BOSS-ONOMICS: DOES MANAGEMENT MATTER?

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Royal Economic Society Lecture 2010
2008-09 “GREAT RECESSION” COMPARED TO PREVIOUS RECESSIONS, CUMULATIVE CHANGE IN UK GDP

Source: NIESR (November 2010)
GREAT PEOPLE TO WORK FOR?

GREAT PLACES TO WORK? .......
Nokia factory shop floor: area around the machines is clean and organised
State-owned telecoms equipment factory in Belarus. Everyone on a mysterious break?
Family-owned textile company outside Mumbai, India
OUTLINE

1. What is productivity & why should we care?

2. International Comparisons: How is the UK doing?

3. Why is there a productivity gap?
   - Technology
   - The role of management

4. What can we do to improve things?
   - Long-run structural change
   - Short run – extreme austerity not the answer
WHAT IS PRODUCTIVITY AND WHY SHOULD WE CARE?

• “Productivity isn’t everything, but in the long run it is almost everything” (Nobel Laureate Paul Krugman)

• Productivity growth
  – Drives growth of real wages
  – Can facilitate redistribution

• Particularly important during current era of budgetary cutbacks
DOWNSIDES TO PRODUCTIVITY GROWTH?

• Poverty?
  – Absolute poverty tends to fall with growth (e.g. China, India)
  – No evidence that faster productivity growth means more relative poverty/inequality

• Happiness?
  – Growth doesn’t guarantee happiness
  – Wellbeing not all about consumption (e.g. environment)
  – But big falls in consumption create misery
WHAT IS LABOUR PRODUCTIVITY? 3 COMPONENTS OF GDP (NATIONAL INCOME) PER PERSON

Basic “welfare” measure

\[
\frac{GDP}{Population} = \frac{GDP}{hours} \times \text{Labour productivity}
\]
WHAT IS LABOUR PRODUCTIVITY? 3 COMPONENTS OF GDP (OR GNP) PER CAPITA

Basic “welfare” measure

\[
\frac{\text{GDP}}{\text{Population}} = \frac{\text{GDP}}{\text{hours}} \times \frac{\text{hours}}{\text{workers}}
\]

Choice? Labour supply

Labour productivity
WHAT IS LABOUR PRODUCTIVITY? 3 COMPONENTS OF GDP (OR GNP) PER CAPITA

Basic “welfare” measure

\[
\frac{GDP}{Population} = \frac{GDP}{hours} \times \frac{hours}{workers} \times \frac{workers}{population}
\]

Labour productivity

Employment rate. Voluntary & Involuntary. Unemployment & inactivity

Demographics
WHAT IS LABOUR PRODUCTIVITY? 3 COMPONENTS OF GDP (OR GNP) PER CAPITA

Basic “welfare” measure

\[
\frac{GDP}{Population} = \frac{GDP}{hours} \times \frac{hours}{workers} \times \frac{workers}{population}
\]

Labour productivity

• Growth per capita matters for welfare. Total growth does not!
MEASURING PRODUCTIVITY

• Labour Productivity (Output per hour) depends on:
  
  – Inputs per hour (physical and human capital, materials, energy, etc.)

  – “Total Factor Productivity” = TFP = “Solow residual”

  – TFP Accounts for most of long-term growth & much of differences in wealth of nations
LARGE INCOME & TFP DIFFERENCES BETWEEN COUNTRIES

Source: Jones and Romer (2009). US=1
**OUTLINE**

1. What is productivity & why should we care?

2. **International Comparisons: How is the UK doing?**

3. Why is there a productivity gap?
   - technology
   - The role of management

4. What can we do to improve things?
RELATIVE LABOUR PRODUCTIVITY (GDP PER HOUR) IN 2009; $PPP

- **Italy**: 41.01
- **EU-15**: 48.7
- **UK**: 50.76
- **Germany**: 53.46
- **France**: 54.65
- **USA**: 58.98

**Source**: Conference Board World Economy Database, September 2010, Table 8

UK ~13% less productive than US
GDP PER WORKER RELATIVE TO UK IN US, FRANCE & GERMANY (UK=100), 1979-2009

Source: Conference Board (2010), PPPs
UK RELATIVE GDP PER WORKER

UK Gap with Germany reverses from -4% to +7%

Source: Conference Board (2010), PPPs
UK Gap with France falls from -13% to -10%

Source: Conference Board (2010), PPPs
GDP PER WORKER RELATIVE TO UK IN US, FRANCE & GERMANY (UK=100), 1979-2009

Source: Conference Board (2010), PPPs
GDP PER WORKER RELATIVE TO UK IN SELECTED NATIONS (UK=100), 1979-2009

Source: Conference Board (2010), PPPs
PROPORTION OF UK WORKERS WITH A COLLEGE DEGREE ROSE BY 12 PERCENTAGE POINTS 1997-2010

Source: GHS and Labour Force Survey, Various years
OUTLINE

1. What is productivity & why should we care?

2. International Comparisons

3. Why is there a productivity gap?
   - “hard” technologies
   - The role of management

4. What can we do to improve things?
IS TECHNOLOGICAL INNOVATION THE CAUSE OF PRODUCTIVITY GAP WITH THE US?

• Partially correct - UK has innovation deficit

• Although universities/basic science strong.....
  – 14% of all top papers (2nd only to US)
  – The highest number of scientific citations (relative to GDP) of all G8 nations

• ....Commercialization of innovation is weak: Research & Development (R&D), Patenting, etc.
RESEARCH AND DEVELOPMENT (R&D) AS A % OF GDP

Source: OECD (GERD/GDP)
INNOVATION A CAUSE OF PRODUCTIVITY GAP?

- Problem is not just “hard” technologies. Also problems with the way firms are managed.
- Technologies available globally - why do some countries/firms not use?
- But how to measure, quantify and compare across firms and countries?
- Research Program with Nick Bloom (Stanford) & CEP/LSE team over last 7 years
THE SURVEY METHODOLOGY

1) Developing management questions
   • Scorecard for 18 monitoring, targets and people
   • ≈45 minute phone interview of manufacturing plant managers

2) Obtaining unbiased comparable responses ("Double-blind")
   • Interviewers do not know the company’s performance
   • Managers are not informed (in advance) they are scored
   • Run from LSE, with same training and country rotation

3) Getting firms to participate in the interview
   • Introduced as “Lean-manufacturing” interview, no financials
   • Official Endorsement: Bundesbank, PBC, RBI, etc.
   • Run by 55 MBA types (loud, assertive & business experience)
# MONITORING – e.g. *HOW IS PERFORMANCE TRACKED?*

| Score | (1): Measures tracked do not indicate directly if overall business objectives are being met. Certain processes aren’t tracked at all | (3): Most key performance indicators are tracked formally. Tracking is overseen by senior management | (5): Performance is continuously tracked and communicated, both formally and informally, to all staff using a range of visual management tools |

*Note:* All 18 dimensions and over 50 examples in Bloom & Van Reenen (2006)
### INCENTIVES - e.g. “HOW DOES THE PROMOTION SYSTEM WORK?”

| Score | (1) People are promoted primarily upon the basis of tenure | (3) People are promoted upon the basis of performance | (5) We actively identify, develop and promote our top performers |

**Note:** All 18 dimensions and over 50 examples in Bloom & Van Reenen (2006)
MANAGEMENT SURVEY SAMPLE

- Interviewed over 8,000 firms across Americas, Asia & Europe
- Obtained 45% response rate from sampling frame (with responses uncorrelated with performance measures)

Medium sized manufacturing firms:
- Medium sized (100 - 5,000 employees, median ≈ 250) because firm practices more homogeneous
- Manufacturing as easier to measure productivity
  (also conducted in Schools, Hospitals, Retail and Law Firms)
THE LINK BETWEEN PRODUCTIVITY AND MANAGEMENT HOLDS TRUE ACROSS DIFFERENT COUNTRIES

Labour productivity*

U.S. | U.K.
--- | ---
4.0 | 4.5
5.0 | 5.5
6.0 | 6.5

Labour productivity*

CN | JP
--- | ---
4.0 | 4.5
5.0 | 5.5
6.0 | 6.5

Labour productivity*

FR | DE | IT | PT
--- | --- | --- | ---
4.0 | 4.5 | 5.0 | 5.5
6.0 | 6.5 | 7.0

Labour productivity*

SE | PL | GR
--- | --- | ---
4.0 | 4.5 | 5.0
5.0 | 5.5 | 6.0

* Log scale (sales per worker)

** Firms are grouped in 0.5 increments of assessed management score
UK MANAGEMENT MID-TABLE BY INTERNATIONAL STANDARDS

<table>
<thead>
<tr>
<th>Country</th>
<th>Average management practice score</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td></td>
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<td>Germany</td>
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<tr>
<td>Brazil</td>
<td></td>
</tr>
<tr>
<td>India</td>
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</tr>
</tbody>
</table>

Note: Based on 8,261 management interviews between 2006 and 2010. We pool across multiple survey waves to maximize the extent of cross-country management comparison.
HUGE VARIATION OF MANAGEMENT PRACTICES COMPARED WITHIN ALL COUNTRIES

Note: Based on 8,261 management interviews between 2006 and 2009.
MUCH OF THE CROSS-COUNTRY DIFFERENCES DUE TO THE “LOWER TAIL”

Distribution of firm level management practice scores
MY FAVOURITE QUOTES:

The traditional British Chat-Up

[Male manager speaking to an Australian female interviewer]

*Production Manager*: “Your accent is really cute and I love the way you talk. Do you fancy meeting up near the factory?”

*Interviewer* “Sorry, but I’m washing my hair every night for the next month….”
MY FAVOURITE QUOTES:

The traditional Indian Chat-Up

*Production Manager:* “Are you a Brahmin?’

*Interviewer* “Yes, why do you ask?”

*Production manager* “And are you married?”

*Interviewer* “No?”

*Production manager* “Excellent, excellent, my son is looking for a bride and I think you could be perfect. I must contact your parents to discuss this”
Various ways that competition may influence management

- **Selection** – badly run firms more likely to exit
- **Effort** – forces badly run firms to try harder to survive

We find competition is strongly linked with better management through a mixture of selection & effort
MORE COMPETITION IS ASSOCIATED WITH BETTER MANAGEMENT PRACTICES

Assessed management practice score

Reported number of competitors
Impact of family firms depends on involvement

- **Ownership** but not management probably positive
  - Concentrated ownership so better monitoring
- **Management** probably negative
  - Smaller pool to select CEO from
  - Possible “Carnegie” effect on future CEO’s
  - Less career incentive for non-family managers
FAMILY FIRMS AND GOVERNMENT FIRMS HAVE WORST MANAGEMENT

Average score on 18 management practice questions

- Government
- Founder
- Family, family CEO
- Private Individuals
- Other
- Managers
- Family, external CEO
- Dispersed Shareholders
- Private Equity

Number of firms:
- Management: 134
- Management (same ownership 3+ years): 635
- Founder: 722
- Private Individuals: 625
- Other: 290
- Managers: 138
- Family, external CEO: 174
- Dispersed Shareholders: 1357
- Private Equity: 137

Note: Sample of 4,221 medium-sized manufacturing firms. The bottom bar-chart only covers the 3696 firms which have been in the same ownership for the last 3 years. The “Other” category includes venture capital, joint-ventures, charitable foundations and unknown ownership.
BETTER MANAGEMENT IS LINKED WITH HIGHER SKILL LEVELS OF BOTH MANAGERS AND NON-MANAGERS

Degree educated non-managers, %

Degree educated managers, %

Management practice score

<table>
<thead>
<tr>
<th>Score</th>
<th>Degree educated non-managers, %</th>
<th>Degree educated managers, %</th>
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<tr>
<td>1.5</td>
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<tr>
<td>5.0</td>
<td>25</td>
<td>84</td>
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</table>
SUMMARY OF DETERMINANTS OF MANAGEMENT (& PRODUCTIVITY)

- Product market competition
- Meritocratic CEO selection
- Human Capital

- These account for almost all of the management gap between UK and US
BUT DOES MANAGEMENT REALLY CAUSE HIGHER PRODUCTIVITY? BLOOM ET AL (2010)

- Run experiment on plants in Indian textile firms outside Mumbai

- Randomized “treatment” plants get heavy management consulting; “control” plants get very light consulting (just enough to get data)

- Collect weekly performance data on all plants from 2008 to 2010

  - Improved management practices led to large and significant improvements in productivity and profitability (~$200k pa)
MANY PARTS OF THE FACTORIES ARE DIRTY AND UNSAFE
THE FACTORIES ARE ALSO DISORGANIZED

Instrument not removed after use, blocking hallway.

Oil leaking from the machine

Cotton lying on the floor

Instrument blocking the hallway
THE TREATED FIRMS INTRODUCED BASIC INITIATIVES (CALLED “5S”)

Worker involved in 5S initiative on the shop floor, marking out the area around the model machine.

Snag tagging to identify the abnormalities on & around the machines, such as redundant materials, broken equipment, or accident areas. The operator and the maintenance team is responsible for removing these abnormalities.
QUALITY DEFECTS INDEX: TREATMENT & CONTROL PLANTS

Notes: Displays the average weekly quality defects index, which is a weighted index of quality defects, so a higher score means lower quality. This is plotted for the 14 on-site treatment plants (+ symbols) and the 6 on-site control plants (♦ symbols). Values normalized so both series have an average of 100 prior to the start of the intervention. To obtain confidence intervals we bootstrapped the firms with replacement 250 times.
1. What is productivity & why should we care?

2. International Comparisons: How is Europe doing?

3. Why is there a European productivity gap?
   - The role of management

4. Why has the situation got worse?

5. What can we do to improve things?
   - Long-run structural changes
   - Short run – extreme austerity not the answer
STRUCURAL REFORMS TO IMPROVE MANAGEMENT & PRODUCTIVITY

• Product market Competition
  – Competition policy, Trade policy, planning
  – Public sector (e.g. UK hospital reforms)

• Meritocratic CEO appointment not eldest sons
  – e.g. 100% Inheritance Tax exemption for family business assets, promotes family firms (cf. Mirrlees Review)

• Human Capital
  – UK weak at lower end (e.g. EMA, Apprenticeships,)

• Openness to foreign investment
• Labour market regulation
• Financial market regulation
AUSTERITY – LABOUR’S PLANS FOR FISCAL TIGHTENING

5% of GDP by 2016/17
(£72.4bn by 2015/16)

Source: IFS, HMT
EXTREME AUSTERITY – JUNE EMERGENCY BUDGET. LARGEST CUT SINCE WW2

7% of GDP a year earlier (£110.3bn)

Source: IFS, HMT
EXTREME AUSTERITY – OCTOBER SPENDING REVIEW. SAME STORY.

7% of GDP a year earlier

Source: IFS, HMT
COSTS OF ACCELERATED AUSTERITY

• Withdrawal of demand risks recovery
  – Private sector cannot speedily adjust to the fiscal shock
  – Recovery still fragile (e.g. 2010 UK growth through construction & stimulus & US very weak)

• Long-run effects of short-run fiscal contraction
  – Scrapping of human and fixed capital (a pessimistic view of UK capacity becomes a self-fulfilling prophecy)
  – Example: long-term unemployment (Pissarides)

• Destruction of successful policies
  – Crisis forces removal of unsuccessful policies, but also a bonfire of successful programs (e.g. EMA)
  – Combined with huge changes (e.g. decentralization to GPs in NHS upheaval) creates uncertainty

• Fairness
BENEFITS OF ACCELERATED AUSTERITY

• UK has unsustainable debt?
  – Deficit driven by global recession & consensus on need for reduction, mainly via spending cuts
  – Reduce borrowing costs? Not if contraction severe
  – Debt crisis exaggerated: (i) Historically moderate (42% in 2006; 79% 2011; av=118%); (ii) maturity; (iii) no default

• Credibility & Confidence
  – “Frontloading” to reassure irrational bond markets?
  – Better to deliver a realistic good plan than fail to deliver an unrealistic bad plan

• Productive capacity is much lower
  – Too pessimistic? some genuine productivity progress post 1997
EXTREME AUSTERITY – THE NEED FOR A “PLAN B”

• Chancellor has argued against a Plan B

• Mervyn King & MPC to the rescue?
  – Low interest rates?
  – Quantitative Easing

• Tax cuts & spending increases
  – Hard to fine tune
  – Extreme loss of credibility
CONCLUSIONS

• Sources of productivity growth are innovation (well-studied) and management (understudied)

• Management and productivity can be improved by micro-economic structural reforms - especially over competition, human capital, tax reform, labour markets.

• Extreme austerity a political choice not economic necessity, will have long-lasting negative effects
  – A reckless experiment?
MY FAVOURITE QUOTES:

Staff rewards the American way

*Production Manager*: “For example, if an employee suggests a company slogan, and his name is used, he gets a TV. If he is employee of the month, he gets a parking space”

Staff retention the UK way

*Interviewer*: “How would you persuade your top performers to stay?”

*UK Chairman*: “Sex is a great thing! If the employee finds a new girlfriend somewhere else, I can’t do anything!”
The difficulties of defining ownership in Europe

*Production Manager:* “We’re owned by the Mafia”

*Interviewer:* “I think that’s the “Other” category……..although I guess I could put you down as an “Italian multinational” ?”

Americans on geography

*Interviewer:* “How many production sites do you have abroad?

*Manager in Indiana, US:* “Well…we have one in Texas…”
MY FAVOURITE QUOTES:

India is such an interesting place…

*Plant Manager:* “Modern manufacturing? Yes, I have heard about it, but it doesn’t make any sense at all, does it?”

*Interviewer:* “How do you identify your star performers?”
*Manager:* “This is India, everyone thinks he is a star performer!”

*Interviewer:* “How do you keep your top performers?”
*Manager:* “I am a star performer and I want to leave!”
Further Reading


3. Lisbon agenda [http://cep.lse.ac.uk/briefings/pa_lisbon_agenda.pdf](http://cep.lse.ac.uk/briefings/pa_lisbon_agenda.pdf)

4. UK productivity improvements : [http://cep.lse.ac.uk/briefings/pa_uk_productivity.pdf](http://cep.lse.ac.uk/briefings/pa_uk_productivity.pdf)
BACK-UP
WHAT IS LABOUR PRODUCTIVITY? UK 2007

\[
\frac{GDP}{Population} = \frac{GDP}{\text{hours}} \times \frac{\text{hours}}{\text{workers}} \times \frac{\text{workers}}{\text{population}}
\]

\~£26,140 \quad \~£33.20 \quad \~1,650\ p.a. \quad 48\%

~£26,140 \quad ~£33.20 \quad ~1,650\ p.a. \quad 48\%
UK LAGS IN RESEARCH & DEVELOPMENT (R&D/GDP), GERD

Source: OECD MSTI 2007-2
WHAT HELPED IMPROVE UK’S PRODUCTIVITY POSITION POST 1997?

• Not driven just by financial sector; e.g. retail/wholesale had very strong productivity growth
• Increase in human capital through university expansion & school reforms (see over)
• R&D supported both directly & introduction of R&D tax credits (in 2000 for SMEs & 2002 for all firms)
• Product Market competition (e.g. Competition Policy Regime improved & ranked 2\textsuperscript{nd} in world)

Also:
• Labour market flexibility
• Openness to FDI
• Labour market supported by welfare reform (e.g. New Deal)
EXTERNAL VALIDATION: MANAGEMENT SCORE CORRELATES WELL WITH PERFORMANCE INDICATORS

**Labour productivity**

![Graph showing the correlation between labour productivity and management practice score.]

**Return On Capital Employed, ROCE**

![Graph showing the correlation between return on capital employed and management practice score.]

**Sales growth (%)**

![Graph showing the correlation between sales growth and management practice score.]

* Log scale
** Firms are grouped in 0.5 increments of assessed management score
IMPROVEMENTS IN UK EMPLOYMENT RATE OF ADULTS, 1978-2010

% of 16-65 year olds in jobs

Source: Labour Force Survey, Various years, ages 16-65
UK SECOND ONLY TO US IN ELITE SCIENCE

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of top scientific papers</th>
<th>Rank</th>
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<tbody>
<tr>
<td>US</td>
<td>58.6</td>
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<tr>
<td>UK</td>
<td>14.4</td>
<td>2</td>
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<td>GERMANY</td>
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<tr>
<td>CHINA</td>
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Notes: Shares of the most cited scientific papers 1999-2008 (top 1%)
Source: BIS/Thompson-Reuters (2009) “International comparative performance of the UK research base”, Table 1.12, p.60
Functionally illiterate (% aged 16-65, 1995)

Source: HDR 1998
# PEOPLE – e.g. DEALING WITH POOR PERFORMERS

| Score | (1): Poor performers are rarely removed from their positions | (3): Suspected poor performers stay in a position for a few years before action is taken | (5): We move poor performers out of the hospital/department or to less critical roles as soon as a weakness is identified |

If you had an employee who could not do his job, what would you do? Could you give me a recent example? How long would underperformance be tolerated? Do some individuals always just manage to avoid being fixed/fired?
**TARGETS - e.g. “HOW TOUGH ARE TARGETS?”**

| Score | (1) Goals are either too easy or impossible to achieve; managers low-ball estimates to ensure easy goals | (3) In most areas, top management pushes for aggressive goals based on solid economic rationale. There are a few "sacred cows" not held to the same rigorous standard | (5) Goals are genuinely demanding for all divisions. They are grounded in solid, solid economic rational |

Note: All 18 dimensions and over 50 examples in Bloom & VanReenen (2006).
UK R&D LOW COMPARED TO OTHER COUNTRIES. TOTAL RESEARCH AND DEVELOPMENT AS A % OF GDP

Source: OECD (GERD/GDP)
UK R&D DECLINE 1987-1997? TOTAL RESEARCH AND DEVELOPMENT AS A % OF GDP

1997

Source: OECD (GERD/GDP)
RECENT TRENDS IN PRODUCTIVITY

- After 1970s Oil Shocks a Productivity slowdown (e.g. US productivity growth slowed to about 1.2% p.a)
- From mid-1990s, US productivity “miracle”
- Crisis after end 2007

<table>
<thead>
<tr>
<th>GDP/hour p.a. growth</th>
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<tbody>
<tr>
<td><strong>US</strong></td>
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<tr>
<td>1995-2005</td>
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<td>2005-2009</td>
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Source: Conference Board, September 2010
WHAT “REBALANCING” IS NECESSARY?

- **Within Private sector**
  - Away from finance, construction, etc.
  - Towards manufacturing, high tech service exports

- **Between Public and private sector**
  - Need to reduce public spending
  - But to what level? Problem in 2000-07 was that taxes should have been raised more to cover spending choices
  - Expansion of health & education a choice post 1999
  - Reducing also a political choice, not an economic necessity, e.g. US vs. Northern EU
FAMILY FIRMS & MANAGEMENT – AN OLD TOPIC

Alfred Chandler\(^1\) and David Landes\(^2\) claimed that the UK industrial decline relative to US & Germany was linked to family firms.

“The Britain of the late 19\(^{th}\) Century basked complacently in the sunset of economic hegemony. Now it was the turn of the 3\(^{rd}\) generation…and the weakness of British enterprise reflected their combination of amateurism and complacency”

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\(^1\) Alfred Chandler, “Scale and Scope: The Dynamics of Industrial Capitalism”, (1994)
\(^2\) David Landes, “The Unbound Prometheus: Technological Change and Industrial Development in Western Europe from 1750 to the Present”, (1969)