05:

The management dimension

Diversifying the Russian economy requires substantial improvements in productivity in non-resource sectors. This, in turn, requires modern approaches to management. Survey evidence suggests that Russian firms tend, on average, to lag behind firms in advanced economies and transition economies outside the CIS as regards all main aspects of management quality. In addition, the distribution of the quality of management across Russian firms is unusually flat, with relatively large numbers of both well-managed and poorly managed firms. Policies aimed at strengthening competition, providing specialist management training, facilitating the entry of multinational firms and developing capital markets could all help to improve the quality of management.

KEY FACTS:

85% increase in profit margins associated with transition country improving quality of management

2,097 manufacturing firms covered in MOI surveys of 2008-09 and 2010

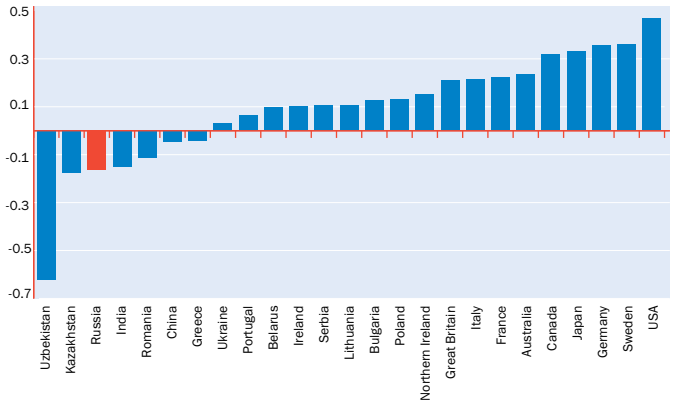
0 No Russian business school in list of 100 top MBA programmes compiled by Financial Times

The management dimension

1. Introduction

The diversification of the Russian economy will require substantial improvements in productivity. Part of this improvement could arise as a result of better management. This aspect has, until now, been neglected in Russia's diversification debate, despite the fact that it is widely accepted that management is a crucial factor in explaining company performance. Indeed, recent evidence suggests that management skills are essential for introducing new technologies and working practices in firms and that better management leads to improvements in overall economic performance.[1] Better management skills are also associated with increases both in research and development (R&D) activities and in new products. This has been found in large cross-country samples including both advanced and developing countries and is particularly true of transition countries. For example, a transition country improving, in terms of the quality of management, from the lower to the upper quartile of a sample has been associated with a 9 per cent increase in operating revenues, a 20 per cent increase in returns on assets, a 45 per cent increase in EBITDA (earnings before interest, tax, depreciation and amortisation) margins and an 85 per cent increase in profit margins.[2]

Chart 5.1
Average management scores



Source: MOI survey and Bloom and Van Reenen (2010).

2. Management skills in Russia: survey evidence

A recent cross-country survey of management practices shows that Russia lags some way behind many advanced economies and emerging markets in terms of management skills. On average, the management scores of Russian companies are much lower than those of their counterparts in Germany and other European Union (EU) countries, as well as being somewhat worse than those of firms in China and India and a number of other transition economies (albeit Russian companies are ranked ahead of their counterparts in Kazakhstan and Uzbekistan; see Chart 5.1).[3]

The MOI survey on which this ranking is based was conducted by the EBRD in 2008-09 and covered around 2,000 manufacturing firms employing 50 to 5,000 people (for details of the survey, see Box 5.1). In order to get a better sense of regional variation, the survey was then extended in 2010 to include 97 firms in Russia's Far East, which had not been covered by the 2009 survey (see Box 5.2). In the survey, senior managers in those firms were presented with a detailed questionnaire regarding management practices. Their answers were used to compile an index indicating the quality of management practices, focusing on four key areas: operational management, target-setting, monitoring and incentive management. Russia's scores were below average in all four areas (see Chart 5.2).

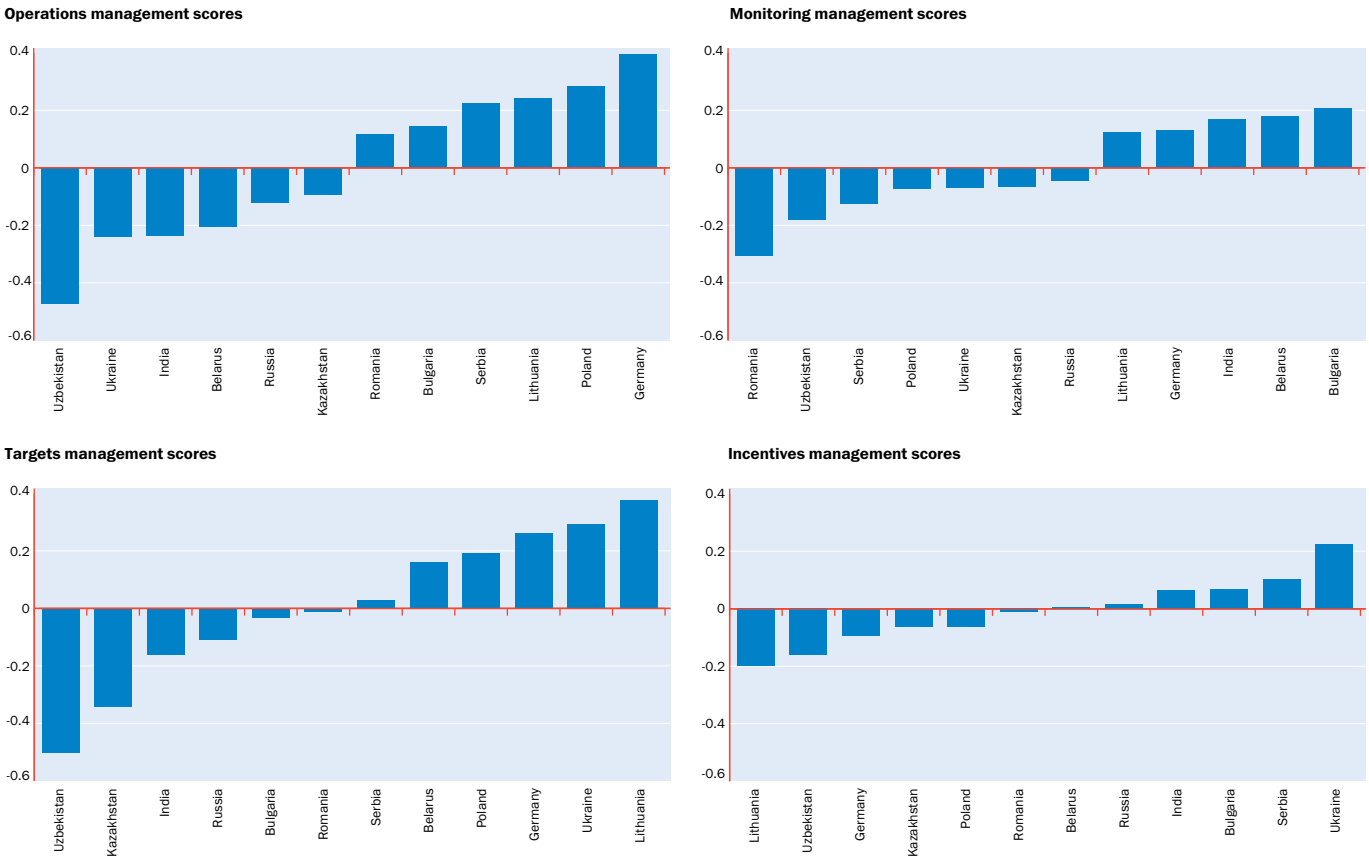
Interestingly, management skills appeared, on average, to be substantially worse in higher-value-added industries (see Chart 5.3). In addition, the distribution of management scores across Russian firms was unusually spread out, pointing to a large number of companies with management practices that were significantly below average and, at the same time, a relatively large number of fairly well-managed companies (see Chart 5.4, which compares the distribution of management scores in Russia and Germany).[4]

3. Factors determining the quality of management

Recent studies have identified a number of factors that tend to improve the average quality of management in an economy. One of the key factors is competition. Competition puts pressure on individual firms to improve management practices (for example by imitating those of their most successful competitors), as well as driving badly managed firms out of business. Strong competition also tends to be associated with more limited variation in the distribution of firms' scores, with few very badly managed firms (as these do not survive) and few firms that are managed much better than the others (as best practices are disseminated more widely across the industry). Indeed, there is a strongly positive correlation between the management scores of Russian firms taking part in the survey and the (self-reported) number of competitors that firms face in their key target markets. In particular, the quality of management is significantly higher in firms that have at least two major competitors. In addition, firms that compete nationally (as opposed to those that compete only in their own regional or sub-national markets) tend to have higher management scores. This effect is particularly strong in

[1] Bloom and Van Reenen (2007, 2010).
[2] Bloom et al. (2011).
[3] Management scores for countries other than EBRD countries of operations, Germany and India are based on Bloom and Van Reenen (2007, 2010). Although there are some methodological differences between their surveys and the EBRD's Management, Organisation and Innovation (MOI) survey, they are broadly similar. In particular, some firms in Germany and Poland participated in both surveys, achieving similar management scores. Scores from surveys in countries not covered by the MOI survey were benchmarked to these firms.
[4] Berglof and Plekhanov (2010).

Chart 5.2
Average management scores by component for selected countries



Source: Bloom and Van Reenen (2007) and MOI survey.

the Far East, where transportation costs to the rest of Russia are substantially higher, so an additional cost advantage may be needed in order for a firm to successfully access the larger national market. Cross-country evidence suggests that exports – the targeting of international markets – are also associated with improvements in the quality of management (albeit this cannot be verified for the Russian sample, as not enough firms there export). This is also broadly consistent with the finding that productivity levels in various countries converge particularly rapidly in certain tradeable industries.[5] It seems plausible that management practices would play a role in such convergence.

Another important factor is the presence of multinational firms in the market. The presence of multinationals tends to facilitate the dissemination of management skills and practices, as well as strengthening competition. The survey suggests that local subsidiaries of multinational firms are, on average, significantly better managed than other companies. And as for firms that are not themselves multinationals, the survey reveals a strongly positive correlation between the quality of management and firms reporting that they compete with multinational firms in their main target market. The positive effect of competing with multinationals is much stronger than the effect of competing with imports in the key domestic market.

Lastly, firms' ownership structure also plays a role. In particular, state-owned firms tend to have weaker management practices, both in Russia and globally (albeit in Russia, it is sometimes hard to distinguish between the effect of state ownership and the effect of operating in an industry where state ownership is particularly common). At the same time, there appears to be no significant difference, in terms of the quality of management, between firms that have been privatised and those that have always belonged to the private sector. There is also evidence that family-owned firms passed down from generation to generation tend to have weaker management practices (although this is not true of first-generation family firms, which are typically established and run by entrepreneurs). The succession problem for family-based businesses – familiar to many countries – clearly has a strong management dimension.

[5]Rodrik (2011).

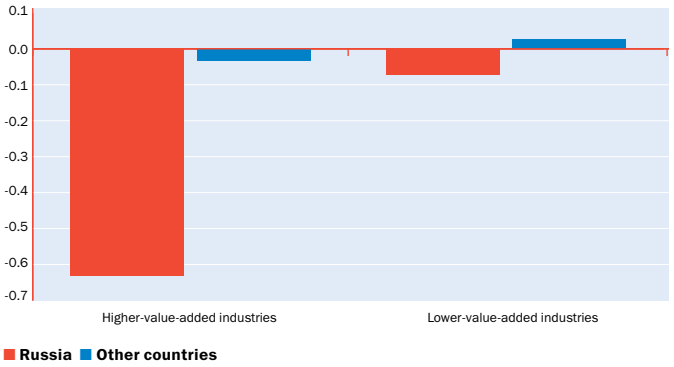
Box 5.1
Measuring the quality of management

The quality of management is, as a concept, inherently difficult to formalise. Following the methodology developed by Bloom and Van Reenen (2007), the MOI survey approached the task of quantifying the quality of management by looking at four separate aspects: operations, monitoring, targets and incentives.[6] A score was calculated for each of these areas on the basis of scores for individual management practices, which were evaluated on the basis of the answers provided to the questions in the survey. The survey targeted manufacturing companies with at least 50 employees and was conducted by means of face-to-face interviews.

In the case of monitoring, for instance, the survey included seven questions corresponding to the following seven key practices. First, respondents were asked how many production indicators were monitored. The answers were given a score ranging from one (if the answer was "none") to three (if more than two indicators were monitored). The frequency with which performance indicators were monitored was also awarded a score, ranging from one ("yearly") to six ("hourly"). The frequency with which performance indicators were shown to managers was awarded a score ranging from one ("never") to eight ("hourly"), while the frequency with which those indicators were shown to workers was also evaluated using the same scale. In addition, a score of three was given to firms with performance indicators displayed on boards in multiple locations, a score of two was given to firms displaying such indicators in a single location, and a score of one was given to firms where indicators were not publicly displayed. Managers were then asked how often they reviewed such performance indicators, with a score of three being awarded if they did so continuously, a score of two being awarded if this was done periodically, and a score of one being given if they rarely reviewed them. Lastly, a score of two was given if performance indicators were used to compare different teams of employees or different shifts, and a score of one was awarded if not.

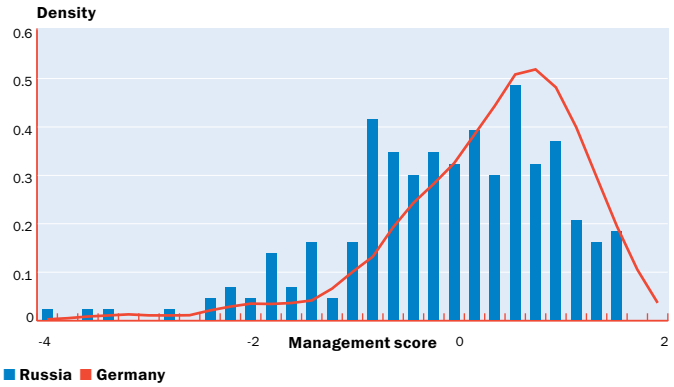
A management Z-score for a particular practice in a particular firm was then calculated as a normalised deviation – based on the answer to a given question (as coded above) – from the average score for that practice across all firms in a broad cross-country sample. Z-scores for individual practices were then averaged to obtain a Z-score for each of the four management components, which were, in turn, averaged to obtain an aggregate estimate of the overall quality of management in a given firm.

Chart 5.3
Average management scores in higher- and lower-value-added industries



Source: MOI survey.
Note: Average management scores (as plotted here) can also be interpreted as deviations from the average for the sample as a whole.

Chart 5.4
Distribution of firm-level management scores



Source: MOI survey.
Note: Russian data do not include the Far East. The density is calculated by dividing the relative frequency (the number of values in each class divided by the number of observations in the set) by the width of the class.

What factors are likely to account for the relatively low average quality of management practices in Russia? Lower levels of competition in many sectors and administrative barriers to firm entry and exit certainly play a role. Chapter 3 has already shown that lower levels of competition are reflected in higher Lerner indices (that is to say, higher mark-ups) relative to countries that are members of the Organisation for Economic Co-operation and Development (OECD).[7] The limited presence of multinationals is also highly relevant. In addition, in many instances performance incentives for firms may remain relatively weak – not only because of the lack of competition, but also owing to explicit

[6] Bloom et al. (2011).

[7] Friebel and Schweiger (2012) provide some further evidence of a link between competition and management practices in Russia.

or implicit subsidies that support poorly managed firms. Furthermore, the fact that incentive arrangements within firms are often insufficiently strong may, to a certain extent, be a sign of path-dependency, as a relatively small proportion of managers have received high-quality management training. No Russian business school currently appears in the list of the top 100 MBA (Masters in Business Administration) programmes compiled by the *Financial Times*.

4. Policy implications

Management remains a weakness in Russia and is one of the factors holding back productivity. At the same time, the poor quality of management practices will affect the pace and effectiveness of the adoption of new processes and products. Without that ability to adapt and improve, it is hard to see how Russia can successfully diversify. There are, however, a number of policy options available with a view to improving the quality of management in Russia.

First, specialist management training needs to be provided more widely. This is currently envisaged within the framework of the Skolkovo project, but needs to be made available more widely across the country.

Second, policies aimed at strengthening competition – particularly policies facilitating the entry of multinational firms – will be essential. Multinationals clearly bring with them strong managerial skills, the influence of which can, over time, spread to local firms, notably those linked to multinationals by means of supply chains and other arrangements. Some of the changes that need to be made in this respect have already been set out in Chapters 3 and 4. In addition, improvements also need to be made, as a matter of urgency, to the design of migration rules covering highly skilled foreign professionals who could potentially be employed by such companies (an issue discussed in greater detail in Chapter 6).

Third, policies aimed at the development of capital markets can strengthen incentives for companies to list and issue exchange-traded debt instruments, thereby subjecting themselves to greater scrutiny by shareholders and creditors. This should, in due course, exert more effective pressure on management regarding performance and corporate governance.

Lastly, cross-country evidence suggests that there is a positive nexus between management, productivity and the type of market in which a firm operates. Being positioned in export markets is consistently associated with improved management and productivity. However, as this report documents, the number of Russian exporters remains small, effectively shutting off access to a powerful source of improvement. While increasing the competitiveness of Russian exports other than natural resources is an aim in itself – as one element of the broad diversification goal that Russia has set itself – the analysis in this chapter indicates that there may be a feedback loop through which participation in export markets can boost both management practices and productivity, thereby further supporting competitiveness and growth outside the natural resource sector.

Box 5.2
Management practices in Russia's Far East

To get a greater sense of the regional picture as regards management, the EBRD conducted a follow-up survey looking at 97 firms in the Far East between February and April 2010. The survey covered the Primorsky Region, the Khabarovsk Region, Sakhalin, the Amur Region and the Jewish Autonomous Region.

The average management score in the Far East was slightly better than in the rest of Russia, although the difference was not statistically significant. This was driven largely by significant differences in incentive management and, to some extent, monitoring, while the scores for operational management and target-setting were very close to the Russian average.[8] This could potentially be explained by the severe shortage of skilled labour in the Far East, a result of significant outward migration from these regions and a rapid decline in population during the 1990s and 2000s. These demographic developments may have put pressure on employers to better incentivise employees, while not necessarily affecting operational management.

Another factor which proved to have a much stronger impact on firms in the Far East was the size of the target market. While firms targeting the whole of the Russian market are typically managed somewhat better than those targeting only their local regional market, this differential proved to be particularly strong in the Far East. This is likely to be due to the transport costs and logistical challenges of selling to the rest of Russia. In order to sell to the whole of the domestic market, firms in the Far East need to have an extra competitive advantage, and part of that may come from better management practices.

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