of 121, which determines GitHub's place among the world's most frequented websites. GitHub's leadership attributes its popularity and ability to produce innovative services to its use of open allocation. Other firms are not so lucky. Chris Dannen, an editor for *Fast Company*'s FastCoLabs, stated in a profile of GitHub that "[sixty two percent] of corporate executives manipulate company structure to drive innovation."

Dannen found that firms, especially traditional hierarchical firms, run into four problems when attempting to reproduce innovation. The first problem is the ability to manage employees' attention towards new innovations, since employees in traditional structures want to focus on what currently exists and the status quo. Another difficulty comes from what is referred to as "creating currency" in an employee's new idea. New, innovative ideas usually originate from the thoughts of a single individual, and it becomes difficult to have other individuals follow an idea that's not their own. Even when employees join the project, the next hurdle comes from maintaining the vision of the original idea. As the project team grows in size, individual contributors feel less essential, and they start to lose the original goal of the project. The last problem is the practice of institutionalized leadership. As in the example of Valve's project teams, leaders are temporary, and they can even change in the middle of the project. In traditional firms, the management structure is not flexible enough to accommodate the changing needs of each specific project, stymying innovation.

The solutions that open innovation provides for these problems are collaboration and communication. The more creative, talented individuals that are able to contribute to a product or service, the better it becomes, and they are more likely to work harder since they receive equal validation as their coworkers. In order for a company's talent to run as efficiently as possible, it needs effective communication. Obviously, this can come in the form of open discussion between all members of the organization, but it also includes thorough training materials and documentation for every project so that new members can join without much downtime.

Good communication has additional benefits. It allows for the entire organization to change direction quickly. A new direction could be towards a changing company culture, a different product category, or even a new industry. In a hierarchical organization, it takes longer to these messages to be relayed to branches of the firm, so a division or team could still be toiling away on a project or a perception of the company long since abandoned by upper management. While GitHub focuses on new changes in direction that come from their core leadership team that are then quickly dispatched to their coworkers, it's important to know that, no matter where these changes come from, they must include the input all members of the organization. In Jim Collins' seminal management book *Good to Great*, he refers to this practice as getting the right people on the bus, and then figuring out where to drive it (13). Just as talented employees need to know that their contributions matter, they must also know that the goals of the company align with their own. Otherwise, they are much more likely to leave. Lastly, good communication makes hiring practices more focused. At Valve, GitHub, and many other creative organizations, hiring practices focus on people, not skills. Hiring people that match the company's culture and mission is important to the long-term health of the firm.

The use of open allocation combined with a focus on people, not their skills, is pivotal for firms in industries where creativity and innovation is key. The old practices of short-term growth, hierarchical organizations, and a slash-and-burn mentality towards hiring and termination practices are unsustainable. Creative ideas can come from any part of an organization, and they are most likely to come from the traditional rank and file employees, since they are closest to the external environment and most aware of customer need. Unfortunately, they are also the most likely to be overlooked by decision makers. An open allocation system makes it so that there are no managers, executives, or subordinates, and everyone can contribute equally, which leads to faster and better innovation and success.

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