The Flattening of Corporate Management

U.S. corporate hierarchies have become flatter over the past two decades, according to new research from the NBER by Raghuram Rajan and Julie Wulf. Chief Executive Officers (CEOs) are increasing the number of managers who report directly to the top while there has been a reduction in the ranks of middle managers. As organizations become flatter, salary and bonus profiles across the hierarchy become steeper, and long-term incentive pay, including the use of stock grants and stock options, spreads through the organization.

In The Flattening of the Firm: Evidence from Panel Data on the Changing Nature of Corporate Hierarchies (NBER Working Paper No. 9633), Rajan and Wulf present evidence from top managers at more than 300 U.S. companies represented in the largest private compensation survey, conducted by Hewitt Associates, a human resources consulting firm. The companies in the survey, which draws on established firms across industries, have an average of almost 50,000 employees.

The number of managers in a company who report directly to the CEO has increased from an average of four in 1986 to an average of seven today. Rajan and Wulf concentrate on divisional managers — the lowest management rank with profit center responsibility and the position most consistently defined in the survey — and find that the number of division heads who report directly to the CEO has increased by 300 percent. The number of levels in the management hierarchy between division heads and CEOs has declined by 25 percent.

Rajan and Wulf show that these patterns do not simply reflect a change in corporate structure, whereby companies have regrouped into fewer, larger operating divisions. By focusing on division manager positions for which they have a number of years of data — and which were not affected greatly by restructuring over the period — the authors show that, regardless of changes in size, management ranks are becoming flatter. Further, more divisional managers are being appointed officers of their companies. Officers are defined by the individual’s responsibilities and duties in accordance with Securities and Exchange Commission and Internal Revenue Service rules.

These findings suggest that layers of intervening management are being eliminated, and that the CEO is coming into direct contact with more managers in the company. One example of this change is the elimination of the position of Chief Operating Officer (COO), which accounts for a significant part of the increase in CEO reports. The number of firms with COOs has decreased by 20 percent over the study period. Getting rid of the COO also is associated with granting greater authority to division heads; they are more likely to be appointed officers in firms that have eliminated the COO position. This suggests that they inherit some of the authority of the eliminated middle layers.

The structure of pay is different in flatter organizations, too, with pay and long-term incentives more closely reflecting a partnership model. Division managers in companies with flat hierarchies are paid less in salary and bonus than people in similar positions in companies with taller corporate hierarchies. Employees in flatter organizations tend to have more long-term pay incentives, like stock and stock options. This is close to what is traditionally seen in a partnership, with significant pay increases associated with promotion, and a greater emphasis on long-term incentives relative to short-term compensation, especially at the top.

Rajan and Wulf conclude that the explanation for flatter corporate hierarchies that fits most closely with the facts is technological and environmental change. As companies use relatively less physical capital — and rely more on human capital — organizational structure and pay patterns more reflect those of partnerships. Pay increases more sharply with promotion, and long-term incentives — such as equity-based compensation — help to tie employees into the company, thus bringing management and shareholder interests into closer alignment.

If companies face increasingly stiff competition, as a result of deregulation or increased international trade, there may be changes in the delegation of responsibility within corporate hierarchies. Managers may be given greater autonomy so that they can respond more quickly to competitive pressures. The elimination of layers of middle management clearly allows companies to delegate more responsibility to divisional managers. Pay that is linked to personal performance and long-term share price performance may help to keep these managers focused on achieving long-term performance.

— Andrew Balls