There are wide and persistent differences in productivity across firms and countries. A new CEP study – conducted jointly with McKinsey & Company – uses a pioneering approach to measure management practices and assess their importance in driving these variations in economic performance.

Management practices:
the impact on company performance

Business schools and popular discussions of the corporate world tend to place huge stress on the importance of good management in top performing companies. Economists, meanwhile, have had relatively little to say about the role of management in driving productivity and other key performance indicators. This is largely because until now, there has been an absence of good quality data on management practices measured in a systematic way across countries and firms.

A new report – by CEP's Nick Bloom and John Van Reenen, and Stephen Dorgan, John Dowdy and Tom Rippin, all consultants at McKinsey – attempts to fill this void, using an innovative survey approach to measure management practices in more than 730 manufacturing firms in France, Germany, the UK and the United States. By matching these data with information from firm accounts, they are able to explore in detail the relationship between management practices, the economic environment and the company's performance.

Overall, the report finds 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 growth in market share. This is true in both the Anglo-Saxon and the continental European countries, suggesting that the researchers' characterisation of good management practice is not intrinsically biased towards UK and US approaches.

Across the whole sample, a conservative estimate indicates that differences in management practices account for a significant proportion – 10-20% – of the differences in productivity between firms and between countries. This figure may actually be substantially greater, which raises the question of why there is such variation in the management practices and productivity of competing companies – and, in particular, how badly managed firms are able to survive, often for years.

Measuring management practices

Measuring management requires codifying the concept of good and bad management into a measure applicable to different firms within the manufacturing sector. The researchers 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 (rather than people they could do without) and providing them with incentives to succeed?

For each company in this study, researchers interviewed 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

Some UK firms use world-class management practices while others are among the worst

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.

To ensure impartiality, only companies that had no relationship with McKinsey were included in the study. And medium-sized firms, which tend to rely on local management, were selected in preference to large firms whose multinational operations might obscure differences between countries.

Management practices across countries

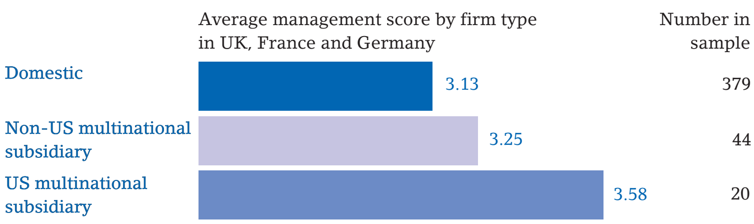
Analysis of the survey data confirms a range of anecdotal evidence that US companies are better managed than companies elsewhere in the world.
As Figure 1 shows, US firms are statistically significantly better managed than continental European or UK firms. The researchers estimate that the differences in management practices between the UK and the United States account for 10-15% of the productivity gap between the two countries.

As Figure 2 shows, US companies also excel even when their operations are located overseas. The research finds that US multinational subsidiaries based in the

Figure 1:
Country level management scores

Note: UK productivity is significantly lower than that in the United States or Germany at the 5% level.

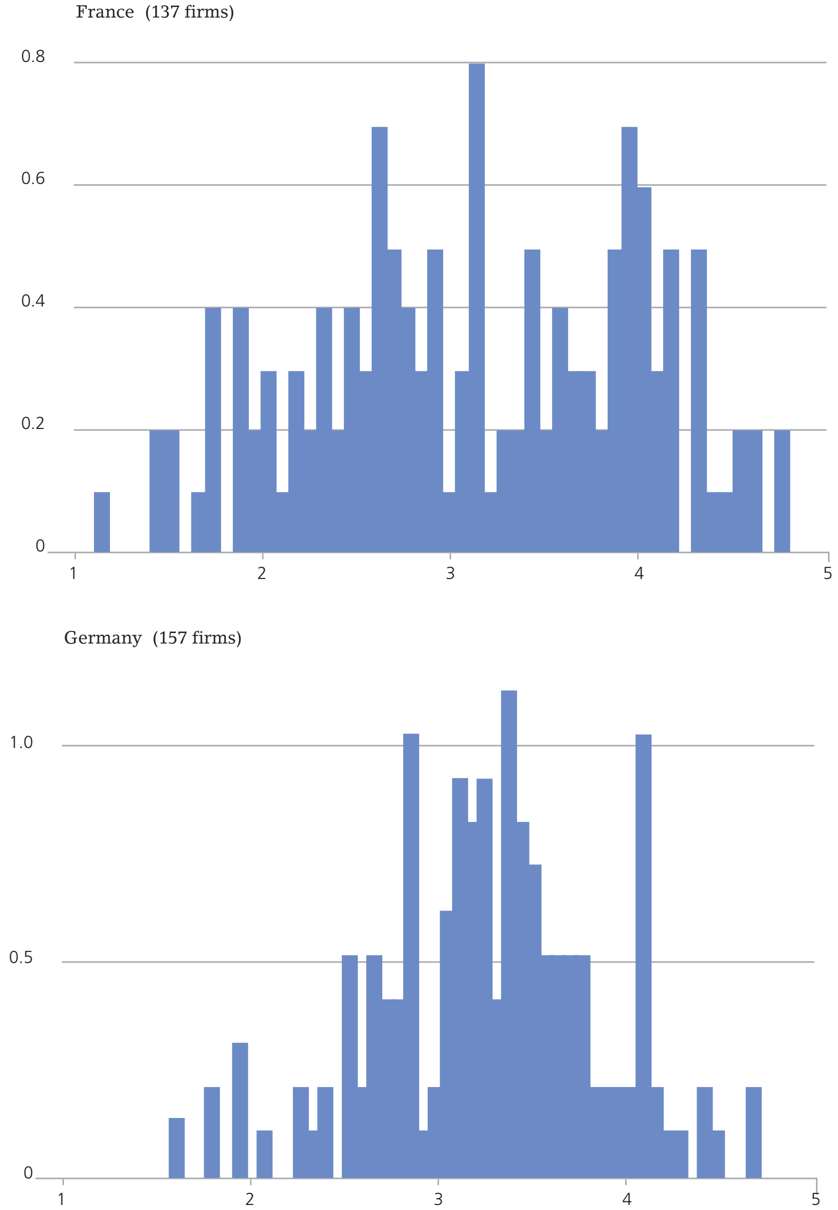
Figure 2:
Management scores of European firms



Note: The gap between domestic firms and US multinational subsidiaries is statistically significant at the 5% level.

Product market competition and weak labour market regulation are key drivers of good management practice

Figure 3:
Firm level management scores



UK, France and Germany are better managed than either domestic firms or other non-US multinational subsidiaries operating in these countries. This suggests that barriers to foreign ownership and cross-border deals are likely to be damaging to the spread of good management.

The data also suggest that countries have distinct management 'cultures'. For example, German firms excel at operations management – shopfloor and process management – while US firms tend to be better at promoting talent and giving people the right incentives.

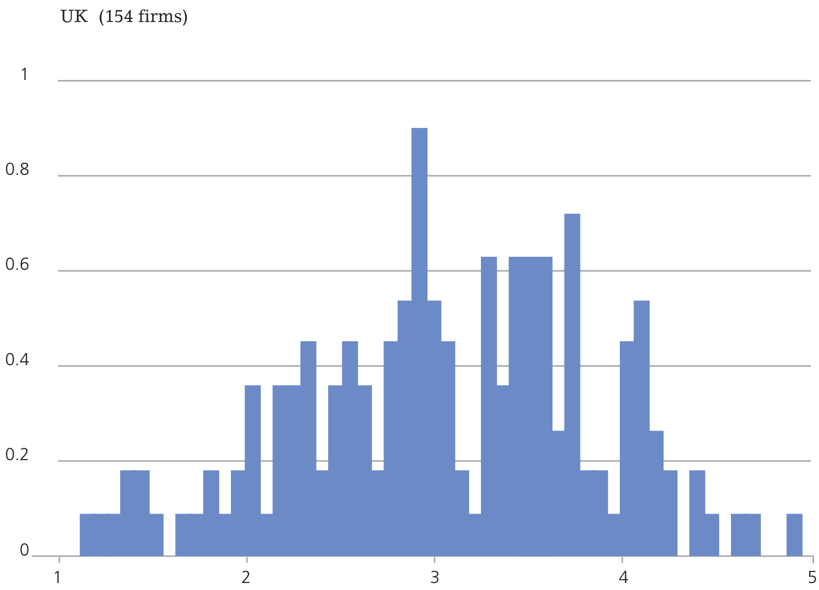
Management practices across firms

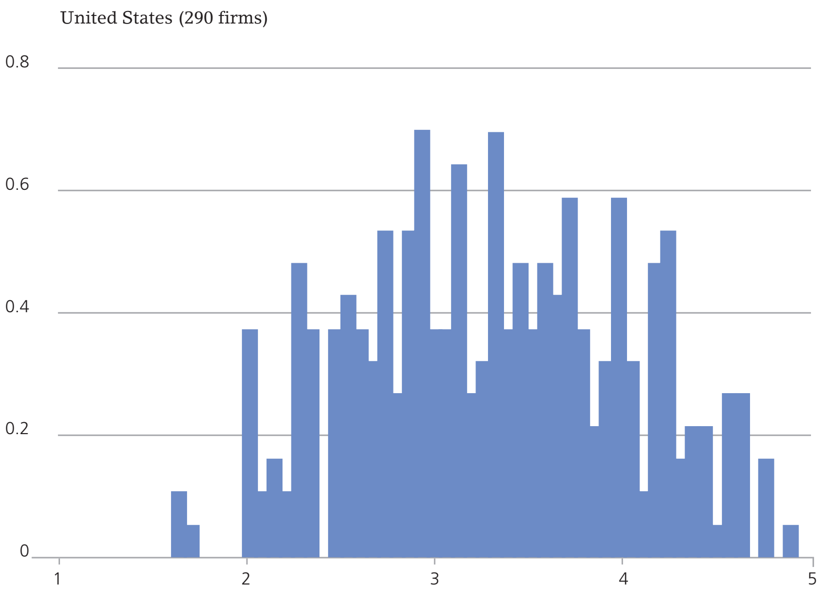
On top of the clear national differences, there is also a huge spread of management practices across firms in every country, as indicated in Figure 3. For example, some UK firms use world-class management practices while others are among the worst in the whole sample.

About 50% of this variation is explained by the country and industry in which the firm is located, with the remainder due to the wide underlying distribution of management practices among firms in the same country and industry. Most notably, the data indicate that a large number of firms are extremely badly managed with ineffective monitoring, targets and incentives.

Well-managed firms perform significantly better than poorly managed firms, with higher levels of productivity, profitability, growth rates and market values. So why do these variations in management practices persist?
The researchers present three reasons:

- Product market competition appears to be a primary driver of good management practices. This could work both by making managers work harder – an 'effort effect' – and also by driving out badly performing firms – a 'selection effect'. The research finds little evidence for an 'effort effect', suggesting that competition may improve management practices mainly by forcing badly run firms to shape-up or close.
- A firm's age also seems to matter with very old firms having the lowest average scores for quality of management practices, particularly those in uncompetitive industries where competition does not weed out underperformers. This is consistent with the idea that new entrants find it easier than their older counterparts to adopt the best management practices of the era in which they were founded.
- Stronger labour market regulation significantly impedes good management practice, particularly in firms with longer





tenured employees. This suggests that regulation impedes the adoption of new management practices.

These factors also play a role in the national differences in management practices and productivity performance. For example, countries with lower levels of competition and tougher labour market regulation – France and Germany – are worse managed on average than countries with weak regulation – the United States.

The UK is something of a puzzle in this dimension: while it has moderately high levels of competition and low levels of regulation, it is the worst managed on average. One hypothesis that the researchers hope to investigate in future is the extent to which the UK's poor management performance in manufacturing is driven by low skills or a preponderance of family-run businesses.

Overall, superior US management seems to be driven by lower levels of labour regulation and a greater degree of product market competition. Compared with the UK, the country's firms also seem to benefit from higher levels of management skills.

Surveying management practices

The interview was run on an amazing array of firms. Products included:

- Magnetic plastic balls that float on water near airports to prevent birds from nesting – this firm reported facing few competitors.
- Sex toys – mainly for the firm's domestic market as tastes vary by country.
- Human tissue grafts from corpses – this firm scored highly on 'just-in-time' production.

And the comments the interviewers received included:

- 'I spend most of my time walking around cuddling and encouraging people – my staff tell me that I give great hugs.'
- 'Improvement process? That's something that happens once a year before the Christmas Tombola.'
- 'We don't do KPIs [key performance indicators]... the only person I report to is God.'
- '[long silence]... sorry I just got distracted by a submarine surfacing in front of my window.'
- On motivating employees: 'Forget it... if you work here, you drew the short straw.'
- To a female interviewer: 'Your voice sounds really great, and I love your accent... are you married by the way?'

Scoring management practices

How is performance tracked?

Firms score 1 if:
Measures tracked do not indicate directly if overall business objectives are being met, and certain processes aren't tracked at all.
For example:
A US manager who tracked a range of measures when he didn't think output was sufficient. He last requested reports eight months ago, checked them for one week, and then stopped checking once output had increased again.

Firms score 3 if:
Most key performance indicators are tracked formally, and tracking is overseen by senior management.
For example:
A US firm bar-coded every product, and performance indicators were tracked throughout the production; but this information was not communicated to workers.

Firms score 5 if:
Performance is continuously tracked and communicated, both formally and informally, to all staff using a range of visual management tools.
For example:
A US firm that had screens visible to every line displaying hourly progress to target. The manager met daily with shopfloor staff to discuss these, and monthly with the whole company to discuss overall performance. He even stamped canteen napkins with key performance achievements.

What are your firm's targets?

Firms score 1 if:
Goals are exclusively financial or operational.
For example:
A UK firm's only performance target is output volume.

Firms score 3 if:
Goals include non-financial targets, but they form part of the performance appraisal of top management only and are not reinforced throughout the rest of the organisation.
For example:
For a French firm, strategic goals are very important. They focus on market share and try to hold their position in technology leadership. But workers on the shopfloor are not aware of those targets.

Firms score 5 if:
Goals are a balance of financial and non-financial targets, and senior managers believe the non-financial targets are often more inspiring and challenging than financials alone.
For example:
A US firm gives everyone a mix of operational and financial targets. They communicate financial targets to the shopfloor by telling workers that they pack boxes to pay the overheads until lunch; after lunch, it is all profit for the business. If they are having a good day, the boards immediately adjust and play the profit jingle. Everyone cheers when the jingle is played.

This article summarises 'Management Practices across Firms and Nations' by Nick Bloom, Stephen Dorgan, John Dowdy, Tom Rippin and John Van Reenen (http://cep.lse.ac.uk/management/).

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