Here's all that's certain about the future: it holds profound and unpredictable change. But as smart CEOs have already learned, that's all you need to know to prepare your company

Change leaders

WE DO NOT HEAR MUCH ANYMORE ABOUT overcoming resistance to change, which 10 or 15 years ago was one of the most popular topics of management books and management seminars. Everybody has accepted by now that change is unavoidable. But that still implies that change is like death and taxes—it should be postponed as long as possible, and no change would be vastly preferable.

But in a period of upheaval, such as the one we are living in, change is the norm. To be sure, it is painful and risky, and above all, it requires a great deal of very hard work. But unless an organization sees that its task is to *lead* change, that organization—whether a business, a university, or a hospital—will not survive. In a period of rapid structural change the only organizations that survive are the "change leaders." It is therefore a central 21st-century challenge for management that its organization become a change leader.

There is a great deal of talk today about "the innovative organization." But making an organization more receptive to innovation—even organizing it for innovation—is not nearly enough to transform it into a change leader. It might even be a distraction. For being a change leader requires the willingness and ability to change what is *already* being done just as much as the ability to do new and different things. It requires policies and practices that make the present create the future. *(Continued)*

An excerpt from the new book
BY PETER F. DRUCKER

Abandon yesterday. The first step for a change leader is to free up resources that are committed to maintaining things that no longer contribute to performance and no longer produce results. Maintaining yesterday is always difficult and extremely time-consuming. Maintaining yesterday always commits the institution's scarcest and most valuable resources—and above all, its ablest people—to nonresults. Yet doing anything differently—let alone innovating—always creates unexpected difficulties. It demands leadership by people of high and proven ability. And if those people are committed to maintaining yesterday, they are simply not available to create tomorrow.

The first change policy, therefore, has to be *organized abandonment.* The change leader puts every product, every service, every process, every market, every distribution channel, every customer, and every end use on trial for its life. And the change leader does so on a regular schedule. The question it has to ask—and ask seriously—is "If we did not do this already, would we, knowing what we now know, go into it?" If the answer is no, the reaction must not be "Let's make another study." The reaction must be "What do we *do* now?"

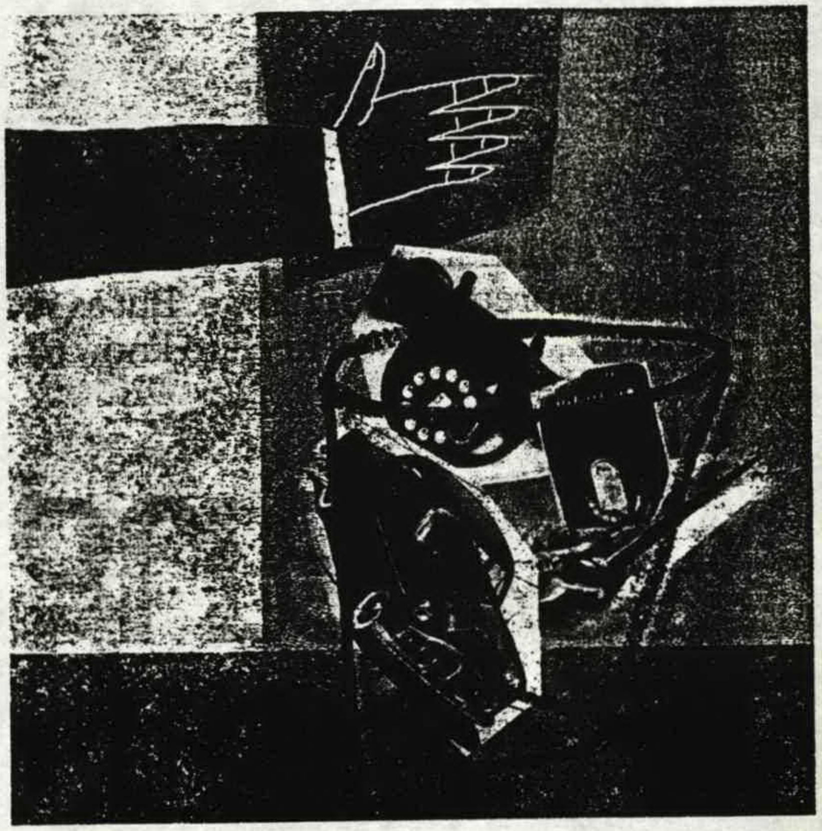
In three cases the right action is always outright abandonment:

1. When you think that the product, service, market, or process "still has a few good years of life." It is the dying products, services, markets, or processes that always demand the greatest care and effort. And we almost always overestimate how much "life" actually is left. Usually, they are not dying; they are dead.

2. When the only argument for keeping a product, service, market, or process is that "it's fully written off." To treat assets as being fully written off has its place in tax accounting, but for management the question should never be "What has it cost?" The question should be "What will it produce?"

3. When for the sake of maintaining the old and declining product, service, or process, the new and growing product, service, or process is being stunted or neglected.

For every product, service, market, or process, the change leader must also ask, "If we were to go into this now, knowing what we now know, would we go into it in the same *way* we are doing it now?" And that question needs to be asked about the successful products, services, markets, and processes as regularly—and as seriously—as about the unsuccessful products, services, markets, and processes. It applies with particular force to distributors and distribution channels, which, in a time of rapid change, tend to change faster than anything else.



The change leader
must put every product, service, process, and market on trial for its life.

In one fairly big company that offers outsourcing services, the first Monday morning of each month is set aside for an abandonment meeting at every level of management. In the course of a year, three to four major decisions are likely to be made on abandoning a product, service, or market, and perhaps twice as many decisions to abandon the way something is done. Also, three to five ideas for new things come out of those sessions. The decisions are reported to all members of management each month. Since the company first began organized abandonment, eight or nine years ago, it has grown more than fourfold (adjusted for inflation), and it attributes at least half of that growth to its systematic abandonment policies.

The question of what to abandon has to be organized systematically. Otherwise, it will always be postponed, for it is never popular.

Improve systematically. Whatever an enterprise does, both internally and externally, needs to be improved systematically and continually: the product or service, the production processes, marketing, technology, the training and development of people, and the use of information. And it needs to be improved at a preset annual rate. In most

Strategy: The new realities

What can strategy—that is, any commitment of present resources to future expectations—be based on in a period of rapid change and total uncertainty, like the one the world is facing at the turn of the 21st century? Are there any certainties?

There are indeed five phenomena that can be considered certainties. They are, however, different from anything present strategies consider. Above all, they are not, essentially, economic. They are primarily social and political.

1. **The collapsing birthrate.** The most important single new certainty—if only because there is no precedent for it in all of history—is the collapsing birthrate in the developed world. Even more important is the age distribution within the population. There is no precedent for a population structure in which old people past any traditional retirement age outnumber young people, as is already the case in parts of Europe and will be in all developed countries well before the middle of the 21st century. The strategy of all institutions in the developed world will have to be based on the assumption of a shrinking population, and especially of a shrinking young population.

2. **Shifts in how disposable income is spent.** While businesses and industries have become highly conscious of their market standing, practically none of them know the truly important figure: the share of their customers' disposable income that is spent on their products or services. And practically no one knows whether that share is going up or down.

Where shares of disposable income are spent is the foundation of all economic information as well as the most reliable foundation for a business strategy. As a rule, trends in the distribution of disposable income to a certain product category or service category, once established, generally persist for long periods of time. They are usually impervious to the business cycle.

For that reason, there are few changes more important to an organization than a new trend in that distribution. And equally important is a change within a trend—that is, a switch from one kind of product or service within a category to another product or service within the same category.

The four sectors whose share of disposable income grew during the 20th century were government, health care, education, and leisure. The changing trends of those four sectors are the first thing a strategy has to consider.

3. **New definitions of performance.** Two developments—the emergence of an affluent (though by no means rich) middle class of nonmanual workers and the extension of life expectancy—have led to the development of institutions such as pension funds and mutual funds. Those are now the legal owners of the key property in a modern, developed society: public corporations. And with that shift in ownership, we are seeing a shift in power.

In the United States since the late 1920s, the prevailing theorem, however fuzzy, held that a business should balance the interests of various stakeholders—customers, employees, shareholders, and so on—which in fact meant that it should not be accountable to anyone. The emerging American theorem that businesses should be run exclusively for the short-term interest of the shareholders is not tenable and will certainly have to be revised.

The future economic security of more and more people—as more and more people can expect to live longer—increasingly depends on their income as stock owners. The emphasis on measuring performance mostly by how much it benefits the shareholders will therefore not go away. Immediate gains, whether in earnings or in share price, are, however, not what shareholders need. They need economic returns 20 or 30 years hence. We will have to learn how to balance short-term results—which is what the present emphasis on shareholder value amounts to—with the long-range prosperity and survival of the enterprise.

Businesses also will increasingly have to satisfy the interests of their knowledge workers. Performance will have to be defined nonfinancially in order to be meaningful to knowledge workers and generate commitment from them.

4. **Global competitiveness.** No institution can hope to survive, let alone succeed, unless it measures up to the standards set by the leaders in its field, anyplace in the world.

One implication: it is no longer possible to base a business on cheap labor. However low its wages, a business—except for the smallest, like a neighborhood restaurant—is unlikely to survive, let alone prosper, unless its workforce rapidly attains the same level of productivity as the employees of the industry's leaders, wherever they are located.

That is true particularly in manufacturing. In most manufacturing industries in the developed world, the cost of manual labor is rapidly becoming a smaller and smaller factor—it's now down to one-eighth or less of the total cost of making a product. That means that the economic-development model of the 20th century—the model first developed by Japan after 1955—no longer works. Low labor costs no longer give enough of an advantage to offset low labor productivity.

In all likelihood, we face a protectionist wave throughout the world in the next few decades. For the first reaction to a period of turbulence is to try to build a wall that shields one's own garden from the cold winds outside. But such walls no longer protect institutions—and especially businesses—that do not perform up to world standards. It will only make them more vulnerable.

5. **The growing incongruence between economic globalization and political splintering.** Businesses can no longer define their scope in terms of national economies and boundaries. They have to define their scope in terms of industries and services worldwide. National boundaries are impediments and cost centers.

But at the same time, political boundaries are not going away. Nothing has emerged yet to take the place of national government and national sovereignty in political affairs. Even within transnational economic organizations, national politics still overrule economic rationality.

We have in fact three overlapping spheres. There is a true global economy of money and information. There are regional economies in which goods circulate freely and in which impediments to the movement of services and of people are being cut back, though by no means eliminated. And then, increasingly, there are national and local realities, which are economic but above all are political. All three spheres are growing fast. And businesses have to live and perform in all spheres at the same time. That is the reality on which a strategy has to be based, but no management anyplace knows yet what that reality actually means.

The first rule for a business in managing the incongruence between economic reality and political reality is, Don't do anything that does not satisfy economic reality. Closely related is another don't: Don't expand or grow globally by going into businesses—especially not by acquisition—unless they fit into the company's overall strategy.

Business growth and business expansion in different parts of the world increasingly will not be based on mergers and acquisitions or even on starting new, wholly owned businesses abroad. They will have to be based on alliances, partnerships, joint ventures, and all kinds of relationships with organizations located in other political jurisdictions. They will, in other words, increasingly be based on structures that are economic units and not legal—and therefore not political—units.

areas, an annual improvement rate of 3% is realistic and achievable.

However, continuing improvement requires some major decisions by an organization. It must answer the questions "What constitutes *performance* in a given area? What is *quality* in a product? To what extent can improvement be defined only by the customer?" Defining performance in services is often especially difficult.

Continuous improvements in any area eventually transform the operation. They lead to product innovation. They lead to service innovation. They lead to new processes. They lead to new businesses. Eventually continuous improvements lead to fundamental change.

Exploit success. It is only 70 or 80 years since the monthly report was invented and introduced into most business organizations. Almost without exception the first page of this report presents the areas in which results fall below expectations or in which expenditures exceed the budget. It focuses on problems.

Problems cannot be ignored. But to be change leaders, enterprises have to focus on opportunities. That requires a small but fundamental procedural change: a new first page to the monthly report, one that precedes the page that shows the problems. The new page should focus on where results are better than expected. As much time should be spent on that new first page as traditionally was spent on the problem page.

As is the case with continuous improvement, exploitation of success will, sooner or later, lead to genuine innovation. There comes a point when the small steps of exploitation result in a major fundamental change—that is, in something genuinely new and different.

Innovate systematically. Innovation is the area to which most attention is being given today. It may, however, not be the most important one—organized abandonment, continuous improvement, and exploiting success may be more productive for a good many enterprises. And without those policies, no organization can hope to be a successful innovator.

But to be a successful change leader, an enterprise has to have a policy of systematic innovation. And the main reason may not even be that change leaders need to innovate—though they do. The main reason is that a policy of systematic innovation produces the mind-set needed for an organization to be a change leader. It makes the entire organization see change as an *opportunity*.

That requires a policy of systematically looking, every 6 to 12 months, for changes within the areas that I call "the windows of opportunity." (For detailed descriptions, see my book *Innovation and Entrepreneurship*, HarperCollins, 1985.) Those windows include—

1. The organization's own unexpected successes and unexpected failures, and the unexpected successes and unexpected failures of the organization's competitors.

2. Incongruities or dissonance between what is and what "ought" to be, or between what is and what everybody assumes—especially incongruities in processes like production or distribution, or incongruities between the efforts of an industry and the values and expectations of its customers.

3. Process needs, such as a weak link in one of the organization's internal processes.

4. Changes in industry and market structures.

5. Changes in demographics.

6. Changes in meaning and perception. If, for example, general perception changes from seeing the glass as half full to seeing it as half empty, there are major innovative opportunities.

7. New knowledge.

A change in any one of those areas raises the question "Is this an opportunity for us to innovate?" Innovation can never be risk free. But if innovation is based on exploiting what has already happened, it is far less risky than not exploiting those opportunities.

One trap to avoid
is confusing novelty with innovation.
An innovation creates value.

Avoid innovation traps. Change leaders will be tempted by three innovation traps. They're so attractive that leaders can expect to fall into one of them—or into all three—again and again.

1. When looking for ways to innovate, the first trap to avoid is an opportunity that is not in tune with the five strategic realities: the collapsing birthrate; shifts in how disposable income is spent; new definitions of performance; global competitiveness; and the growing incongruence between economic globalization and political splintering. (See "Strategy: The New Realities," page 68.) The misfit opportunity often looks very tempting—precisely because it looks truly innovative. But even if the innovation does not result in failure—as it usually does—it always requires extraordinarily wasteful amounts of effort, money, and time.

2. A second trap is confusing novelty with innovation. The test of an innovation is that it creates value. A novelty creates amusement only. Yet again and again, management decides to innovate for no other reason than that it is bored doing the same thing or making the same product day in and day out. The test of an innovation—as is also the test of quality—is not "Do we like it?" It is "Do customers want it and will they pay for it?"

3. The third trap is confusing motion with action. Typically, when a product, service, or process no longer produces results and should be abandoned or changed radically, management reorganizes. To be sure, reorganization is often needed. But it should come *after* the action—that is, after what must be abandoned has been faced up to. By itself reorganization is just motion and no substitute for action.

There is only one way to avoid those traps or to extricate oneself if one has stumbled into them: organize the introduction of change.

Introduce change on a small scale. One cannot do market research on the truly new. Also, no innovation is right the first time. Invariably, problems crop up that nobody thought of. Invariably, problems that loomed very large to the innovator turn out to be trivial or nonexistent. It is almost a law of nature that anything that is truly new, whether it is a product or a service or a technology, finds its major market and its major application not where the innovator and entrepreneur expected.

The best example is an early one. The improvement of the steam engine that James Watt designed and patented in 1769 is the event that, for most people, signifies the advent of the Industrial

Revolution. Actually, throughout his life Watt saw only one use for the steam engine: to pump water out of coal mines. That was the use for which he had designed it. And he sold it only to coal mines. It was his partner, Matthew Boulton, who was the real father of the Industrial Revolution. Within 10 or 15 years after Boulton had first sold a steam engine to a cotton mill, the price of textiles had fallen by 70%. And that created both the first mass market and the first factory.

Studies, market research, and computer modeling are not a substitute for the test of *reality*. Everything improved or new needs first to be tested on a small scale—that is, it needs a pilot test.

And since everything new gets into trouble at some point, it needs a champion. And that person needs to be somebody the organization respects. It need not be somebody within the organization. A good way to test a new product or new service is often to find a customer who really wants the innovation and who is willing to work with the producer on making it truly successful.

If the pilot test is successful—if it finds the problems nobody anticipated but also finds the opportunities nobody anticipated—the risk of change is usually quite small. And it is usually also quite clear where to introduce the change and how to introduce it.

Budget for change. In most enterprises there is only one budget. In good times expenditures are increased across the board. In bad times expenditures are cut across the board. That practically guarantees missing out on the future.

The change leader requires two separate budgets. Its first budget should be an operating budget that shows the expenditures needed to maintain the present business. That is normally 80% to 90% or so of all expenditures.

That budget should always be approached with the question "What is the *minimum* we need to spend to keep operations going?" And in bad times it should, indeed, be adjusted downward.

And then the change leader should have a separate budget for the future. That budget should remain stable throughout good times and bad times. It should rarely amount to more than 10% to 20% of total expenditures.

Very few of the expenditures for the future will produce results unless the budget is maintained at a stable level over a substantial time period. (It is important to note, however, that there may be times that are so catastrophic that maintaining those expenditures could threaten the very survival of the enterprise.) That goes for work on new products, new services, and new technologies; for the development of markets, customers, and distribution channels; and, above all, for the development of people. The future budget should be approached with the question "What is the *maximum* this activity can absorb to produce optimal results?"

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The most common, but also the most damaging, practice is to cut back on expenditures for success, especially in bad times. The argument is always "This product, service, or technology is a success anyhow; it doesn't need to have more money put into it." But the right argument is "This is a success and therefore should be supported to the maximum possible." And it should be supported especially in bad times, when the competition is likely to cut spending and therefore is likely to create an opening.

Balance, change, and continuity. Organizations that are change leaders are designed for change. But people need continuity. They need to know where they stand. They need to know the people they work with. They need to know the values and the rules of the organization. They do not function well if the environment is not predictable, not understandable, not known. Continuity is equally needed outside the enterprise. To be able to change rapidly, one needs close, long-standing relationships with suppliers and distributors.

Balancing change and continuity requires continual work on information flow. Nothing disrupts continuity and corrupts relationships more than poor or unreliable information (except, perhaps, deliberate misinformation). It has to become routine for any enterprise to ask at any change, even the most minor one, "Who needs to be informed of this?"

Information is particularly important when a change is not a mere improvement but is something totally new. Any enterprise that wants to be successful as a change leader has to have a firm rule that there are no surprises. Above all, there needs to be consistency in the fundamentals of the enterprise: its mission, its values, its definition of performance and results. Precisely because change is a constant in the change-leader enterprises, their foundations have to be extra strong.

Finally, the balance between change and continuity has to be built into compensation, recognition, and rewards. We learned long ago that an organization will not innovate unless innovators are properly rewarded; that a business in which successful innovators do not make it into senior management, let alone into top management, will not innovate. We will have to learn, similarly, that an organization will have to reward continuity by considering, for instance, people who deliver continuing improvement to be as valuable to the organization and as deserving of recognition and rewards as the genuine innovator.

The more an institution is organized to be a change leader, the more it will need to balance rapid change and continuity. That balance will be one of the major concerns of tomorrow's management.

ONE THING IS CERTAIN: WE FACE YEARS of profound changes. It is futile to try to ignore the changes and to pretend that tomorrow will be like yesterday, only more so. But to try to anticipate the changes is equally unlikely to be successful. The changes are not predictable. The only policy likely to succeed—although it, too, is highly risky—is to try to *make* the future. ■

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