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A question of management

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Why do so many badly run companies survive?

TO BOTH its admirers and its enemies, the most awe-inspiring feature of capitalism is its ruthless efficiency. In theory, poorly performing firms are shown no mercy. They are crushed and cast aside as fitter rivals come up with superior goods and services or cheaper methods of production. In fact, the system is nothing like as ruthless as it is cracked up to be. Plenty of suppliers fail to deliver goods on time. Lots of firms are slow to adopt new technology. Many managers are hopeless at motivating their staff. And badly run firms can survive for years, even in the same industry as state-of-the-art companies.

All of this has long had economists pondering two questions. First, why are there such wide differences in the productivity of competing companies? Second, why do these differences persist, rather than being squeezed to nothing by the remorseless market? They ascribe some of the gaps to differences in the quality of capital equipment, or in workers' skills, or in the development and installation of new technology. But there has long been a suspicion that quite a lot of the discrepancy between fit and flabby firms has to do with the quality of management.

The difficulty lies in putting a number on it. If economists are to explain company performance in terms of management practices, these must somehow be quantified. But how do you measure the "quality" of the layout of a shop floor, communication with workers or incentives for employees? An intriguing new study* by Nick Bloom and John Van Reenen, of the London School of Economics, and Stephen Dorgan, John Dowdy and Tom Rippin, all consultants at McKinsey, attempts to do just that, and goes on to examine why badly run firms survive.

The study is based on interviews with managers at more than 730 manufacturing companies (none of them McKinsey clients), ranging from 50 employees to 10,000, in America, Britain, France and Germany. The interviewees knew only that they were taking part in a "research" project, not that their management practices were being appraised. The answers were given a score between one, the worst, and five, the best, in each of 18 categories. For instance, under one heading a British consumer-products firm whose managers' only meaningful performance target was volume (with no mention of quality or waste) scored one; a German industrial-goods firm that focused on market share and technological leadership (but did not make shop-floor workers aware of these goals) scored three; and an American manufacturer that communicated financial targets to its shop floor by telling workers that they packed boxes until lunchtime to cover overheads and after that for profit—and that played a jingle if the break-even point was reached early—scored a full five.

The American companies came out on top, averaging 3.37, followed by the Germans (3.32), the French (3.13) and the British (3.08). However, in each country there was a wide range of scores: only 3% of the variation could be explained by the country of operation. One-fifth was accounted for by variation between industries. Three-quarters of it persisted among firms in the same country and industry. Thus, even among competing neighbours, there was huge variation in management practices.

Differences in management practices do seem to matter. The authors estimate that they account for 10-15% of the gap in total factor productivity (after stripping out differences in capital inputs) between American and British firms. And higher management-practice scores correlated with higher returns on capital employed, sales per employee, sales growth and growth in market share. So if poor management does not pay, why does it last?

The authors suggest three reasons. First is the degree of competition in an industry. In industries in which profit margins are low, there are many rivals or imports have a big market share, management practices tend to be better. There is little evidence, though, that competition raises standards by forcing managers to work better. More important, say the authors, is their second explanatory factor: the age of companies. Competition works mainly by weeding out young, badly managed firms.

Age and decay

On the one hand, younger companies might be expected to be better managed than older ones—or at least to be more open to the latest ideas—because they have had less time to get set in their ways. On the other, older companies are survivors by definition, so they are likely to be better managed than most. The authors find that in the least competitive industries, the former effect dominates: firms tend to be worse managed, the older they are. In the most competitive industries, management improves with age for a few years before declining: the worst-managed firms are found out, and fail, before long.

The third reason that the authors suggest for the persistence of poor management practices is regulation—in particular, restrictive labour laws—which seem to protect laggards. They find that tighter labour laws (such as those in France and Germany) do seem to drag managerial performance down. The effect is magnified where managers have been in their jobs longest—perhaps because such managers are less inclined to initiate change.

It is surprising that the study finds so little international variation in the quality of management practice. There is, however, much to be learned from foreigners. The authors reckon that American-owned companies in Europe did better than purely local firms or those owned by European multinationals. Remember, too, how Japanese car plants overseas left the locals trailing, even in America? And it would be interesting to extend the survey, as the authors propose, to China, the world's newest manufacturing power, and see how its firms measure up.

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* "Management Practices Across Firms and Nations": http://cep.lse.ac.uk/management and www.mckinsey.co.uk