What drives good m around the world?

It has long been suspected that bad management plays a key role in explaining the UK's productivity gap with the United States and some of our European neighbours. CEP's global survey of over 4,000 firms suggests that there is indeed a 'management gap' – and reveals the forces driving variations in the quality of management practices.

The exploits of David Brent in the television series *The Office* have made bad British management practices infamous around the globe. But these failings have a far longer historical pedigree. The Harvard business historians Alfred Chandler and David Landes have both claimed that poor management practices held back British companies. In 1947 as part of the Marshall Aid scheme to revive post-war Europe, American businessmen and engineers concluded that 'efficient management was the most significant factor in the American advantage'.

But how do British firms now compare in terms of management practices, not only with the United States and continental Europe but also with the rising industrial giants of India and China? Until recently economists have had little to say about the role of management in driving productivity and other key performance indicators. This is largely because there has been an absence of good quality data on management practices. Working in partnership with McKinsey & Company, CEP has been carrying out a large research project that attempts to fill this void.

We have developed an original survey method to measure management practices in a systematic way in more than 4,000 firms in Europe, the United States and Asia. By combining these data with firm accounts and industrial statistics, we are able to explore in detail the relationship between management practices, the economic environment and company performance.

Overall, we find compelling evidence that better management practices are significantly associated with higher productivity and other indicators of corporate performance, including return on capital employed, sales per employee, sales growth and survival. This is true in every country we look at, suggesting that our characterisation of good management practice is not culturally biased towards 'Anglo-Saxon' approaches.

We estimate that management practices can account for up to a third of the differences in productivity between firms and countries. Why are there such startling differences in the management practices and productivity of competing companies? Our research offers some potential explanations for these differences and suggests areas where policy can encourage the spread of good management practices.

Measuring management practices

Measuring management requires us to codify the concept of good and bad

So you think manufacturing is boring...

During the summer of 2006, we interviewed over 4,000 managers. Some of these individuals were extremely colourful characters, providing endless entertainment to the research team with their comments immortalised on our team quotes board. Some of our favourites included:

Talent rewards the Indian way

Interviewer:

How do you identify your star performers?

Indian plant manager:

This is India. Everyone thinks he is a star performer.

management

management into a measure applicable to different firms. We used an interview-based management practice evaluation tool that defines and scores from 1 (worst practice) to 5 (best practice) across 18 of the key management practices that appear to matter to industrial firms, based on McKinsey's expertise in working with thousands of companies across several decades. The 18 practices fall into four broad areas:

- Shopfloor operations: have companies adopted both the letter and the spirit of lean manufacturing?
- Performance monitoring: how well do companies track what goes on inside their firms?
- Target setting: do companies set the right targets, track the right outcomes and take appropriate action if the two don't tally?
- Incentive setting: are companies hiring, developing and keeping the right people and providing them with incentives to succeed?

For each company in the study, researchers interviewed by telephone one or two senior plant-level managers, who knew only that they were taking part in a 'research' project. These managers were selected because they are senior enough to have a reasonable perspective on what happens in a company but not so senior that they might be out of touch with the shopfloor. The interviews relied on open questions and the interviewers were trained to probe for details of practices on the ground.

The interviews were run by an international team of 47 postgraduate students (mainly MBAs), who worked from CEP in a specially created survey centre

The British chat-up

Male production manager:

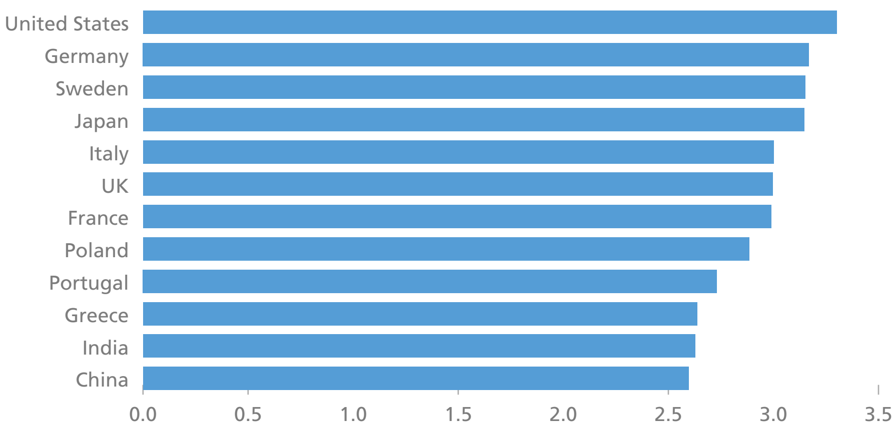
Your accent is really cute and I love the way you talk. Do you fancy meeting up near the factory for some fun?

Female (Australian) interviewer:

That's a great offer – how could I refuse? Unfortunately, I'm washing my hair every night for the next three months.

Figure 1:

US firms are the best managed, followed by the Germans and Swedes, with the Greeks, Indians and Chinese the worst



The bars indicate for each country the average score on the 18 management questions (1=worst practice, 5=best practice).

Strong competition and flexible labour markets both lead directly to improved management performance during the summer of 2006. This was a 24-hour operation since the Chinese day starts at midnight in London, just before managers on the West Coast of the United States pack up to go home.

Management practices around the world

As Figure 1 shows, there are significant differences in management performance across countries. The United States is at the top of the management league table, while Greece, India and China are the worst performers. Germany, Sweden and Japan are (not surprisingly) strong performers given the manufacturing focus of the survey, while France, Italy and the UK are all solidly mid-table.

But the United States is not entirely dominant. US firms score particularly highly for people management, such as promoting and rewarding talented workers quickly. But as Figure 2 shows, in shopfloor operations management, Sweden, France, Italy, Japan and Germany do relatively better.

Overall, cross-country differences account for only 9% of the variation in management practice. Performance differences between companies in the same country are far larger than any cross-country variation. For example, the best third of Indian companies outperform the European average. This is worrying for those who complacently assume that vastly superior Western management protects them from offshoring.

Multinationals tend to achieve excellent management practices wherever they are located

Managers are very poor at self-assessment

Since good management is strongly linked with good performance, why do so many firms fail to make a priority of improving their practices? The techniques are pretty well known yet many firms remain poorly managed.

To examine possible causes of this disconnect, we asked managers as a final question in the interview to assess the overall management performance of their firm on a scale of 1 to10. To avoid false modesty, they were asked to exclude their personal performance from the calculation.

As Figure 3 indicates, interviewees' answers to this question are not well

Americans on geography

Interviewer:

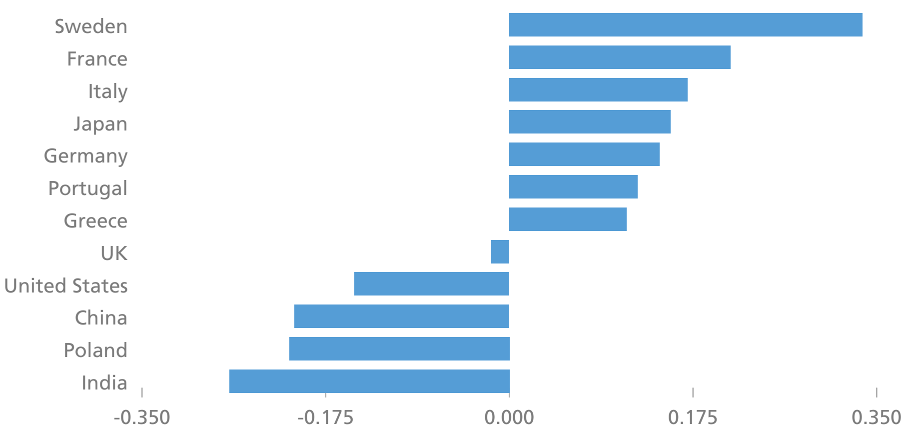
How many production sites do you have abroad?

Manager in Indiana:

Ummmm… well… we have one in Texas…

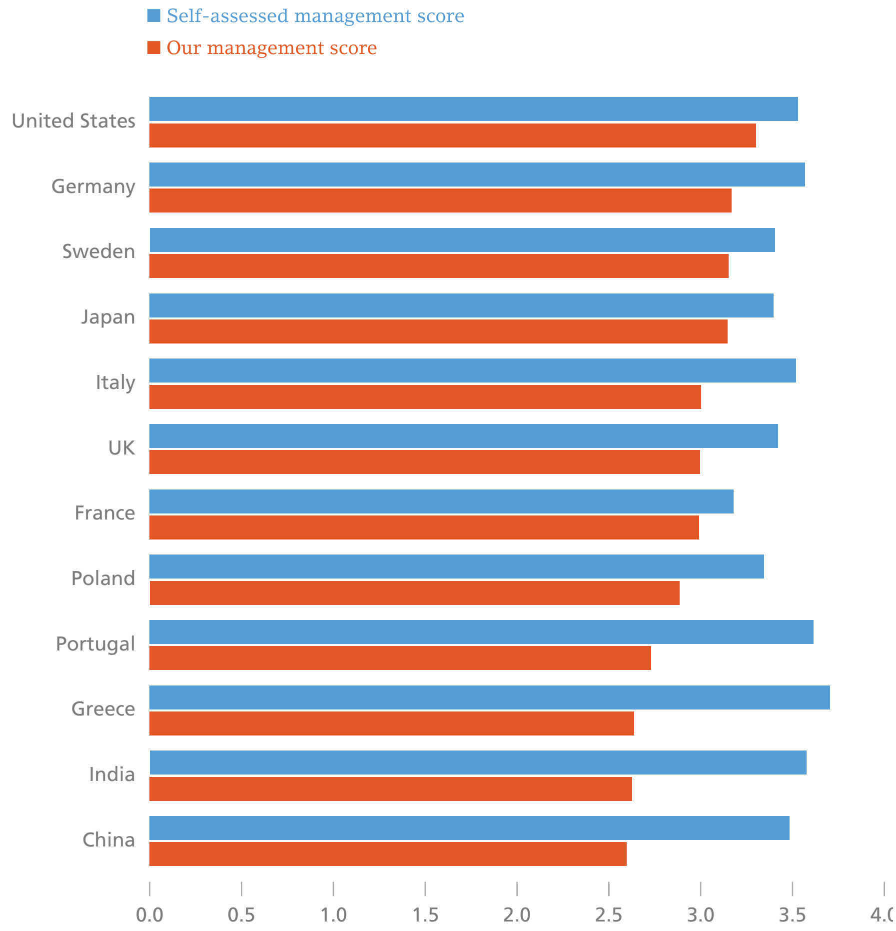
Figure 2:

European firms are relatively better at operations management than people management



The bars indicate for each country the average score on six questions focused on operations management minus the average score on six questions focused on people management.

Figure 3:
Managers are over-optimistic about their own management practices across the globe



The bars indicate for each country the average score on the 18 management practice questions and the average score on the self-assessed management question: 'Excluding yourself, how well managed is your firm on a scale of 1 to 10, where 1 is worst practice, 10 is best practice and 5 is average'. The scores are divided by 2 to put them on the same scale as our management scores.

correlated with either our management practice score or their own business performance. At the country level, we find Greek, Portuguese and Indian managers to be the most over-optimistic about their management practices, while the Japanese, Swedish and French managers are the most pessimistic.

Government policy plays an important role

A variety of policy factors have an effect on companies' adoption of good management practices. Most significant among these are their competitive environment and the flexibility of the local labour market.

When competition (whether measured by narrow industry profit margins, trade openness or number of rivals) is higher, management is better. This could be a result of two effects: first, good practice spreads quickly in highly competitive environments; and second, poor practice is eliminated by Darwinian natural selection as poorer performing companies are removed from the marketplace.

We also find that flexible labour markets matter, since these appear to allow companies to adopt better people management practices. In countries with rigid employment laws (using the World Bank's index), firms find it difficult to implement effective hiring, promotion, retention and firing practices.

The high position of the United States in the management league table is helped by its competitive product markets and flexible labour markets.

The difficulties of defining ownership in Europe

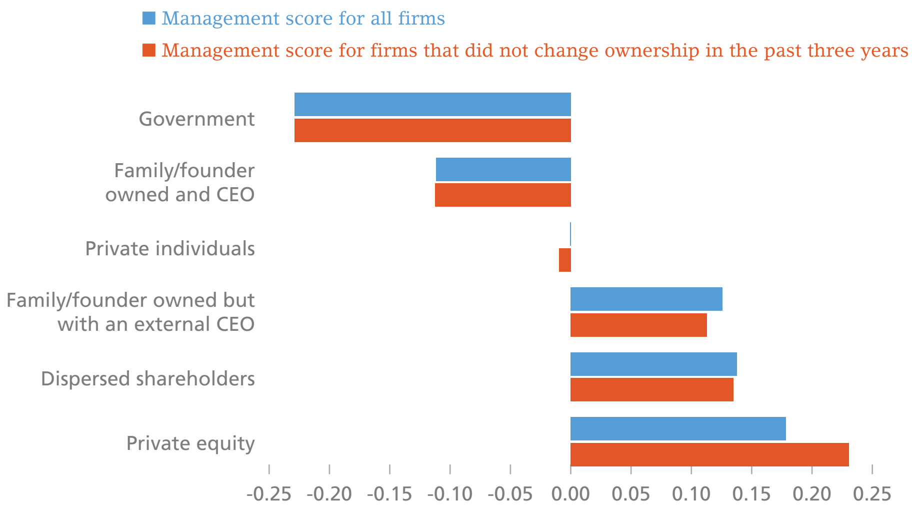
Production manager:

We're owned by the Mafia.

Interviewer:

I think that's the 'Other' category… although I guess I could put you down as an 'Italian multinational'.

Figure 4:
Management scores are highest for private equity owned firms



The bars indicate for each type of firm ownership the deviation from the country and industry average score on the 18 management practice questions. The scores are for domestic firms only, of which there are 2,385 in the sample. The red bar for each type of ownership only includes the 2,180 firms that have had the same ownership for the past three years. The number of firms for the blue/red bar are as follows: government (53/53); family/founder owned and CEO (1,185/1,082); private individuals (364/285); family/founder owned and external CEO (153/145); dispersed shareholders (624/566); and private equity (64/37).

The best-managed firms are those with three or more years of private equity ownership

Private equity, public gain

One particular ownership form that appears to be linked with superior management practices is private equity. As Figure 4 shows, private equity firms are the best managed. This superior performance of private equity appears to be quite robust – they come out on top both with and without controls for country and industry.

One possible explanation is that private equity firms only buy well-managed firms so that their high management scores simply reflect their ability to cherry-pick the firms that they buy. But the usual story of private equity buy-outs is the reverse: they buy badly managed firms with the aim of turning them around. This suggests that their management scores are more likely to be biased downwards by having recently purchased badly run firms.

To investigate this we re-plotted the management scores for only those firms that have had the same ownership for at least the last three years and found that doing this increases the lead of private equity firms over all other firms, making them the best managed in the sample.

Family owned firms that appoint the eldest son as the CEO are particularly badly managed

Multinationals, family ownership and skills

Firm ownership and the availability of skilled people, both in management and among the workforce in general, are also associated with important differences between the better-managed firms and the rest.

For example, multinational companies are well managed around the globe, achieving extremely good management practices in countries like Greece and India despite the poor management practices of local domestic firms.

Family ownership and the traditional practice of *primogeniture* – handing down the CEO position to the eldest son – are associated with particularly bad management practices (see Figure 4). This appears to be an issue for Europe

Employee retention the old-fashioned way:

Company chairman:

Sex is a great thing! If I can get my employee a local girlfriend he'll never leave.

since in France, Greece, Italy, Portugal and the UK, around 10% of the manufacturing firms are family owned with a CEO that has been chosen because they are the eldest son. The United States performs much better on this dimension, with only 2% of its firms being family owned with the CEO chosen because he is the eldest son.

The skills of both the managers and non-managers in the firm also appear to play an important role. For example, 84% of managers in the highest scoring firms are educated to degree level or higher, as are a quarter of the non-management work force. Among the lowest scoring firms, by contrast, only 54% of managers and 5% of the wider workforce have degrees.

What can the government do?

Our research shows a significant management gap between the UK on the one hand and the United States and some European countries on the other. This is a situation that the government can modify by encouraging the uptake of good management practices.

Our research suggests that strong competition and flexible labour markets both lead directly to improved management performance. Multinational companies have a strong positive effect too, and their influence is felt throughout the countries in which they operate. In these respects, the British government has a good track record and it is in other European countries that these lessons need to be taken on board.

The UK performs less well in the areas of skills and family ownership. British levels of basic education are low by international standards, and any policies that addressed this would have a big impact. As regards family ownership, there is currently a distortion in the inheritance tax system that actually promotes the continued ownership of privately held manufacturing firms in family hands, keeping these out of private equity ownership.

Our research suggests that by appointing managers on the basis of primogeniture rather than competitively on the basis of merit, we are possibly promoting more bad management and productivity practices in the UK.

The things we did to get interviews

French secretary:

You want to talk to the plant manager? There are legal proceedings against him, so hurry up.

More details on this research can be found in 'Management Practice and Productivity: Why They Matter' by Nick Bloom, Stephen Dorgan, John Dowdy, Christos Genakos, Raffaella Sadun and John Van Reenen, July 2007 (http://cep.lse.ac.uk/management/Management_Practice_and_Productivity.pdf).

For full details of the survey methodology, including all the questions, see 'Measuring and Explaining Management Practices across Firms and Nations' by Nick Bloom and John Van Reenen, CEP Discussion Paper No. 716 (http://cep.lse.ac.uk/pubs/download/dp0716.pdf) and forthcoming in the *Quarterly Journal of Economics*.

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