BUSINESS

The Tesco brand dominates the British retail sector, but how has it fared in the US?

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Tesco's Fresh & Easy stores are virtually idolised by devoted customers

Tesco goes west

Four years ago, Britain's biggest retailer entered the world's biggest market. Romesh Vaitilingam tells the story so far…

IN NOVEMBER 2007, Americans were treated to a new shopping experience. Fresh & Easy Neighborhood Market, the brainchild of Britain's biggest retailer, Tesco, opened its first six stores in Los Angeles and Orange County, California. Meanwhile, back in Britain, Professor Michelle Lowe was beginning a research project on retail innovation, supported by the ESRC's Advanced Institute of Management (AIM) Research.

Tesco's venture seemed the ideal opportunity to study how innovation works in one of Britain's most successful service companies, particularly at a time that Tim Mason, chief executive of Fresh & Easy, described as a "transformational moment" in the firm's history. For one of the world's four largest retailers (along with the US's Wal-Mart, France's Carrefour and Germany's Metro), launching an innovative chain of supermarkets in west coast US markets was a high-risk venture, especially during what rapidly became a deep recession.

Professor Lowe, who is now at the University of Southampton, has followed the progress of Tesco's ambitious market entry since it began over four years ago. Despite often negative media portrayals of the Fresh & Easy chain in the British media (and persistent expectations that its parent will soon admit failure and leave the market), her research reveals considerable strength in the US brand that Tesco has created through a series of innovations in market positioning and retail and supply network operations.

The AIM study finds evidence of a significant consumer franchise for the relatively small-scale (10,000 sq ft) 'convenience format' neighbourhood stores, which draw on the small store operating skills Tesco has developed over the past ten years in Britain and overseas. And while the company is often attacked in this country for perceived domination of the high street, across the Atlantic it is widely seen as a champion of urban regeneration, courted by local authorities and attracting devoted customers.

Professor Lowe notes that in thinking about its entry into a highly competitive market, Tesco saw the opportunity in the US attitudes that were shifting in relation to local shopping, preservatives and additives in food, health, the environment and community responsiveness. All of this suggested the potential of developing a strongly focused neighbourhood brand.

Rex

As Tim Mason said when Fresh & Easy launched, "We wanted to design a business that was for the 21st century, which recognised the issues that Americans care about today: issues of neighbourhood, issues of community, issues of obesity, issues of global warming." In the context of existing US retailers, that new format was positioned to be "as fresh as Whole Foods, with the value of Wal-Mart, the convenience of Walgreens and the product range of Trader Joe's".

A FRESH APPROACH

To deliver a supermarket designed for west coast US consumers, Tesco invested time and money in intensive research. A group of its top executives spent months carrying out detailed anthropological investigations, studying US families to see what they put in their fridges and cupboards and how they did their cooking and shopping. All this information-gathering indicated that there was a gap in the market for a store selling food that bit healthier and that bit less processed at prices significantly below what a standard US supermarket would charge.

One of the surprises for the Tesco researchers was that while the US was known as the land of plenty, the quality of processed fresh food in supermarkets was not high. Simon Uwins, chief marketing officer of Fresh & Easy, recalls: "One of the things we wanted to provide was chilled ready meals. Fresh processed food should have no artificial colours, no artificial flavours and only use preservatives where absolutely necessary for the safety of the product. But when we looked round to see how we were going to provide those products, there was no one there who was capable of doing it."

So Tesco invited two trusted British suppliers to join them: Wild Rocket supplying fresh fruit and vegetables, and Two Sisters providing meat to a state-of-the-art 'campus' in Riverside, California, which housed a distribution centre and the Fresh & Easy kitchen. The company also developed innovative partnerships with local US suppliers, for example, coffee supplier Cafe Calabria, which is based in San Diego.

When the first stores opened in parts of California, Arizona and Nevada, they offered the kind of chilled prepared meals and other 'food-on-the-go' products that are common in British supermarkets but rare in the US. Fresh & Easy also introduced a range of innovations within the store, including assisted service checkouts and 'the kitchen table', where consumers can sample products.

The venture has been very successful in terms of judging the market for a new brand

A further distinctive feature of Fresh & Easy, from the start, was its emphasis on digital and viral marketing. In 2007, it was novel to invite bloggers to store launches. The company also saw the opportunity to engage with local communities through social media like Twitter, which had begun the previous year. Another significant factor was where the stores opened. In many US cities, deprived areas have become virtual 'food deserts'. So when Fresh & Easy started to open in these underserved markets, they were welcomed. Professor Lowe points out that the stores do have a real commitment to being a good neighbour, embedding themselves in their localities and sponsoring socially worthwhile projects. This has been a key element of building the brand's presence in the US.

Alamy

Tesco Express – the model for Fresh & Easy in the US

Fresh & Easy was an immediate hit with its customers. But no one foresaw the hit that was about to be taken by the US economy. Some of the consumer markets Tesco had targeted would be those worst affected by the recession. There were whole areas where new Fresh & Easy stores might have been opened that were economically devastated, and this has clearly held back the expansion of the chain.

BEATING THE RECESSION

Fresh & Easy reacted to the recession by increasing special offers and promotions, and slowing down the rate of new store openings. Some commentators took this as a sign of defeat, but Simon Uwins says it was simply time for the new business to slow down and take stock: "We were planning to open a number of stores, have a gap, reflect, see if there's anything that we needed to change and then push the accelerator button. But because of the recession, we thought it was only prudent not to do that, and just keep the openings running at the same level as we had been."

So has Fresh & Easy been a success even in the face of the recession? Professor Lowe believes that the venture has been very successful in terms of judging the market for a new brand, in terms of researching the market and in terms of engaging with consumers. But while the stores are clearly creating value for customers and growth is solid in difficult economic circumstances, as a whole the chain has yet to turn a profit.

Nevertheless, Professor Lowe thinks that the Fresh & Easy concept is so innovative that Tesco might be a little way ahead of the curve: "The question is: will the curve catch up with you at exactly the right moment, and that's not being helped by the recession. But that's the ideal notion of innovation: just ahead of your customers catching up with you."

Overall, the AIM study suggests several lessons. First, it emphasises the importance of understanding innovation not only in high-tech manufacturing but also the 'hidden innovation' in retail and other services. Second, it reveals that the flow of retail innovation has perhaps shifted from its historic pattern of the US to Britain. Third, it shows that British retailers looking to expand westwards are not always destined for failure. And finally, in providing the opportunity to learn from one of Britain's most successful multinational companies, the research demonstrates the value of studying and celebrating British business achievements. ■

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Growth through 'process innovation'

We need to value how we improve the way we make things, as well as how we invent them

The Model T Ford assembly line created the first widely affordable cars

Getty

THERE ARE TWO stages in making a new good valuable to society. First, it has to be invented, and we rightly celebrate inventors through the ages. But inventions also have to be adopted, and that means that they have to offer good value to consumers. The people who come up with ways of producing things more cheaply – 'process innovation' – are also important in making us better off.

We have investigated the scale of two such innovations: mechanical cotton spinning and the motor car assembly line. Both led to sensational price declines and both transformed what had been luxury items for upper class consumption – Indian calicoes and motor cars – into items of everyday consumption for a significant part of the population. Workers on Ford's Model T assembly line could afford the cars they made; cotton spinners could wear cotton shirts.

Those who make existing goods cheaper should be celebrated as much as those who invent them

Henry Ford did not invent the motor car. Nor was his Model T a particularly good motor car. Ford was not even the first to use a moving assembly line. But he was the first to 'mass produce' a car, a phrase he was also the first to use. The effects were impressive: the time taken to assemble a Ford chassis fell from just under 12.5 hours in the spring of 1913 to 93 minutes a year later. Greater efficiency led to big falls in price: the Model T cost $950 in 1909 and $360 in 1916, a fall in real terms of more than two thirds. Ford realised his aim of building a car "so low in price that no man making a good salary will be unable to own one".

Between 1908 and 1927 Ford sold a total of 15 million Model Ts. It was so ubiquitous that in his 1945 novel *Cannery Row*, John Steinbeck wrote that 'Most of the babies of the period were conceived in Model T Fords and not a few were born in them.' Ford also forced other car firms to follow suit, so that between 1908 and 1923 the average price of a car fell from $2,126 to $317 in 1908 terms. At the same time, annual sales rose from just 64,000 to 3.6 million.

SOCIAL SAVINGS

One way of working out what Ford's process innovation was worth to the US people is to calculate how much extra they would have had to pay to buy the cars they did in fact buy, at the price prevailing prior to Ford's innovation. This measure is known as 'social savings'. On that basis, Ford's value to the US people was a staggering 14.7 per cent of GDP. Of course, we know that not everyone who bought a car at $317 in 1923 would have been willing to pay $2,126 for it. We can estimate how demand changed in response to different prices, and on that basis Ford's innovation was worth around 1.8 per cent of GDP. Although much smaller than our earlier number, it still means that the average value of a Ford car to consumers was around twice the price they had to pay. Ford made himself rich, but most of the benefits of his innovation went to the people who bought his cars.

The same is true of mechanising cotton spinning in the Industrial Revolution. Again, the fall in price was spectacular. Cotton yarn that had sold for 107 pence a pound in 1784 sold for just under 13 pence in 1820. The social savings from mechanising cotton yarn production were of a similar order of magnitude to those of mechanising car production – 17.6 per cent of British GDP. Of that, 7.5 per cent went to British consumers, while the other 10.1 per cent went to the people around the globe who were now able to buy cotton goods more cheaply.

The estimate of 'consumer surplus', this time simply for the cotton used by British people, was around 2.6 per cent, again a substantial number. As the famous historian AJP Taylor, himself born to a cotton family, once remarked, "Every piece of cotton cloth is going to make someone warmer or cleaner or more comfortable."

MAJOR EFFECTS ON WELFARE

These two process innovations each produced gains for consumers that were, even when estimated conservatively, equal to the expenditure on them. Furthermore, the gains took relatively little time to be realised. Improving the production processes of these two existing goods was as valuable as inventing the internet, and much more valuable than inventing mobile phones. Indeed, it is hard to imagine any product that has been invented that has had a bigger effect on welfare, as quickly, as these two improvements in the way in which we make things.

It is sometimes said (usually wrongly) that everything worth inventing has been invented. But even if that were the case, economic growth could and would continue. Innovators would strive successfully, and to great effect, to produce existing things more cheaply. This would raise our standard of living, allowing us to buy more of the goods that already exist or to spend less time at work while having the same material standard of living.

Those who make existing goods cheaper should be celebrated just as much as those who invent them in the first place. Both are crucial to understanding why we can, today, live so much better than we were able to in the past. ■

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Employment tribunals

The value of lay members

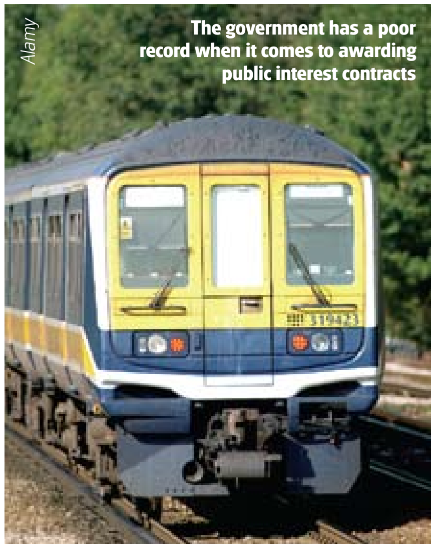
IN EMPLOYMENT TRIBUNALS what is the role of lay members? Do the judges in employment rights cases, who usually sit with representatives from the two sides of industry, value the 'tripartite system'? Professor Susan Corby of the University of Greenwich and Professor Paul Latreille of Swansea University have surveyed employment tribunals (ET) judges and judges on the Employment Appeal Tribunal (EAT), the body that hears appeals from ETs.

The study finds that most ET judges, who *can* sit alone in specified cases, do not wish to dispense with lay members. Only a minority of judges (one in six) 'always' prefer to sit alone, although a further two in five say they prefer to sit alone 'sometimes'. The results indicate that ET judges consider lay members' most important contribution is to provide a non-legal perspective, followed by acting as the 'eyes and ears' of the judge. Moreover, although the government has proposed that judges should normally sit alone for claims of unfair dismissal, four out of five ET judges consider that members add value to decision-making in such cases. What about judges on the EAT, which is also constituted on a tripartite basis? The researchers find that few EAT judges assess lay members' contribution to the hearing process in terms of the lowest score on a 1-4 scale. But comparing average scores, EAT judges have a less favourable view of lay members' contribution than do ET judges. Furthermore, few EAT judges disagree with the statement that lay members add more value at the ET than the EAT.

Interviews with other stakeholders (representatives of claimants and respondents, and organisations providing such representation) indicate that they value the presence of ET lay members. This is mainly because they can reassure parties that it is not just a lawyer deciding their case. Most interviewees also think that members' workplace experience contributes usefully to decision-making in fact-sensitive ET cases, although they prefer a judge alone in cases centred on legal technicalities. Interviewees' views about lay members on the EAT are mixed, with some seeing them as superfluous, as the EAT only rules on points of law.

Both judges and those directly or indirectly representing the parties broadly endorse the role of lay members at ETs, but endorsement is more muted for the EAT. ■

www.gre.ac.uk/about/schools/business/enterprise/research/weru/research-projects



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The government has a poor record when it comes to awarding public interest contracts

Train building

Is Britain on track when awarding public contracts?

IN JUNE 2011, the Department of Transport effectively awarded the £1.5 billion Thameslink rail contract to a consortium led by Siemens and decided against the competing bid from a consortium led by Bombardier. As a consequence, roughly 1,200 new train carriages will now be built in Siemens' German factory at Krefeld rather than at Bombardier's British factory at Derby.

Within a couple of weeks, Bombardier announced 1,400 redundancies at Derby. Many feared that the company's next move would be complete closure of the Derby facility, which is the last surviving British factory capable of making trains (rather than assembling imported component kits).

The coalition government's transport and business secretaries, who made the final decision to award the contract, predictably blamed the outcome on the previous government, which had drafted the original contract in 2009. But more remarkably, all the Westminster politicians agreed with thousands of petitioners from Derby and a chorus of critics in the national media who denounced this as a bad decision. Significantly, the two responsible ministers did not try to defend the award but instead, in an open letter to the prime minister, argued that the government needs to change the way in which contracts are awarded to ensure a 'level playing field' for British manufacturers.

If there was much disquiet and some anger about the outcome, there was less clarity about what was wrong with a contract that was not in the public domain. And there was no clear focus on how things might be put right by using broader public interest criteria in future public contracts (as other governments in Europe already do) when calculating the 'most economically advantageous transaction' under European Union rules. This was a chance for the ESRC Centre for Research on Socio Cultural Change (CRESC) to do some 'rapid response social science research'. Within a month of being awarded ESRC research funding, CRESC had published a public interest report focusing on the two main issues: 'bundling'; and the definition of the public interest.

The Thameslink contract was a new style of public procurement contract, which covered the building of the 1,200 carriages plus their maintenance and lease financing for 30 years. When the contract inappropriately bundled train building and rolling stock finance, judgements about which company could build better and cheaper trains were contaminated by the question of who could raise lease financing more cheaply. In the Thameslink case, there never was a level playing field because the successful consortium had a finance cost advantage of maybe £700 million because Siemens had an A+ credit rating against Bombardier's BB+. More fundamentally, the CRESC report argues, the whole question of 'value for money' for the taxpayer was being defined too narrowly because the state was behaving like a consumer with a copy of *Which?*, balancing narrowly defined cost and quality considerations.

This kind of calculation makes sense for a private consumer choosing a toaster at John Lewis, but surely public choice should take account of broader social considerations and potential repercussions. On CRESC's calculation, these include the benefit of the £20,000 a year of taxes paid by Bombardier's Derby workers and a much more modest gain from indirect employment because many Derby components are imported.

Public choice should take account of broader social considerations and potential repercussions

CRESC's report was widely welcomed as an expert and independent intervention whose evidence and arguments about procurement will inform political debate and reinforce the Treasury Select Committee's criticism of similar contracts for 'private finance initiative' financing to build new schools and hospitals. CRESC concludes that the state can lose more through ineptly designed contracts than it gains from private sector management skills. ■

www.cresc.ac.uk/publications/knowing-what-to-do-how-not-to-build-trains

Executive compensation

Aligning the interests of managers and stakeholders

THE DESIGN OF executive pay packages has been highlighted by both the Bank of England and the Financial Services Authority (FSA) as one of the causes of the financial crisis. FSA head Hector Sants, for example, has highlighted the need to reconsider the guidelines in this area, arguing that: "In many cases the remuneration structures… gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk, to the detriment of shareholders and other stakeholders, including depositors, creditors and ultimately taxpayers."

So what structure of managerial incentives and compensation packages might prevent excessive risk-taking? That is one of the questions addressed in research by Professor Grzegorz Trojanowski of the University of Exeter. He has been looking at remuneration practices in Britain over the last decade and making comparisons with the US. Professor Trojanowski notes that until recently, the focus of research and policy discussions has been limited to the alignment of managerial incentives with the interests of a single category of stakeholders, namely shareholders. For example, Britain's Combined Code of Corporate Governance stipulates that: 'Performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders.'

The unintended consequence of such an approach is the resulting conflict of interests between different categories of investors, namely debt and equity holders. While both groups provide companies with financing, creditors usually prefer safer strategy choices compared with those favoured by shareholders. Too strong an alignment of incentives of managers with the pursuit of shareholder value may encourage executives to take excessive risks, which may then harm the holders of corporate debt.

Corporate bonuses have been derided by policymakers and in the media

Corporate bonuses have been widely derided by policymakers and in the media. But according to this study, they may not be the only components of remuneration packages that encourage excessive risk-taking. And while the enormous risks taken by some financial companies have been in the spotlight, similar problems of perverse incentives are likely to plague all types of companies, not just banks and insurers.

Professor Trojanowski's investigation reveals that British executives receive a much smaller proportion of their pay as shares and options than their US counterparts. And many of these grants are in the form of 'Long-Term Incentive Plans' (LTIPs), which are deferred for a number of years and paid only on meeting particular performance criteria. This should in principle encourage longer-term orientation in managerial decision-making.

Nevertheless, irrespective of the capital structure of the companies they manage, relatively few British executives receive debt-like instruments as part of their remuneration package. Both creditors and shareholders play a vital role in corporate finance, but executives are paid mostly in cash and equity rather than debt. Few chief executives receive compensation in the form of cash LTIPs, and bonuses continue to be widespread, at best tied to short-term results. The study also reveals that compensation seems to be the aspect of corporate governance to which management pays particular attention. Among the firms

Productivity growth: decline and resurgence

How competition cured the 'British disease'

BRITAIN'S RELATIVE ECONOMIC decline throughout the 20th century was a national embarrassment that only went away in the 1980s. The symptoms of this so-called 'British disease' included debilitating industrial relations and self-indulgent management. Research by Professor Nicholas Crafts, director of the ESRC Centre for Competitive Advantage in the Global Economy (CAGE) at the University of Warwick, shows that competition provided the cure.

His study of this episode of national economic history – when other European countries grew more quickly and Britain was overtaken by many of them – provides further support for what is now a widely accepted fact among economists: that weak competition impairs productivity growth in advanced economies. Only when Britain returned to a regime of competition and openness similar to that which had prevailed before the First World War did productivity growth resume.

The retreat from competition in the British economy was triggered by the financial crisis of the 1930s, but it was not fully reversed until the 1980s. Early post-war Britain was notable for the establishment of cartels, nationalisation, weak competition policy and protectionism. The CAGE research reveals that compared with the founder members of the European Economic Community (EEC), there was a relatively slow reduction in trade costs for Britain. It was not until the late 1970s that something approaching free trade was restored.

The weakness of competition in product markets interacted with two aspects of British 'exceptionalism' in terms of institutions: corporate governance and industrial relations. The former was characterised by the absence of strong shareholders and an ineffective market for corporate control; the latter by the presence of craft control, multi-unionism and legal immunities that underpinned trade unions' bargaining power.

PA Photos

Financial sector executive pay packages have been criticised for encouraging risk

where compliance with the Combined Code of Corporate Governance is weakening, the independence of remuneration committees is the most likely provision to be sacrificed in the face of looming under-performance. This suggests that managers may try to capture the pay-setting process and protect their remuneration packages.

Overall, the alignment of managerial incentives with shareholders' preferences seems weaker in Britain than in the US. But this does not automatically mean that executives' incentives are congruent with those of creditors. For many British managers, as far as their compensation is concerned, cash is still king. ■

papers.ssrn.com/sol3/papers.cfm?abstract_id=1723462

Boosting high-growth technology firms

Lessons learnt from the 'Cambridge cluster'

HOW CAN POLICYMAKERS encourage the development of high-growth technology firms that will create new industries and new jobs? Research by Vivian Mohr and Dr Elizabeth Garnsey of the Institute for Manufacturing at the University of Cambridge points to three areas for government intervention: accelerating the development of legislative frameworks for newly emerging industries; reducing tax barriers for the involvement of serial entrepreneurs; and supporting the incubation of new technologies.

Their study analyses unique longitudinal data on more than 3,000 technology firms in the so-called 'Cambridge cluster' over the past 25 years. The researchers have also conducted over 20 in-depth interviews with involved managers.

12 per cent of all high-growth firms were established by a serial entrepreneur

Employment in Cambridge's high-growth firms increased over six times between the late 1980s and the 2000s. By 2008, these firms accounted for a third of all jobs in the cluster yet only eight per cent of all firms. Firms that were internationally oriented were over four times more likely to experience three or more years of rapid organisational growth.

But the high-growth firms are also highly vulnerable, with three quarters of them having experienced an employment growth setback of 20 per cent or more during their first seven years in existence. Overall though, the firms continued to create jobs during periods of cluster contraction in the early 1990s and 2000s amid a broad-based contraction of other firms.

The research finds that 12 per cent of all high-growth firms were established by a serial entrepreneur: this contrasts with only three per cent of non-high-growth firms. Similarly, whereas 11 per cent of all firms in the cluster are either academic or corporate spin-offs, this effect was nearly three times as pronounced among high-growth firms, where 31 per cent of firms are spin-offs.

This evidence on the regional prominence of these firms in terms of innovation, jobs and resilience supports the recent policy emphasis on supporting rapidly growing firms. But the evidence on the importance of serial entrepreneurs suggests that policymakers could do more, increasing incentives for these individuals – particularly academic serial entrepreneurs – to become involved in creating new firms by reducing tax barriers.

Similarly, earlier and stronger international promotion of small and medium-sized firms could help these companies develop partnerships with foreign companies that may prove pivotal to their eventual success. The interviews also indicate a role for policymakers by shortening the time required to develop robust legislation for newly emerging industries. ■

www.ifm.eng.cam.ac.uk/ctm/publications/w_papers

The evidence indicates that, in these circumstances, weak competition led to poor productivity outcomes. Competition policy was largely neglected, which was clearly a mistake. On the one occasion where a serious reform was made – the Restrictive Practices Act of 1956, which led to the abandonment of collusion in many sectors – there was a significant impact on productivity performance.

The results of the 'Thatcher experiment' in the 1980s paved the way for reversing Britain's relative economic decline. Competition was much strengthened by trade liberalisation and deregulation, and by discontinuing 1970s industrial policy. As competition strengthened, there were major changes in industrial relations, which were associated with organisational change, together with divestment and restructuring in large firms.

Weak competition impairs productivity growth in advanced economies

At the sectoral level, stronger competition and greater openness were associated with improved productivity performance. As the age of information and communication technology came along, Britain was able to embrace the opportunities associated with rapid diffusion of the new technologies. This required big changes in working practices and management hierarchies, which the country was able to make more effectively than many of its European neighbours. This would not have happened with 1970s-style industrial relations and a heavily regulated service sector.

Professor Crafts concludes that some reflections on this story are particularly worth remembering. First, it was not just the Thatcher experiment that made the difference. Trade liberalisation was well under way already, and the reform of British anti-trust policy was only seriously undertaken by the last Labour government in the Enterprise Act of 1998 and the Competition Act of 2002.

Second, by implication, it is clear that Britain's failure to sign the Treaty of Rome, which established the EEC in 1957, had a substantial cost in terms of its adverse impact on productivity performance.

Third, although Britain is an egregious example of the long-lasting damage that the 1930s did to supply-side policy, somewhat similar effects of that financial crisis were felt across the advanced countries. Fortunately, this time it has been different. ■

www.cepr.org/pubs/dps/DP8384.asp

The future of financial services

Myths about markets and bankers' pay cloud the debate

MORE THAN FOUR years into the financial crisis, the issue of bankers' pay still looms large in debates about the future safety of the financial system. Some call for regulation of salaries while others insist that free markets regulate themselves. Everyone wants to see a resolution of the compensation issue, but over-simplification of what is a diverse and complex system has hampered efforts to find a way forward.

The Advanced Institute of Management (AIM) Research has brought together a unique group of researchers and bankers to shape the debate about the future of the financial services industry. In the course of their work, it has become obvious that a lack of understanding about how the financial system really works lies at the heart of confusion over how to make it safer.

Take compensation, where there is a widespread failure to take account of the diversity of bankers' salaries. For example, branch employees in a retail bank won't bring down the system and their salaries are in line with the national average. Indeed, the relatively few risk-takers in the industry are in firms with systemic impact (such as wholesale banks), where salaries are increasingly high.

Public discomfort is not just a question of bankers' remuneration. Footballers, pop stars and lawyers command similarly high fees and are not reproached in the same way. Public concern focuses on bankers because of what is seen as excessive risk-taking and a 'get rich quick' culture. The banking sector is often described as having a 'casino culture', which encourages risk-taking at junior and middle levels, particularly in trading and market-making.

What is needed is collective action to standardise pay structures and methods of payment

The fact that the most successful traders and market-makers (in investment banks) are often those who have gambled and won exacerbates the problem. If graduates can earn around £70,000 in their first year and progress to £1 million within seven, why would they not try to play the casino – especially as the downside may just be getting fired and starting a mainstream career in their early thirties.

Compared with some of the other challenges facing the system, the compensation issue can be resolved relatively easily – and some of it will take care of itself both from the reduction in bank profits and from the increasing capital requirements for trading activities that entail risk. Traders will move to hedge funds, probably for the best.

What is needed is collective action to standardise pay structures and methods of payment across institutions and countries. The ability to push this through different countries is doubtful, yet some industry-wide regulation is undoubtedly necessary. Even if chief executives wanted to tame traders' pay, they fear losing scarce revenue streams by their talent fleeing to competitors – a 'tragedy of the commons'.

Shareholders need to play a corrective role in overseeing compensation

Furthermore, to make the financial system safer and more efficient, shareholders need to play a corrective role in overseeing firms' compensation. It is worth remembering that relative rather than absolute pay is what motivates people once they have reached a certain threshold. Yet coarse regulation may backfire. A dialogue should be established between the regulated and non-regulated sectors. The compensation basis in banks should be changed to mitigate pressures from short-term investors. Finally, attention should be paid to the role of equity analysts as banks grapple with pay change, and inevitably look for stock market reactions.

It is now clear that the financial system exacerbated the crisis rather than dampened it, and part of the reason was the stylised depiction of markets. Having made a thorough analysis of the sector as it really is, the AIM group hopes to move the debate on to a more realistic discussion of the challenges ahead. ■

www.aimresearch.org

With a little help from my friends (and relations)

How immigrants use social networks to find work

TO WHAT EXTENT do immigrants in England rely on networks of friends and relatives to look for jobs – and how successful are they in securing employment? A study by Dr Corrado Giulietti, Dr Christian Schluter and Dr Jackline Wahba of the ESRC Centre for Population Change found that almost half of unemployed immigrants use social networks to search for jobs, and that doing so can help them into work.

Analysing data from the Special Licence Quarterly Labour Force Survey, the researchers found that the incidence of network use is substantial but far from universal, despite the fact it is considered to be inexpensive. There is considerable variation between different migrant groups: for example, Pakistani and Bangladeshi immigrants report the highest incidence and Indians the lowest (68 per cent, 66 per cent and 48 per cent, respectively).

It is no surprise that informal job search methods are as common as formal methods

The findings also suggest that for immigrants who use social networks, the success rate of this method is not guaranteed, ranging between 30 per cent (Black Africans) and 50 per cent (Black Caribbean). What's more, it is the less established and lower skilled unemployed immigrants who are more likely to use social networks. The study confirms that immigrants tend to concentrate in relatively deprived urban areas. They are also likely to cluster by ethnic origins, resulting in certain neighbourhoods being dominated by one ethnic group. But those areas with high ethnic concentration tend to be economically disadvantaged relative to other areas.

As a consequence, one challenge is to disentangle the effect of living in a deprived area where unemployment is high from the effect of living in a very ethnically concentrated neighbourhood. Failing to distinguish between these two may lead a negative effect on employment to be wrongly attributed to living in an ethnically concentrated area.

Understanding how individuals search and obtain jobs is important for employers and policymakers. Whether jobseekers use formal or informal methods seems to matter as to whether or not they are successful in their job hunt.

These findings indicate that once local labour market characteristics are taken into account, using social networks does help to secure employment for immigrants. So it is no surprise that informal job search methods are as common as formal methods, particularly for immigrants who lack knowledge of the local labour market. Future research should shed light on the role played by social networks in the quality of the employment found, such as remuneration and job satisfaction. ■

www.cpc.ac.uk/newsletter/?link=newsletter.php&action=story&id=66

What form of social interaction most benefits immigrants who are searching for a job?

Managing complexity

Apple is a company that manages the complexities of today's business environment to great benefit

Companies should start a simplicity revolution in the face of an ever-more complicated world

TODAY'S GLOBAL ECONOMY is an increasingly complex environment in which to do business. Executives have to face complexity on all fronts of their operations, as they adapt to globalisation, demographic shifts, climate change, emerging economies, social and economic change, and the sheer pace of innovation. But just what is it that leads previously successful multinational corporations – one-time darlings of their industries such as Nokia or the Royal Bank of Scotland – to struggle when their outwardly similar competitors continue to perform consistently, even in difficult financial environments?

Whether by accident or design, the more usual reaction of businesses facing increased complexity has been to increase their internal complexity through increased size, greater diversity of functions or more levels of hierarchy. But a study by the Advanced Institute of Management (AIM) Research finds that this is not necessarily the best response.

The research, led by Professor Simon Collinson, Lead Ghoshal Fellow at AIM, and Melvin Jay, one of the founders of a management consultancy firm called Simplicity, sets out to map not only how different businesses respond to complexity but also how their responses have affected their performance. What they find is a definite pattern of both 'good' and 'bad' complexity: the challenge for businesses is to identify which organisational complexity adds value and contributes to performance, and which adds costs and damages performance. Nearly two thirds of the managers interviewed for the research report that complexity is responsible for over five per cent of productivity loss, and as many as one in ten reported a 30 per cent loss of productivity.

Professor Collinson and Mr Jay have created the Global Simplicity Index, which takes the largest 200 firms in the Fortune Global 500 and ranks them according to their complexity and performance, to help them further understand the relationship. They identify four types of firms and their particular challenges:

SIMPLIFIERS: low-performing organisations with low levels of complexity, which have failed to capitalise on value-creating forms of complexity
PERFORMERS: high-performing organisations with low levels of complexity, which have managed to perform without over-complicating their business

Who you know

The role of social ties in corporate board appointments

MEMBERSHIP OF ELITE private clubs continues to influence boardroom appointments, according to research by Edward Cowley and Dr Helen Simpson of the ESRC Centre for Market and Public Organisation (CMPO) at the University of Bristol. But social connections made at school or university seem to play less of a role in board appointments and the careers of company executives.

In 2011, Lord Davies' Review of Women on Boards reported that: "The informal networks' influence in board appointments, the lack of transparency around selection criteria and the way in which executive search firms operate, were together considered to make up a significant barrier to women reaching boards."

The CMPO researchers have gathered a wealth of information to examine the impact of these informal networks. They analyse data on the educational and employment backgrounds of board executives, their positions on boards of trustees, and affiliations to private members' clubs and golf clubs. The research asks whether the likelihood of gaining further board appointments is related to these social connections. More precisely, it examines whether an individual is more likely to be appointed if he has a link with someone already on the board – for example, through membership of the same golf club, such as Wentworth or Sunningdale, or the same private members' club, such as the Reform Club or White's.

The findings suggest that social connections through these clubs, as well as networks of contacts established through existing boardroom positions, play an important role in shaping who gains a seat on a board. Educational connections established through attending an elite school, such as Eton, or the same Oxford or Cambridge college, play a lesser role, although they may well have a prior influence on social club memberships.

The data encompass individuals who had already gained their first boardroom position. For

COMPLICATORS: high-performing organisations with high levels of complexity, which generally manage to couple high complexity with performance, but are still losing profits because of value-destroying complexity
STRUGGLERS: low-performing organisations with high levels of complexity, who are finding it difficult to manage the high levels of complexity that damage their performance

THE SIMPLICITY REVOLUTION

By interviewing managers in these firms, the researchers identify six main drivers of complexity: the external environment; strategic choices; the company's product and service portfolio; organisational structure; management processes and procedures; and the behaviour of people. These are big, intimidating challenges for managers to deal with – encompassing everything from the global financial crisis to the inherent, intrinsic complexity that develops in a rapidly-growing firm in a new industry – and as a result many companies place tackling this complexity on a list of problems 'too difficult to deal with'.

But the researchers argue that there are ways companies can start a simplicity revolution. They suggest a programme of diagnosing the sources of complexity, prioritising the changes that need to be made and focusing on how to solve the major problems. Change must begin at the top for it to be effective across the organisation, and all employees must be engaged in the process.

There is undoubtedly a cost involved in reducing complexity in an organisation, but 'Performer' companies such as Apple, Microsoft and GlaxoSmithKline are testament to the value that can be gained. For those companies who manage to solve the complexity conundrum, there is competitive advantage to be had. ■

www.simplicitypartnership.com
www.aimresearch.org

this group with existing board experience, women actually appear more likely to gain additional board positions than men. But if social connections are also important for a *first* executive appointment, then the role of networks formed through mainly or exclusively male social clubs is likely to prove a barrier to increasing female representation on boards.

In relation to this, one recommendation from Lord Davies' Review is that firms should make more information available about their appointments process and the work of their nomination committees. This is probably the best way to improve transparency in recruitment and subsequent board diversity. ■

www.bis.gov.uk/assets/biscore/business-law/docs/w/11-745-women-on-boards.pdf
www.bristol.ac.uk/cmpo

Finding 'big, fixable problems'

The key to building enterprises and creating jobs in Africa

LARGE-SCALE, LONG-TERM job creation is essential for Africa's future. But while diagnosing the continent's wide range of economic ills is easy, what is really challenging is implementing solutions. In pioneering work for the International Growth Centre (IGC), Professor John Sutton of the London School of Economics emphasises the need to find and fix a small number of 'big, fixable problems'.

The best way to do that, he says, is to construct 'enterprise maps' of national economies – complete descriptions of their industrial structure and the existing capabilities of major firms. These can provide the low-level background knowledge for governments, local companies and overseas companies looking at opportunities for foreign direct investment (FDI). Having worked on enterprise maps for a number of sub-Saharan African countries, Professor Sutton points to a number of big, fixable problems, including difficulties with transferring land rights; illegal exporting to get round protection of infant industries; and an absence of mid-level finance for mid-sized companies.

Careful monitoring and development of FDI ventures should be a key focus of policy concern

Professor Sutton mentions industries that are seen almost everywhere in Africa – beer, cement, sugar – and the capabilities that they require – selling to a 'safe' local market, high transport costs and the absence of an international supply chain with other firms whose quality standards domestic firms must meet. He also describes the most notable scarcity in African countries – not entrepreneurship, which is abundant, but a cadre of middle managers with the market intelligence and ability to run mid-sized companies effectively. Mid-sized diversified companies – capable of spotting domestic market opportunities, often through 'import substitution' – are the ones most likely to generate much-needed jobs.

THE ETHIOPIAN STORY

The IGC has published the first of Professor Sutton's studies as *An Enterprise Map of Ethiopia*. The book describes the history and current capabilities of the country's leading industrial companies (agribusiness, manufacturing and construction), focusing on 50 key large- and mid-sized firms. The motivation is to help with the expansion of economic capabilities in Ethiopia by first understanding where the capabilities of the existing successful companies came from. The 50 firms represent almost all the largest firms in their respective sectors.

One of the book's most important observations is the fact that around half the leading firms in Ethiopia have emerged from the import/export (trading) sector. This is where the deepest and most acute knowledge of local and international market conditions is already at hand. A common and unfortunate tendency among many observers of developing economies is to see the trading sector as separate from and irrelevant to the growth of manufacturing industry. But these firms have a vital role in seeding successful manufacturing firms.

THE ROUTE TO FUTURE GROWTH

A second important observation is that among the 50 leading firms, only two can trace their origins back to a small domestic firm. The second private sector source of Ethiopia's leading industrial companies is foreign companies. This is likely to be an increasingly important route to future industrial growth – and the inflow of FDI in the past decade has been increasing significantly from a very low base. Four countries are leading this phenomenon: China, India, Saudi Arabia and Italy. Their FDI projects span every sector of Ethiopian industry. The book concludes that careful monitoring and development of FDI ventures should be a key focus of policy concern over the next decade.

Another crucial issue of economic policy the book identifies is import substitution – developing local industry to provide substitutes for expensive imports – and the need to nurture this on a level playing field with export projects, which tend to be given preferential treatment. Finally, the book addresses issues of access to medium-term finance for growth, and the availability of land for industrial use. ■

www.theigc.org/sites/default/files/sutton_pdf.pdf

Industrial policy for growth

Higher education should be treated as a 'strategic sector'

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Britain has the world's second largest share of overseas students

WHAT IS THE point of higher education? The head of a US university once said that his main job was to provide a plentiful supply of "sports for the alumni, parking for the faculty and sex for the undergraduates". In more restrained Britain, the two main economic benefits of the academy are thought to be increasing the supply of skills and generating research.

Both of these have a sound rationale. Expanding human and intellectual capital increases productivity, which boosts the wages of all British workers. And the benefits of skills and ideas are not just grabbed by the individuals who are fortunate to have them – benefits flow out to many others. An idea is a promiscuous thing, stimulating innovation way beyond the person who first thought of it. But there is an overlooked third rationale for universities, one which is becoming more important than skills and ideas. This is the fact that higher education is a major export-oriented 'strategic sector'. But aren't these industries the preserve of car and silicon chip manufacturing, perhaps extending to software in Cambridge or yoghurt production in France?

In fact, higher education is a prime example of a strategic sector. In thinking pro-actively about a long-term growth strategy, we need to do two things. First, identify sectors of the global economy that are likely to have sustained growth; and second, focus on areas where Britain has some comparative advantage. Higher education scores highly along both of these dimensions.

STUDYING OVERSEAS

The market for overseas students is huge and growing rapidly, driven by firms' increasing demand for education. Anyone who doubts this should consider the fact that the wage returns for graduates continue to grow in Britain, despite the fact that since 1997 the proportion of people with a degree rose from 15 per cent to 27 per cent. If the supply of education doubles but the wages of the educated also still increase, demand for skills must be growing tremendously. What's more, globalisation has reduced the costs of studying overseas – witness the huge growth in numbers of Indian and Chinese students. There are now about 3.3 million overseas students and the market for these students is growing at about seven per cent a year. According to the McKinsey Global Institute, they could be worth £5 billion to Britain in tuition fees alone if we can maintain our market share.

The country excels in higher education. Elite science is incredibly strong: with under one per cent of the world's population, Britain produces over 14 per cent of the most highly-cited scientific publications. This strength is reflected in the fact that Britain has the world's second largest share of overseas students and has been catching up with the US.

How should the government treat strategic sectors like higher education? The right approach is to remove barriers to the international expansion of the sector and make sure that domestic policy facilitates existing strengths rather than inhibits them. Spending a lot on protecting the sector from foreign competition is a mistake – in the 1970s, governments unsuccessfully tried to create national champions through mergers and subsidies in computers and cars. By contrast, Cambridge, Oxford, Imperial and the London School of Economics (LSE) have become national champions because they have been allowed to be autonomous and to compete aggressively in the market for ideas, faculty and students. A funding mechanism based on research excellence has also helped: the failure of continental European universities to match Britain's success is largely due to centralised control of funding and spreading it too widely.

The right approach is to remove barriers to the international expansion of the sector

But policy can also have a damaging effect on higher education. The most disastrous example is David Cameron's election promise to reduce net immigration to fewer than 100,000 people per year. Since the government cannot control migration to and from the European Union, it belatedly realised that options to meet this self-imposed target were limited, and chose to restrict the supply of visas reserved for the most talented immigrants. This has had a major effect in restricting the ability of top universities to attract faculty since they compete in a worldwide market.

The government also chose to limit students' opportunities to work in Britain after finishing their studies – which makes the country a much less attractive place for top students. For example, Chinese students considering studying economics at LSE may want to work in the City for a few years afterwards and this is now heavily restricted.

Finally, the government is also directly planning to reduce the numbers of student visas. These measures on immigration are a prime example of an anti-growth policy stifling one of Britain's few internationally competitive, high-skill service sectors.

CREATIVE STRATEGIES REQUIRED

Another example of a policy affecting universities is the funding of undergraduates. The success of universities in the market for overseas students is partly because there is no cap on fees or numbers for postgraduates and overseas students. This led to vibrant competition between universities. But it has not been true for home undergraduates whose fees were capped at a low level in England until 2011. Liberalising the home student market is the right way to go, but the chaotic way it is being implemented does no one any favours.

A serious policy for growth should identify sectors like higher education as strategic and find creative ways to promote them – healthcare, parts of software and green technologies would be other examples. The current policy portfolio on higher education is doing the opposite and threatens to choke off one of our most dynamic sectors. ■

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