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The Landscape of Tough Times

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The vertiginous GDP falls in the principal industrial countries since mid 2008 – the worst since the 1930s – have now begun to stabilise. Yet the impact of the near collapse of the western banking system and the ensuing credit crunch will not be lightly shrugged off. The sharp rises from excessively oversold levels in world stock markets are more to do with relief that Depression has been avoided by unprecedented action amongst governments to stimulate demand, bail-out banks and inject liquidity into the credit markets than a barometer of the strength of recovery. The debate among economists is how anaemic it will be. The Governor of the Bank of England has warned of some years of stringency. In Britain, private sector demand will be held back as consumers rebuild their savings and companies their balance sheets. Banks remain understandably risk averse. At the same time, the next government, of whatever hue, will focus on deficit reduction – although important differences exist about the timing and extent of public expenditure cuts and tax increases. The evidence from other recessions of this scale is that unemployment rises substantially and can take up to a decade to fall back to pre-recession levels.

Against this background how can companies and organisations best organise themselves to prosper? What lessons should be learned from the financial catastrophe? What are the wider economic and social pressures that might generate further change? This short paper attempts some propositions for debate – and hazards some answers.

The situation is fragile. One reality is already clear; those who regard the benchmark of 2002-7 as representing normal trading to which the economy will effect an eventual if slow return are wrong. That period was abnormal, unsustainable and ended in collapse. Whatever else, the economy is not going to return to that.

Common ground – mistakes nobody should want to make again

It is a commonplace that the crash in the financial system exposed profound weaknesses in its business model, governance and regulation. Less remarked is that the same weaknesses were evident in much of British business. It was not only banks, for example, who over-prioritised shareholder value maximisation and set aside other important business goals such as the ensuring that the business model was sustainable and operated with integrity. The period from Enron's collapse in 2001 to Lehman's bankruptcy in September 2008 was the high water mark for what a growing number of business thinkers, leaders and commentators now regard as an era of profoundly misguided corporate leadership and disintegration of important business values. There was a general downgrading of the pursuit of an identified business purpose as companies' core business mission, and instead the over-riding business goal became the maximisation of short term profits in whatever way possible. Company boards were part bullied, part in thrall and part anxious to join the party by the demands, glamour and extravagant rewards offered by Big Finance.

British companies were particularly exposed to hostile take-over and merger – share ownership in Britain is disproportionately dominated by transient institutional investors and banks from Europe and the US were prepared to offer enormous loans to predators – whether private equity houses or ambitious multinationals – to finance take-over bids. Keeping one's share price high, always important, became the number one goal of British companies both to fend off acquirers and to secure amazing rewards set by company boards to align shareholder and director interests. The ethos percolated into the warp and weft of every British company. For the managers of companies owned by private equity, the message was explicit; hit the revenue and contribution targets and within five years when the company is floated on the public markets you will make a fortune. It was a similar story for quoted PLCs. The most important thing for any manager was to hit or exceed targeted numbers. People engagement; innovation; cultivation of customers – all were subordinate to the goal of meeting the numbers geared to short-term financial success. Checks and balances within companies along with accountability processes were discarded. Management became – and still is – an exercise in which the end, hitting targeted contribution overwhelmed every other consideration of the business. Managers became asset sweaters and target achievers rather than business builders and people engagers.

Company boardrooms and other stakeholders offered too little challenge about what was going on; even if they had, long standing weaknesses in corporate governance meant any change of direction would have been difficult to achieve. In any case the easiness of credit, the buoyancy of asset prices and the promise of ever-rising demand made business easy and mistakes costless; good and bad prospered alike. Companies followed the crowd. Executive pay may not have risen as fast as City bonuses, but it carried on rising rapidly by extraordinary degrees whether the underlying business was doing well or badly. In his annual surveys for *Fortune*, Graef Crystal¹, one of the world's foremost executive pay consultants, admits that he cannot get more than 40 per cent variation in CEO pay as everybody benchmarks themselves against each other rather than against performance.

So if tough questions are being asked of banks – now reluctantly signing up to constraints on bonuses that however minimalist would have been unthinkable two or three years ago – they will increasingly be asked of business more generally, and of business by itself. The challenge comes at two levels. The first is that there is abundant evidence that long run business success requires a capacity to maintain the promise of the quality and integrity of whatever business offer, and continually to upgrade and innovate over time. Profits derive from this capacity. Once the capacity is inverted so that a business's purpose is solely profit, the paradox is that this undermines the companies' capabilities. It turns people into profit automata; it means that all processes are valued only to the extent they turn a profit.

¹ Crystal G., *In Search of Excess: the Overcompensation of American Executives*, Norton, W.W. & Company, 1991

This starts to undermine not only companies, but the idea of capitalism itself. For the time being anti-capitalist sentiment has been directed at bankers. The world has got through the recession with surprisingly few concessions to the protectionists, but the pressure for limits on imports will grow as the recovery proves anaemic. The wildcat strikes at the Lindsey Oil Refinery in Lincolnshire over British jobs for British workers were a storm warning of what may lie ahead if unemployment remains stubbornly high. The high votes for UKIP and the BNP were a political reflection of the same phenomenon. Bankers' singular unpopularity could easily broaden to business more generally.

Business for a long time in the last century suffered obloquy for being exploitative and short-termist; it has only been over the last generation that it has found legitimacy easier as 'the wealth, job generating' part of the economy. When it is not generating jobs and there is less wealth, the proposition becomes harder – especially if those at the top continue to reward themselves extravagantly while others suffer pain. The risk of a return to its former standing is obvious. David Cameron is alert to the danger, arguing for a more moral capitalism, keenly aware of the political danger of being an unthinking advocate of all things business – and insists that business accepts social responsibilities. Gordon Brown now criticises market fundamentalism; he and Business Secretary Peter Mandelson argue that finance should serve industry, for government activism supporting industry and for support for innovation. Already a very different post-credit crunch politics is emerging.

An incoming Conservative government in May or June 2010 – the most likely but yet not certain outcome of the election with a hung parliament a real possibility – will certainly avoid protection and state capitalism. However 2010 is not 1979; it requires rather different interventions than the good old time religion of a bonfire of controls, rolling back the state and relying on the 'magic' of markets. Managing recovery, economic rebalancing and the restructuring of both the private and public sectors is much more complicated than simple appeals to deficit cutting and deregulation. Moreover there plainly needs to be a rebasing of company values and priorities. The concern is less that a new Conservative government does not understand these issues, but that already it is over-prioritising one – the necessity to cut the budget deficit. If it acts prematurely it risks prolonging the recession, and not attending to other key economic challenges. For example there is also an urgent need to create a new settlement that allows companies to be genuinely innovative and wealth creating rather than rely on financial engineering, leverage and debt driven consumption to produce profits and earning per share growth. It remains unclear exactly what a Conservative government would propose, and to what degree some of its actions would potentially actively damage Britain's emergent innovation system – ranging from increased spending on science, to leveraging investment in key sectors. The uncertainty only adds to the general malaise. On top all the issues and economic uncertainty experienced here

are being reproduced throughout the industrialised west. The US and EU are looking for sustainable recovery, and debating similar options and worrying about similar phenomenon. We are not alone.

Further change – the emergent ‘knowledge based’ economy

The good news is that the 2010s is likely to see an acceleration in the trends creating the knowledge economy – the result of an acceleration in the pace of introduction of ‘general purpose technologies’ (GPTs) and of their early adoption by a critical mass of adaptive, experimental, rich consumers. A general purpose technology is a technology with wide spill-over effects into other sectors beyond the one in which it was created. Thus the railway, internal combustion engine and aircraft were not just transport technologies; they radically transformed whole economies and societies. The railway created the suburbs and a world market in goods and services; the automobile, another GPT, defined a civilisation; aircraft are indispensable to globalisation and warfare. Other GPTs – mass production and lean production – have transformed the production process. These technologies, feeding off each other, are growing exponentially. There were four GPTs in the nineteenth century and eight in the twentieth. Innovation theorists like Professors Richard Lipsey, Kenneth Carlaw and Clifford Bekar² expect the rate of introduction to accelerate over the current century.

Everybody understands that the internet and ICT are disruptive general purpose technologies that are killing old business models in publishing, film, music and the postal and telecommunication services and creating new ones – hence Nokia, Microsoft, Cisco, Google, Quikflix, Amazon, Facebook and Vodafone. There is a widespread view that this is a discrete technological event and although other innovations will succeed it they will do so in a manageable, linear fashion as they have in the past. Few grasp the twenty first century reality. Innovation is about to fuse and cascade into a continually disruptive flow across the entire economy. No sector – energy, mining, chemicals, cement, car industry, aerospace, pharmaceuticals, office equipment, banks, insurance, retailing, transport – is going to be unaffected.

The innovation is not just at this high level; it impacts on middle level and ground level innovation as well. The change is not brought about only by changes to supply; consumers are becoming more discerning, sophisticated and anxious to buy goods and services that are experientially rewarding. It is this interaction that will challenge business models across the board. There is going to be an intensification of what the Austrian economist Joseph Schumpeter called ‘creative destruction’.³ Already the average lifespan of an S and P 500 company has shrunk from 40 years in the mid 1950s

² Lipsey R., Carlaw K., Bekar C., *Economic Transformations: General Purpose Technology and Long-Term Economic Growth*, Oxford, 2006.

³ Schumpeter J., *Capitalism, Socialism and Democracy*, Routledge, 1943.

to around eleven years today – and similar trends are observable in Britain. For example the loss rate of non-multinationals entering the marketplace is increasing; between 1983 and 1991, 27 per cent of non-MNEs had disappeared within three years – the rate sharply increased to 41 per cent between 1991 and 2001. Many of the firms, production processes and goods and services that will dominate the economy in the 2030s are not yet invented.

There are varying definitions of the knowledge economy – by share of GDP, proportion of the workforce with higher educational qualifications or simply the number of workers who self report that they are problem solving for all or part of their working week. The Work Foundation calculates that on whatever criteria, the knowledge economy is both significant – exceeding two fifths of GDP – and is likely to surpass half within fifteen to twenty years. Our view is that the challenge for all advanced economies is to make sure they are as well positioned as possible to build new business models and companies in this emergent knowledge economy. It is the key to growth, reducing unemployment and lowering our carbon footprint.

The route to the high performance workplace:

Reviving business purpose, committing to fair companies and engaging employees.

There are two necessary but insufficient conditions for success over the next decade. The first is to possess clarity of business purpose, which creates clear values in turn. This is the route to trust relationships between directors and staff, the company and its customers and supply chain. If companies have a clear idea of who and what they are everything becomes easier; who to recruit, investment priorities and which markets to target. It allows companies to align their brand, business model and purpose. It is the basis for any credible narrative for the investment and banking communities.

Declared business purpose	Ambitions
To help our customers connect to the people and things that matter to them (Telecommunications)	To provide world-class telecommunications and information products and services and develop and exploit our network at home and overseas
To build strong communities by creating opportunities for people – including customers, shareholders and associates – to fulfil their dreams. (Bank)	To become one of a handful of universal banks leading the global financial services industry
Caring for the world, one person at a time (Pharma)	To become a diversified global healthcare leader

The table above takes the declared business purpose from a telecom, pharmaceutical company and bank. The purpose translate into a strategy from which the company aims to be a profit maximiser. This chain of causation is important. It declares what the business is about and thus what its capabilities need to be. It creates an animating framework and focus for the pursuit of profit, rather than making profit the sole purpose of the company. Subtle – but important.

The second condition for success is a commitment to fairness. Employees in particular firms and hard pressed sectors may have to accept wage freezes, reductions in benefits, changes in role and pay holidays over the difficult years ahead. They will be survivors as others lose their jobs. Yet it is only through workforce engagement and commitment that successful innovation can be achieved and hyper responsiveness to consumers successfully mastered. Managements and leaders have to earn trust – which can only be done by committing to fairness.

Fairness is about both outcomes and processes. Outcomes must be proportional to effort, especially discretionary effort that has plainly made a difference to the enterprise. Salaries, wages and bonuses must reflect due desert. Pay and promotion must be transparent, earned through effort or result should be directly linked to the business's purpose. Equally those who forego wages and benefits must be able fairly to benefit in future through issues of shares or long term bonuses. Care must be taken to ensure that procedures and processes embody fairness – in performance management, in promotion, in setting bonus targets, and in resolving disputes. In this respect trade unions can be important custodians of good fair processes, and as communication routes that uphold the authenticity and integrity of management actions. Employees value fair process as much as fair outcomes.

Companies like Rolls Royce, Standard Chartered and Sainsbury have fared better than expected over the recession in part because of this approach. These two preconditions – business purpose and fairness – are intertwined and interdependent. As *Engaging for Success*⁴, the report to the British government on employee engagement published in July 2009 says 'Engaged organisations have strong and authentic values, with clear evidence of trust and fairness based on mutual respect, where two way promises and commitments – between employers and staff – are understood, and fulfilled.'

Challenges for business

It must fall to company leadership teams to crystallise their business purpose and values, and to organise the buy-in of shareholders and employees. The Work Foundation in *Cracking the*

⁴ MacLeod D. and Clarke N., *Engaging for Success: Enhancing Performance through Employee Engagement*, Department for Business, Innovation and Skills (BIS), 2009. <http://www.berr.gov.uk/whatwedo/employment/employee-engagement/index.html>

*Performance Code*⁵ shows that firms that combine and integrate market responsiveness, shareholder value maximisation, innovation, employee engagement and stakeholder involvement around a clear business purpose significantly outperform those who do not. This has been true of companies as disparate as Tesco, with its famous Quadrant which ranks customers, shareholders, workers and stakeholders as co-important constituencies the company must work to satisfy, or Boeing with its commitment to build great aeroplanes.

But it is also true of the public sector. One of the reasons that some MPs lost their way over expenses is that the House of Commons purpose as a deliberative national legislative assembly has been lost – becoming instead simply a means to support the government of the day right or wrong. MPs, reduced to commoditised lobby fodder, became the commodities their purposelessness assigned them – and manipulated allowances as cynically as they were manipulated.

Questions of purpose are not ‘soft’, as some believe; indeed relegating business purpose has coincided with a disastrous period of business management. Asserting business purpose, publishing it and being held to account for its implementation is an essential precondition for successful management and high performance.

Actions for business

Business purpose	Fair-proofing
Appoint a strong board prepared to hold management to account for achievement of declared business purpose	Establish a common understanding of fairness i.e. ‘due desert for discretionary effort’
Exploit every communication vehicle to impart the business purpose to staff and encourage feedback	Approach engagement with fairness, respecting ‘the deal’ from employees’ experience and perspective
Ensure pay and promotion is earned through effort or result directly linked to business purpose	Establish an equality of sacrifice with no exemptions and balance short term benefit forfeit with long term benefit gain
Establish and empower a custodian of business purpose and procedural fairness	

This has significant implications throughout the firm. Chairs should ensure that CEOs have strong co-directors and non-executive directors prepared to hold management teams to account for the achievement of the declared business purpose. Boards should be genuine places for deliberation rather than rubber stamping CEO decisions.

⁵ The Work Foundation in *Cracking the Performance Code* (2005): www.theworkfoundation.com/crackingtheperformancecodereport

Any company concerned to integrate a range of functions as co-equally important has to demonstrate that by how they are held organisationally; for example marketing, HR and Research/Innovation should be reinvented as functions equal to the financial function. In particular, Human Resource Management needs to be more than the function that organises the transactional part of the employee/employer relationship from payroll to dispute resolution, important as both are. The ambition to be a strategic adviser to the CEO is in most organisations an ambition too far – and presumes unity of purpose rather than the reality of different agendas and interests. Instead HRM must aim to be the custodian of the ‘deal’ – the moral bargain between an employer anxious to enlist employee engagement around the business purpose and an employee who will be readier to engage the more the ‘deal’ is explicit and honoured – especially in terms of fair outcomes and process. Every communication vehicle should be exploited to impart the business purpose to staff – and encourage feedback. There needs to be regular interactive ‘town hall meetings’, video conferencing, and of course walking the floor.

All internal procedures need to be ‘fair-proofed’ to make sure they meet fairness standards – one of the dimensions of the ‘deal’. Management need to engage in an urgent debate with employees to ensure that they all have a common understanding of what fairness means and how it governs pay relativities – I suggest ‘due desert for discretionary effort’ – and that they are all on the same moral page in being committed both to fairness and to a shared understanding of what it means in terms of pay, process, respect and voice.

When it comes to stringency on wage freezes or even pay holidays, management must insist on equality of sacrifice with no exemptions. There is a strong case for deepening and extending employee stock ownership schemes which can offer shares as deferred payment in exchange for sacrifices in pay or for exceptional discretionary effort as part of the ‘fair-proofing’ exercise. Employee share ownership schemes work. For example, the Treasury in the largest study of share ownership ever to have been undertaken in Britain⁶ found that ‘on average, across the whole sample, the effect of tax-advantaged share schemes is significant and increases productivity by 2.5 per cent in the long run.’ Different schemes reinforced the effect and it found that schemes chosen by firms without tax advantages tended to pay off more than those with tax breaks. This suggests that if cash is just the motivation, it works less well than a determined effort to signal that what matters to management is inclusion, engagement and fairness. When workers are given their due desert within a system of due process, leading them to believe that they are being treated fairly, they work harder.

⁶ Oxera (2007b) [*Tax Advantaged Employee share Schemes: analysis of productivity effects Report 2: Productivity Measured Using Gross Value Added*](#), HM Revenue and Customs Research Report 33

The Work Foundation is exploring the nature of the emerging employer/employee 'deal' to open up the implication of this approach⁷ yet what is already clear is that the precondition for the high innovation workplace is a capacity to hard-wire market feedback into internal processes to ensure responsiveness and improvement – but any such hard-wiring is predicated on employees wanting to operationalise the system. Equally while all innovation depends on self-consciously creating the space to experiment and to fail – 'organisational slack' – again innovation springs from engaged, concerned and involved workers who are prepared to exploit the slack. Engaging employees is becoming a crucial strategy for commercial success.

Challenges for unions

Trade unionism is in transition. Declines in membership in the private sector continue, particularly in the fast growing knowledge based economy. Representation in knowledge based services in Britain and the west generally tends to be tiny. Knowledge workers – indeed many contemporary workers – are reluctant to associate themselves with the values and approach of traditional trade unionism; adversarial, and putting egalitarian values before those of fairness and equity. Yet at the same time the case for employee voice and the need to develop a dialogue over the issues in this paper – business purpose, 'fair-proofing', employee engagement, job design, the structure of pay and the commitment to innovate and be consumer responsive – is ever more pressing.

Trade unions are confronted with a choice. They can stick to their knitting – pay, conditions and job security. Or they can embrace this new agenda as opening up possibilities for achieving respect, autonomy, fair process, tempered security, the opportunity for self-expression and of course due pay for due effort at work. If Nobel Prize winning economist Edmund Phelps⁸ is right that every worker seeks to do something entrepreneurial and self-actualising with their working lives, the opportunity now presents itself to turn this into reality. Unions who have wanted to go in this direction have too frequently encountered suspicious, cautious managements unwilling to open up; unions' reputation goes before them. Now is the moment for both sides to venture change.

Challenges for the government

The drive for innovation and high performance cannot work at company level alone. It needs to be complemented by government action. The next government of whatever political hue needs to develop a compelling vision of what the British economy should look like in 2020 and work towards that goal.

⁷ The Work Foundation's Future of HR programme is investigating the nature of the employer/employee 'deal': <http://www.theworkfoundation.com/thefutureofhr>

⁸ Phelps E., Nobel prize speech (2006).

This will require a multi pronged approach. There will need to be an array of national policies aimed at creating greater resource flows in cash, skills and innovative imagination that support innovation and the wider knowledge economy. Secondly, the UK will need to build on its current strengths to consolidate an institutional framework that supports innovation – in finance, universities, networks and the governing and regulation of innovation eco systems. And thirdly, it will need to develop a framework of ownership, governance, regulation and law that allow firms to develop the organisational slack, financial headroom and leadership and managerial capabilities – along with employee engagement – in which innovation can flourish.

Most importantly of all, companies will have to build committed, engaged workforces, new conduits to harness consumer feedback to maximise market responsiveness and to embed innovation processes at every level in their business.

The promotion of innovation must be at the heart of its financial, business and industrial policies. This has profound implications for the financial system, universities, skill provision, corporate governance, the structure of welfare and the development of lifelong learning – and the culture and approach of the government.

The Work Foundation

The Work Foundation's programmes are oriented around this emergent agenda. Our research, advisory and consultancy work on the knowledge economy, spatial economic development, leadership, the future of HR, skills and what we call Good Work, are aimed at helping companies, unions and the government alike. They are designed as an interlocking series of interventions that can help Britain exploit the opportunity of tough times. In addition, we are exploring partnerships, research and networks that will develop ideas on:

- How to progress innovation at both a national, city and organisational level;
- How to organise more contractual flexibility with better income security, lifelong learning and active labour market policies;
- How to advance the cause of business purpose and shareholder commitment;
- How to develop the workplace 'deal'; and
- How to promote mental and physical well-being at work.

Conclusion

Recognition is growing that the credit boom and asset price bubble allowed many companies to dodge fundamental issues about how to generate sustainable wealth. The credit crunch and catastrophic recession have forced the issues into the open. The Work Foundation will do everything it can via its research and extensive networks to open up the case for good ownership and good work as the means to innovation and sustainable growth in the low growth, challenging environment ahead. Others must contribute. At stake is the health and vitality of our economy and society.

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