Carlos da Silva Costa: The quality of management

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Conference organised by the Economic and Social Council (CES) “The Quality of Management, Lisbon, 10 May 2019.

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As prepared for delivery.

I would like to thank the President of the Economic and Social Council, António Correia de Campos, for the kind invitation to join you today. I am delighted to be here.

The subject of management quality is of paramount importance for the sustained economic development of our country and I believe it is very relevant that we also discuss it in the context of social dialogue.

This is a subject that concerns not only investors but also workers, suppliers and creditors and the customers of a firm, as well as the community the firm is a part of. All social partners depend upon and determine the quality of the firm’s management. They have a role to play in promoting the quality of management. They are also creditors and beneficiaries of the gains resulting from our firms’ management quality.

The civic and institutional environment determines the principles and values that guide the management of organisations, in as much as the legal framework determines such management and, in particular, how sustainably it performs.

This reflection is all the more pressing given that any society is living in a constant state of tension between the aspirations for consumption and well-being of the population and the ability of its firms and organisations to generate income in order to meet such aspirations.

This is the case of Portuguese society. Today, we are living in a phase of economic growth that is already distant from the emergency situation we experienced at the beginning of the decade. However, Portuguese society’s aspirations to individual well-being and social equity exceed the production capacity of the economy. And this misalignment between aspirations and possibilities, which is dynamic, can only be addressed with more and better economic growth.

Over the last two decades, Portuguese GDP per capita has remained 30–40% below the European Union average[1], a gap that was not overcome by the convergence observed in the most recent past. This shows how much leeway there is for us to make up.

It is therefore important to identify and implement conditions that promote the sustainable growth of the potential output — that is to make the Portuguese economy structurally able to grow at higher rates in the medium and long term, regardless of cyclical oscillations.

We know that what separates the Portuguese economy from the best performing economies in terms of per capita output are the **productivity differences for every hour worked, rather than the number of hours worked**. The solution to achieving sustainable growth of our GDP per capita should therefore focus on activating the ‘levers’ that determine the productivity of our workers.

From among the main productivity ‘levers’, it is usual to highlight the following four:

1. Employee skills;
2. Capital levels per worker;
3. The innovation ecosystem; and

4. The attractiveness of the business environment.

Two ‘levers’ are often ignored, which are decisive if all others are to achieve their maximum potential: these are, on the one hand, the **entrepreneurial capacity** (I would call it the ‘entrepreneurial drive’ of a given community) and, on the other hand, the **nature, robustness and quality of the management models**.

For the combination of capital and labour to result in the production that is desired by the market, a firm needs an entrepreneur, an organisation and a management model.

I will focus today on the importance of the model and the quality of management for firms and organisations’ sustainable development and, consequently,

- For potential output growth;
- For the capacity of a given community to strike a balance between aspirations and possibilities;
- And, through redistribution, for safeguarding social cohesion, or containing causal factors of conflict or social disharmony.

The management model reflects the way in which the manager coordinates environment, organisation and strategy. That is, the management model defines an organisation, which designs a strategy in such a way as to take the best advantage and even influence the environment that surrounds it.

This coordination can lead to a differentiation of the firm’s performance from that it would naturally have had, if it had only passively adjusted to its environment.

One example of this differentiation can be seen in the comparison between the evolution of large textile manufacturers in Vale do Ave and Galicia in the last few decades. The differences in performance are not found in the sectoral category, which is identical, or in the workers, who come from the same social stratum, or in their geographical location, as they are close to each other. The differences arise precisely from the management models used.

Widely known academic studies, written namely by Professor John Van Reenen, estimate that approximately 30% of the productivity differences between countries are explained by differences in management quality. For the specific case of the Portuguese economy, this estimate is not very different: **27 % of the productivity gap between Portugal and the most productive economy under analysis – that of the US – is related to the difference in management quality**.

As evidenced in the latest edition of the *Global Competitiveness Index* published by the World Economic Forum, there are 15 European Union economies ahead of Portugal. In the list of indicators where our country is worst classified, some are intimately connected to entrepreneurship and management models, namely:

- Attitude towards risk, in which we are 80th in 140 economies;
- Willingness to delegate authority – position 70 out of 140;
- And integration of disruptive ideas – position 46 out of 140.

While these international comparisons point to an important margin for progress in our country, national data also show a significant potential to promote productivity through improved management.

Statistics Portugal launched the first edition of the Management Practice Survey in 2017. This survey was targeted at senior managers of firms based in Portugal and aimed to gather qualitative information on their management practices, in a variety of areas, from strategy to organisation, monitoring of objectives and decision making.

This is a means for assessing the impact of management practices on productivity and on other performance indicators of Portuguese firms.

Based on the results of this survey, Statistics Portugal has constructed a composite indicator allowing the sample of firms to be divided into two groups, depending on the quality of their management practices. Compared to others, the firms with the best practices have,

- Higher returns,
- Higher turnover and gross value added growth rates;
- Higher investment rates;
- A greater increase in the number of employees with higher education levels;
- And a greater use of information and communication technologies.

In addition, **firms with better management practices** also have higher gross value added per worker, i.e. **they have higher levels of productivity per worker**.

The promising nature of these first results certainly merits further development and consolidation. That said, they suggest that improving our management models could make our economy more productive.

I would like to draw attention to three ways in which the management models of the Portuguese business fabric can progress.

The first of these is the **quality of the organisation**. A well-conceived organisation adapted to the challenges faced by the firm can trigger the functions and competences most relevant to its success. Empirical research shows that **when Portuguese firms are reorganised** in response to an external shock, **adding a new hierarchical level of managers, their productivity accelerates**.

A second vector that promotes management quality is the **size of the organisation**. Today, **any firm with ambition is facing global, complex, extensive and constantly changing markets**. Responding to such challenges requires large organisations, able to capitalise on and mobilise quality resources. There are already empirical studies that confirm this positive link between company size and management quality.

With a productive fabric like ours, largely made up of family-run businesses transitioning to the 3rd generation, the increase in the size of the organisations is closely linked to the business view of the families holding the equity.

This leads the way to the third vector which I would like to draw your attention to: **the relationship between ownership and management**.

Empirical research has also found evidence that firms where there is share capital from outside the founding family are associated with best management practices.

Data also suggest that the mere separation of ownership and management is beneficial: **as a general rule, the quality of the management is higher when it is entrusted to people outside the family that owns the firm**.

Professionalisation of management is therefore a necessary condition to ensure the survival and long-term sustainability of family businesses and thus preserve their share capital.

In addition, the separation of ownership and management makes it possible to strike the right balance between the legitimate interests of the different stakeholders in the firm, thereby also contributing to its sustainability.

Meaning that, in a context where family businesses are predominant and where a large number is transitioning to the 3rd generation, or is already controlled by the 3rd generation, serious consideration needs to be given to the separation of entrepreneurial, ownership and managerial functions. Specifically with regard to firms in the stage of generational transition, it is important to ensure that the ownership function is not only distinct from the management function but also exercised through decision-making mechanisms established in the firm's articles, with a view to the sustainability of the organisation and the empowerment of the management. Firms should prevent the decision-making mechanisms coming to a standstill owing to lack of interest or differences between heirs, rendering management powerless and calling into question the continuity of viable firms.

In addition, public policy should favour the segregation of these functions so as to ensure that there is room for management professionalisation and thus improve the quality of management. In fact, public policy can encourage management professionalisation in family-run firms in different ways:

- First, by re-analysing the tax treatment of profit distribution to encourage differentiation between ownership and management, and to foster a suitable balance between profit distribution and reinvestment;
- Second, making the requirement for firms to present audited accounts widespread in order to give the manager the necessary leeway to balance the various legitimate interests – stakeholders – in the most beneficial way for the firm;
- And third, by developing and providing a new figure or "legal entity" that congregates the shareholdings of a given family and awards the function of ownership of a given firm to an institution, i.e. creating the "family holding" figure, through the legal classification of a centralised management model of the holdings of the members of one family; this model should be optional, supplemental and adjusted to the specific features of family businesses, with a statutory and tax treatment that:

  – promotes the holding company's commitment towards its holdings and their locations;

  – guarantees the necessary legal certainty;

  – is simple and easy to access by smaller firms.

- Finally, economic policy actors can make an important contribution by fostering widespread knowledge and open discussion on the impact of the quality of management on business productivity and the well-being of society. This contribution is being made today by the Economic and Social Council. The same contribution is also made by Banco de Portugal,

  – through the inclusion of the topic of management quality in its research agenda;

  – through the production, publishing and analysis of quality statistical information that can support the study of the topic; and

  – by raising the banking system's awareness of the strategic importance of considering management models, in addition to the actual collateral, in the risk assessment of firms and their projects.

In short, there is no doubt that the quality of management is central to the challenge of promoting productivity. The good news is that Portugal still has much to gain from activating this 'lever'. In our day and age, marked by such a strong heterogeneity and weak overall productivity, it is imperative that we do not miss this strategic opportunity.

Finally, let me thank you again for the invitation to be with you at this conference. I will be available should you wish to comment or ask any questions.

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[1] Nominal data (Source: Eurostat).