



# Individualism and the cultural roots of management practices



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## ABSTRACT

We study the cultural foundations of management practices, which are increasingly recognized as important determinants of firm performance. This research closes the loop on two developing literatures, one seeking cultural explanations for economic development and the other seeking to account for differences in firm performance from differences in how firms are managed. Theoretically, we expect individualist culture to improve management practices because it formalizes the labor relation. Results show that higher individualism is strongly associated with more sophisticated management practices. Several robustness checks confirm our findings. In a direct test, culture is a much more important determinant of management practices than are key formal institutions. Moreover, a formal test shows that management practices are indeed an important mediator in the empirical link between culture and per-capita income. The evidence presented in this paper moves us forward in opening up the black box of culture-performance linkages, helping us to understand better the channels through which culture can affect economic prosperity.

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## 1. Introduction

In a case study of the history of economic development, Clark (1987) found marked cross-country differences in productivity of nineteenth and early twentieth century cotton mills, even when the mills themselves used the exact same equipment. He traced back the cause of these differences to the way factories were managed. Contemporary work by Bloom and Van Reenen (2007, 2010) similarly documents substantial cross-country variation in management practices with important implications for firm performance: total factor productivity, return on capital, sales growth, survival, etc. These findings raise the question what can explain differences in management quality across countries. One possible answer is culture, which is increasingly recognized as a cause of economic differences, as when economic activities take place in a certain context of social norms and other informal institutions (Harrison, 1992; Landes, 1998; North, 1990; Williamson, 2000). We draw on theories and insights from the cross-cultural organizational behavior literature to combine these two strands of research with the aim of explaining differences in management quality, thereby illuminating a channel through which culture can affect economic performance.<sup>1</sup>

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<sup>1</sup> For empirical evidence on the importance of firm productivity for aggregate economic performance, see, for example, Van Biesebroeck (2008). Marshall (1919) provides an early exposition of the importance of management for the economic development of nations.

Early empirical analyses of culture's role in socio-economic outcomes were limited to showing region or country of origin effects, for instance in shirking behavior (Ichino and Maggi, 2000). Over the last few years, researchers have moved beyond such a reduced form approach, relying on simple survey items to measure country differences in cultural values (Guiso et al., 2006; Tabellini, 2008) and, more recently, using sophisticated indexes of comprehensive dimensions of national culture to explain differences in economic development (see, particularly, Gorodnichenko and Roland, 2011a,b). The most significant of these dimensions is individualism, which various authors argue is a key factor in explaining economic differences (Greif, 1994, 2006; North, 2005; Platteau, 2000).

This paper takes the next step in opening the black box of firm performance and culture-performance linkages where we seek to understand the cultural roots of management practices. Theoretically, we expect increased individualism to go together with a formalization of the labor relation, including objective performance appraisal criteria and more structured hiring and selection methods. To test this hypothesis, we draw on Bloom and Van Reenen's (2007, 2010) work that has developed a comprehensive indicator of differences in process-oriented features of management.<sup>2</sup> We take our measure of individualism from Hofstede's (1980) seminal study, measuring and conceptualizing differences in national culture. Hofstede's (1980) study is among the most cited works in social science (Bond, 2002; Hofstede, 2001), but economists have only just started using his framework, not only to account for economic development, but also to explain country differences in economic phenomena more generally.<sup>3</sup> Confirming our hypothesis, results show that individualism is a strong determinant of management practices. This finding is robust to different model specifications. In an extension, we find that culture is a much more important determinant of the level of sophistication of management practices than formal institutions are. To come full circle, we further analyze management practices as a mediator in the empirical link between individualism and per-capita income. A formal test shows that a significant part of the effect of individualism on income per capita runs through management practices. We find that looking at the cultural foundations of management practices indeed helps open the black box of culture-performance linkages, putting forward management quality as an important channel through which culture can affect economic performance.

## 2. Individualism and cultural differences in management practices

In their effort to understand economic development, economists are increasingly digging beyond macro-level data on output per capita, considering industry differences and plant-level variation in productivity (Bartelsman and Doms, 2000; Bartelsman et al., 2013; Harberger, 1998). Evidence shows that firm fixed effects, specifically management practices, are crucial (Bloom and Van Reenen, 2007, 2010; Syverson, 2011). A key issue subsequently is which factors can account for differences in management practices. Bloom and Van Reenen (2007, 2010) uncover a variety of factors predicting differences in management practices, including firm size and ownership type, especially whether a firm is family-owned or not. These findings concern variation within countries, however, and not much is known about the aggregate-level determinants of management practices. A question that is particularly salient concerns the role of culture in explaining different management practices and organizational forms (Van Reenen, 2011). Initial results indicate that trust is an important predictor of decentralization (Bloom et al., 2012b), but little is known about distinct cultural influences on how firms actually manage their operations.

As individualism concerns the most fundamental aspects of groups of people living and working together, it is a primary dimension of culture (Bond, 2002; Oyserman et al., 2002; Triandis and Suh, 2002) and a likely determinant of management practices. Individualism can be defined as the extent to which individuals are supposed to take care of themselves (Hofstede, 1980; Gorodnichenko and Roland, 2011a,b; Markus and Kitayama, 1991) and is typically viewed in opposition to collectivism, which is defined as the extent to which individuals remain integrated into groups, particularly the (nuclear) family (Hofstede, 1980; Markus and Kitayama, 1991). To establish a detailed theoretical link between individualism and management practices, we draw on research in the field of cross-cultural organizational behavior (OB).

Cross-cultural OB is a research field in management and breaks down in three areas, micro, meso and macro, depending on the level of analysis (Bond and Smith, 1996; Gelfand et al., 2007; Tsui et al., 2007). Themes in this literature include individuals' motives and cognitions (micro OB), leadership and negotiation (meso OB) and organizational culture (macro OB). Most germane to understanding the influence of individualism on management practices is the body of (experimental and theoretical) work in cross-cultural OB that relates individualist cultural values to micro and meso organizational phenomena. Culture matters for preferences (Fernández, 2008; Guiso et al., 2006) and drawing on cross-cultural OB we find that individualism is associated with preferences conducive to a formalization of the labor relation, making it transactional in nature instead of an in-group phenomenon that is shaped by relational ties.

<sup>2</sup> Bloom and Van Reenen (2007, 2010) initiated the World Management Survey. This database contains evaluations for 18 concrete management practices, covering all key domains of management, namely monitoring, targets management, and incentives management. The 18 practices together give a comprehensive index of overall quality of management practices.

<sup>3</sup> Examples of phenomena influenced by national culture, specifically individualism, include investment strategies (Beckmann et al., 2008; Chui et al., 2010), behavior in laboratory games (Buchan et al., 2006; Herrmann et al., 2008), and contributions to open-source software (Engelhardt and Freytag, 2013).

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