Kevin Kaiser and S. David Young

THE BLUE LINE IMPERATIVE

What Managing For Value Really Means

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By Kevin Kaiser and S. David Young

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Kevin Kaiser. To the thousands of MBA, EMBA and executive participants I have taught who have inspired me, driven me, and helped me over so many years to develop countless insights and concepts. And to the thousands more I hope to teach in the future.

S. David Young. To my daughter Adiva.

Preface

The effort to write this book began with a conversation we had years ago about the difficulty of teaching business school participants what it means to "manage for value." In our view, this topic incorporates four essential elements: (1) What is value?; (2) Why is it important?; (3) If it's so important, why aren't managers already doing it?; and (4) How can we help managers to do it? The more time and energy we spent trying to explain, the more we realized that none of these questions has a simple answer. As we developed the material to support these efforts, and as we delivered that material to an increasing number of participants, we received more and more requests for book recommendations that would summarize the increasingly broad-thinking ideas we were teaching. Some books address the finance element while others address the accounting element, but those books explain only the "silo" dimension of value and are more about tracking and modeling value than how to manage for it. What we observe, and teach, is that managing for value requires taking a more holistic approach, to consider economic (micro and macro), scientific (biology or physics) and psychological and customer-value aspects. We found we had increasing difficulty finding books to recommend which covered the "manage for value" topic. So, in answer to the repeated requests from our students, we decided to write this book.

We had both faced the difficulty of conveying the principles of value creation to our executive and MBA participants, and realized that if these current and future managers don't understand what value is, then it is extremely unlikely they will successfully manage for value in their organizations. We noticed that when we would ask a class of 40 participants

to write down a definition for value, we would usually receive 40 different answers. So how were we to write a book on managing for value if no two managers understood or agreed on what value meant? We talked to different faculty at our business school to see how they defined value. Asking faculty in Finance, Marketing, Organizational Behavior, Strategy, and other areas, it turned out that business school academics were also using different definitions (and often disagreed quite strongly with the definitions offered by their colleagues). Thus, we perceived the need to establish a common definition of value in order to have any chance of helping people manage for it.

It is relatively easy to show what is **not** managing for value – for example, managing for profit is **not** equivalent to managing for long-term value. However, knowing what value is **not** doesn't really clarify what value **is**. To answer this question, we took a somewhat unconventional "crowd-sourced" approach, to try and incorporate the different perspectives we encountered. Our aim in this book is to talk about value in a way that our academic colleagues across the disciplines can be comfortable with using in their research and in the classroom, as well as one which our seasoned executive education participants can accept and see fitting with their experience. We also chose to define it using a method of backward induction as the answer to the question: What does an organization have to accomplish in order to not end up bankrupt over a century or more? This approach enabled us to avoid the opinions and differing perspectives of individuals, and to define value in an objective way. So although each person may hold a definition of value that is personal and unique to them, we also found there is a definition that is objective and common to all of us, including organizations. We explain both in this book. We also demonstrate the critical connection between the two definitions, in which one drives the other.

Blended into the ongoing development of the effort to define value was the analysis of why it is important to manage for it, and similarly, why it is so difficult to do. The question of why it is so important to create value, which appeared self-evident at the beginning, turned out to be a rather broad discussion. As we demonstrate in this book, it is the combination of a market-based system for allocating resources and a well-functioning market for capital, which is forcing organizations to align the two definitions of value if they wish to sustain their existence. This

means, simply, that in order to be confident of generating the cash to sustain the organization, it is increasingly important that the organization delivers sustainable happiness to those it serves with its products and services. In this way, the creation of value becomes an imperative (rather than a choice dependent upon what the manager feels like doing on any given day) – those organizations that create and deliver value will have a future, and those that do not, will face economic ruin. Upon closer inspection, we noticed that this system is no more, nor no less, than an evolutionary force of nature. When viewed over thousands of years, rather than a year, or a decade, or even a century, the need to deliver value, as defined herein, is clearly not a question upon which humanity can easily choose to agree or disagree. Those who create value will be defined as sustainable, and they will sustain, and those who do not will soon face extinction.

Despite this "imperative," we observe many organizations destroying value – sacrificing the longer-term sustainability of the organization to achieve a short-term target. Indeed, we like to pose the question in our executive programs to those who've worked in any of these organizations: "How many of you have knowingly destroyed value in order to deliver on a target or indicator that you've been assigned to hit?" Initially we were shocked by the high percentage of hands which were raised in confirmation that they had engaged in this behavior. (Now we are accustomed to it, so we are no longer shocked.) When asked to explain how they destroyed value, the responses were remarkably similar: it was whenever they engaged resources for an objective which could have been attained using fewer resources. This behavior was found to be rampant in all organizations; from companies and banks to charities and governments. This begs the question: Why do people destroy value if they actually know what value is? And why is it important for them to create it and avoid the demise of their organization? We devote a considerable amount of space and time in this book to this question, which we now know to be far more important than we appreciated at the outset of this project.

Once we had uncovered the "what," "why," and "why not" of value, we then tackled the profoundly difficult question: How do we orient our organizations around value as an objective? What techniques and tools can we apply in order to (1) know when we are creating value (at least,

within a range), (2) encourage our people to take value-enhancing decisions, and (3) build a culture across our organization that will attract and reward those who create value? Our approach to these questions again followed a similar process as those above, where we would pose hypothetical tools, frameworks, techniques and ideas, based on insights from several areas of academia (with emphasis on psychology, neuroscience, organizational behavior, and finance), to our classroom participants. With their challenges and feedback, and based on observations of their behaviors and answers to carefully designed questions and case studies, we were able to test the validity and effectiveness of alternative techniques and hypotheses.

What emerged is presented in this book as blue line management. It seeks to incorporate insights from many areas of study to enable a manager to design, and continuously adapt, a management system and process that will keep the organization and its people oriented around value creation, while remaining highly motivated and keen to show up each day in order to do it again.

We continue this process of testing our insights and ideas, and in this way the book will never be complete. But the time has come to get this out to a broader group than those people we have in our MBA and executive classrooms, so that the benefits can be spread far and wide, and the learning can be accelerated. We hope you enjoy the journey on this path to value creation, and look forward to any and all feedback, and additional insights, which we are certain you can offer to improve still further both our understanding and our ability to effectively convey the key messages related to "managing for value."

Kevin M.J. Kaiser
S. David Young

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Chapter One

What Is Value?

"Oh Happiness! our being's end and aim!"
– Alexander Pope, English poet, 1688–1744,
An Essay on Man, Epistle 4

What does the word "value" mean to you? In a business context, perhaps you define it as your company's share price, or the book value on your corporate balance sheet. If you're a marketer, you may think of it in terms of market share or customer satisfaction. As a parent, spouse, friend, or shopper, you may consider it a measure of something decidedly more personal.

With so many competing notions of value, and with the temptation to interpret value as whatever notion is most convenient for us at the time, how can anyone confidently talk about "managing for value"?

In the pages that follow, we offer a perspective on value and value creation that we hope clears away the confusion over these much-abused terms. What makes our definition of value different from the myriad of others is that our notion of value is not a social construct. It is not specific to time, place or context. It has nothing to do with anyone's opinion. It is an idea driven by nature through an instinctive, collective process.

Value creation has nothing to do with beliefs – yours, ours, or anybody else's. You may be familiar with the expression, *"Fifty million Frenchmen can't be wrong."* Well, yes they can. The same goes for 300 million Americans, a billion-plus Chinese, and so on. After all, it is entirely possible that every person working for Enron thought that their company was creating value when, in fact, it wasn't. Tens of thousands or even

tens of millions of people believing that they are creating value does not make it so. Value creation, when properly understood, is not simply someone's ethical perspective on how to manage a company. Value creation is a self-generating, self-governing, basic planetary imperative based on nature itself, and if you don't uphold it, the planet will shut you down every time.

Consider a continuum of value where on one end we have the most basic of raw materials, and on the other, the consumers of these materials. Whether we're drilling for oil, pumping gas at the local service station, or driving the latest Jaguar, we are all participants somewhere within this value chain which rules the globe.

The reason it rules the globe is simple. Beyond our basic drives of food, shelter, and sex, we are driven to try to make each day of our lives a little better than the day before. To do so means finding ways to become happier, and that, at its most basic level, means taking the resources available to us and using them to create value. No matter what products or services we strive to create, our overall purpose is the same: delivering happiness to ourselves and creating ongoing value in our lives.

Value, in other words, is really just another word for happiness, at least from the perspective of the consumer. Consumption is a non-stop process that occupies every moment of our existence, whether we're conscious of it or not. Happiness is the cognitive experience that dominates our waking lives. As Richard Layard writes, *"We are programmed to seek happiness."*

However, he also writes that, *"Generally, what makes us happy is good for us, and has therefore helped to perpetuate the species."*[1] In other words, the creation of a system for delivering value – we call it business – was no accident. It was inevitable. We will say much more about this later, but for now, let's talk further about the basic value imperative by which we are all instinctively governed.

For humans, again, value equals happiness. To help deliver this happiness to ourselves, we at some point created businesses that could generate the products and services to make us a little happier each day. "Happier" might mean more comfortable. It might mean more excited or

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[1] Richard Layard, *Happiness: Lessons from a New Science*, revised edition, (London: Penguin Books, 2011), p. 224.

interested. It might mean more entertained. It might mean better able to dust high window ledges. Business was the means of delivery. For any business to survive, not only must it deliver happiness that customers are willing to pay for (the *"cash applause of consumers"* as one observer puts it)[2], but the cash it receives must also be sufficient to cover that needed to pay its own suppliers, while at the same time ensuring a competitive return on the capital invested. From the perspective of business, we can therefore express value a different way. Later, we will introduce this other definition of value, and using it as a basis we will assert the concept of blue line management, the core thesis of this book. Blue line management is an approach that uncompromisingly focuses talent, energy, and decision-making on the sole objective of creating value. Every decision a company makes has an impact on value; it either creates value or destroys it. To put it in the starkest terms, blue line companies last because they are focused on long-term value. Other companies, which we refer to as red line companies, inevitably die because they are focused on other misguided definitions of value.

We Want Our Stuff

Allow us to talk a bit more about the concept of happiness. Since humans created business for the purpose of delivering happiness, and since this book is about what we are calling the value creation imperative, which stems from humankind's overarching desire to be happy, happiness matters. A lot.

Happiness is relative, of course. What satisfies our needs, and therefore motivates us, may not satisfy yours. Some people may think of clean drinking water as their greatest need. Others might not feel happy unless presented with three different options for sparkling bottled water at a fancy restaurant. If you're a subsistence farmer in Southeast Asia and you survive the winter, you're happy. If you're a middle manager who hits the targets and gets that coveted promotion, you're happy. If you're Warren Buffett giving away 99% of your wealth (currently estimated at

[2]Deidre N. McCloskey, "A Kirznerian Economic History of the World", *The Annual Proceedings of the Wealth and Well-Being of Nations*, Upton Forum, 2010, p. 58.

$47 billion)[3] to good causes, and succeed in persuading a bunch of other billionaires to do likewise,[4] you're likely to be very happy. What you seek, what helps you survive, what motivates you, is happiness.

Since what makes us happy is different from what makes you happy, what enables happiness for all of us – and anyone else – is choice. We are not made happy by the same things, so we deeply appreciate the chance to pick and choose the sources of our happiness from among a great variety of possibilities. The massive growth of consumerism, particularly in the last century, has today given us unprecedented amounts of choice. There really are umpteen different types of bottled water to choose from. We can buy bacon-flavored chocolate, and possibly even chocolate-flavored bacon, and if you're in the market for a new cell phone, well, the options are seemingly endless.

In the 1980s, a Canadian doctor we know took a group of visitors from Leningrad (now Saint Petersburg) on a tour in Canada, including a visit to a regular grocery store. The Russians were astonished at the huge number of choices available, in particular the dozens of varieties of breakfast cereal. They commented that back home in Leningrad, they had but two. Their Canadian host pointed out that he really only liked two of the cereals on display, so he didn't understand the need for so many. But he realized that while other customers at the store might also enjoy only two of the cereals on offer, their two favorites would probably be different from his. Perhaps this crazy plethora of cereals was needed after all, at least according to the definition of our collective happiness.

A similar story was told by heavyweight boxing champion Vitali Klitschko on describing the shock he felt during his first visit to an American supermarket: *"I thought there was only one type of cheese, you know, the thing we'd always called 'cheese,' and in a grocery store, I saw a hundred kinds of cheese! It was amazing."*[5] Why a hundred cheeses? It's the only way to accommodate everyone's taste.

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[3] T. Leonard, "The dinner that cost Bill Gates, Warren Buffet and other celebrities billions", *Daily Telegraph* online, 2010, http://www.telegraph.co.uk/news/worldnews/northamerica/usa/7929657/The-dinner-that-cost-Bill-Gates-Warren-Buffett-and-other-celebrities-billions.html

[4] http://givingpledge.org/

[5] http://www.grantland.com/story/_/id/7128487/vitali-wladimir-klitschko

Naturally, it doesn't stop with cereal and cheese. We want choice for everything we desire. *"'Desire' as a fundamental aspect of the self,"* wrote historian Jan de Vries, *"is not a product of modern industrial capitalism; its origins are to be found earlier."* It began, he asserts, in Western Europe in the seventeenth century, during a process he termed the *"Industrious Revolution,"* when increased consumption of luxury goods led to a desire for more income, changing people's working habits and spurring the creation of faster, more efficient production methods.[6]

We could go back even further. What we desire has always driven our decisions regarding where and how to direct our time and energy. But as we'll see shortly, it is only within the last few centuries that an efficient, shared method for really improving our lives has emerged, changing the landscape forever.

So what does all this conversation about happiness and choice have to do with you as a business leader? Everything. As consumers, we value, and are therefore willing to pay for, the products and services that make us happy, whatever our definition of happiness is. The only job of any business is to figure out what makes people happy and then try to deliver that happiness at a price the consumers find reasonable, while at the same time earning a competitive return on invested capital. If a business can do that sustainably, it is value-creating.

But if it can't find out what makes people happy, or if it thinks it has figured it out but is wrong, or if it figures it out but charges too much for that happiness, or, finally, if it has figured out what makes people happy and charges the right amount for it but can't make enough profit to adequately compensate for its own capital outlay, it will die. This may take some time, but the inevitable will happen eventually. We as consumers will kill the business because it is not creating value in our lives.

Sometimes we don't know what we want of course, and that can make your job very tricky. When Gillette released their MACH3 three-blade razor in 1998, it was an enormous success. Soon after, the company surveyed its customers to see if they might prefer a four-blade razor. The majority said no, they were quite content with the three blades, so Gillette decided not to develop a new razor.

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[6]J. De Vries, *The Industrious Revolution: Consumer Behavior and the Household Economy, 1650 to the Present*, (New York: Cambridge University Press, 2008), p. 43.

In 2004, rival shaving company Wilkinson Sword (Schick in the US) released a four-blade razor, the Quattro. Consumers embraced the Quattro, buying it in droves. Had Gillette's customers lied? No – they simply didn't know what they wanted. (This particular battle is far from over. Gillette introduced the five-bladed Fusion razor in 2006.)

Not only are there differences between what makes us happy and what makes you happy; even more important, what makes any of us happy today may not make us happy tomorrow. As shown above, we don't even know whether we prefer three razor blades or four. How can we be expected to decide on the really important stuff? Did we know we wanted the iPad before it arrived? Did we know we needed cameras in our cell phones? No.

The only thing certain is that companies need to constantly innovate in order to keep providing us with the things that make us happy, and therefore create value. As Steve Jobs explained, *"It's not about fooling people, and it's not about convincing people that they want something they don't. We figure out what we want. And I think we're pretty good at having the right discipline to think through whether a lot of other people are going to want it, too. That's what we get paid to do."*[7]

It's hard enough for companies to figure out what makes us happy when we ourselves don't always know what we want. Making matters worse, market researchers and others who research the customer psyche can't necessarily be relied upon to accurately reveal what we find valuable. The French vilify McDonald's, yet there are now over one thousand McDonald's, or McDo, as they are called locally, in France – including one in the Louvre. Even worse for the naysayers, the McDonald's on the Champs-Élysées is the most profitable in the world.[8]

Behavioral researchers have begun to question whether all of this choice is really good for us – whether, in the grand scheme, it really serves to create value for humanity.[9] According to one observer, *"Choice*

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[7] http://www.investinganswers.com/a/50-quotes-genius-behind-apple

[8] http://www.huffingtonpost.com/2009/10/05/mcdonalds-to-open-a-resta_n_309453.html

[9] "The Tyranny of Choice", *The Economist*, December 18, 2010, pp. 111–113.

no longer liberates, but debilitates. It might even be said to tyrannise."[10] It is suggested in some circles that such a bewildering array of choice in just about everything we buy leads to confusion, indecision, panic, buyer's regret, and anxiety. Researchers at McKinsey & Company estimate that if one were to add up all the different sizes, shapes, colors, and flavors of all the products on offer in a major economy such as New York or London, it would come to over ten billion distinct items.[11]

Does this panoply of choice cause us to feel overwhelmed at times? Sure. But it's the unavoidable by-product of human innovation driven by human desire for happiness, that is, value.

Consider for a moment the alternative. Humans have been struggling for millennia to reach a state in which we ourselves, and not others, get to make the critical choices in our own lives. What's more, since our wants and desires are so varied, the only way they can all be accommodated is by the vast range of choice we are only now beginning to witness – no doubt there is still a long way to go. For practically the whole of human existence, most people on the planet had no choice but to defer to their social betters in terms of what level or status they could aspire to – or even, more simply, what stuff they were entitled to get. It's a good bet that our ancestors, observing our lives today, would have little sympathy for the plight of having too much choice.

Trader Joe's is a fast-growing retail grocery chain in the US The average Trader Joe's carries only about 10% of the stock-keeping units of a typical supermarket, and most of those products carry one of the company's own brands. For example, if you're looking for Frito Lay corn chips, you won't find them at Trader Joe's. You will find instead a store brand of pita chips made in a Frito Lay factory. If you're seeking a full range of snack foods, or branded products in any food group, you'll have to visit a more conventional grocery store.

Yet Trader Joe's is one of the fastest-growing retailers in the US. Friendly, high-quality service is one reason. But another is that some shoppers apparently prefer the limited range, preferring to ask for guidance

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[10] Ibid., p. 112.

[11] Tim Harford, *Adapt: Why Success Always Starts with Failure*, (New York: Farrar, Straus and Giroux, 2011), p. 3.

from the merchandise buyers at Trader Joe's instead of making decisions themselves.

But there's an important point here that we shouldn't forget. Shopping at Trader Joe's is itself a choice. Outsourcing some of your shopping decisions to the people at Trader Joe's? That's a choice too, and a pretty powerful one. Should the habitual Trader Joe's clientele occasionally duck out to a Safeway or Winn-Dixie to get that must-have brand that they can't find at their favorite grocer, well, that's a third choice. Yes, we can rant all we want about the tyranny of choice, but again, don't try to play that card with your subsistence-driven ancestors who would probably want to stick a mastodon bone in your eye.

For business managers, the practical consequence of all this choice is simple, yet challenging. Choice is, as we said, about giving customers what they want, for a price they are willing to pay, while making a profit.

Let's focus on the first two parts of that statement: giving customers what *they* want, for a price *they* are willing to pay. You don't dictate these choices; they do. Every decision, from initial product development to final packaging, must be made with a view toward ensuring that the cost of adding features is less than what the customer is willing to pay. If you can accomplish this, you are reaching blue line nirvana: increasing both the customer's happiness and your company's value.

You can only deliver benefit to customers in two ways: by providing higher quality products and services – that is, increased happiness – at the same cost, or by providing the same products and services at a lower cost – increased happiness by a different name. Both equate to a bump-up in happiness without a corresponding increase in the resources required to deliver it. Value creation, and therefore the long-run survival of your business, depends on the achievement of at least one of the two versions of this feat.

Business history is littered with stories of companies that suffered because they failed to heed this lesson. Xerox insisted on adding more and more features to their copiers without any regard to whether these features were the ones their customers saw as important. When Canon then entered the fray with simpler machines that did what the customers really wanted them to do – namely copy documents well – without any bells and whistles, Xerox sales collapsed. As Peter Drucker reminds

us, *"Quality in a product or service is not what the supplier puts in. It is what the customer gets out and is willing to pay for. A product is not quality because it is hard to make and costs a lot of money, as manufacturers typically believe. This is incompetence. Customers pay only for what is of use to them and gives them value. Nothing else constitutes quality."*

We are particularly fond of Toyota's approach to value. The Toyota Production System, as described by Professor Jeffrey Liker, *"starts with the customer by asking, 'What value are we adding from the customer's perspective?' Because the only thing that adds value in any type of process – manufacturing, marketing, development – is the physical transformation of that product, service, or activity into something the customer wants."*[12] This philosophy points to the almost religious significance Toyota places on squeezing waste from the system anywhere it can. Toyota believes steadfastly that every activity the company performs must contribute to value for the customer. Everything else counts as squandered resources.

As we said above, what makes us happy can also be what helps us survive. Our "stuff" is more than just expensive water in restaurants or razors with extra blades, to be sure. It's also what keeps us warm, feeds us, or helps make us better when we get sick.

This wasn't always the case, of course. Human history suggests it's only relatively recently that we started to make a noteworthy dent in the problems of basic survival, let alone becoming the technologically-indulged creatures we are today. For reasons we'll explain in a bit, true value creation is a relatively recent human phenomenon, with virtually all of the improvements in our living standards taking place over the last 400 years.

Sustained value creation is even more recent than that. The Industrial Revolution may have begun in earnest sometime around the middle or latter part of the eighteenth century, but it didn't translate to overnight value creation. Noticeably improved living standards among the working

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[12]Jeffrey K. Liker, *The Toyota Way*, (New York: McGraw-Hill, 2004), p. 9–10.

classes were not evident for at least another 75 years. We haven't been getting our stuff for very long.

Centuries of Subsistence

> *"Throughout recorded history, most people in Europe – as elsewhere in the world – had possessed just four kinds of things: those they inherited from their parents; those they made themselves; those they bartered or exchanged with others; and those few items they had been obliged to purchase for cash, almost always made by someone they knew."*[13]
>
> – Tony Judt, historian, 1948–2010

Until a few hundred years ago, the human experience had changed very little. Over the millennia since we first became upright, people reliably died young, cold, hungry, and of what we now think of as trivial diseases. This was a function of how human groups evolved, from hunter-gatherer bands of 10 to 100 people to larger tribes, chiefdoms, and eventually empires. As the size of our groups increased, we went from being able to share our catch and fires with our nearest kin, in what one scholar calls "evolutionary egalitarianism,"[14] to being part of a hierarchical system that concentrated economic power among a relative few. This left the rest of the population impoverished, and with negligible chance of changing their lives for the better.

Until we could find a way to circumvent this problem, we were stuck with subsistence, a condition that afflicted much of humanity well into the nineteenth century. In France and other parts of Europe, people even developed a form of hibernation, where they would virtually shut down their existence for half the year, focusing strictly on staying alive. They had nothing to do, no fields to till, and not enough food to sustain them if they were to go out and be active during the cold months. Writing in

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[13]Quote taken from Tony Judt, *Postwar: A History of Europe since 1945*, (New York: Penguin Books, 2005), p. 337.

[14]M. Shermer, *The Mind of the Market*, (New York: Henry Holt and Company, 2008), p. 18.

the *New York Times*, Graham Robb pointed out that *"Villages and even small towns were silent, with barely a column of smoke to reveal a human presence."*[15] He also cited a 1900 edition of *The British Medical Journal* describing how peasants in Pskov, Russia, similarly slept for half the year: *"At the first fall of snow, the whole family gathers round the stove, lies down, ceases to wrestle with the problems of human existence, and quietly goes to sleep. . . . After six months . . . the family wakes up . . . and goes out to see if the grass is growing."*[16]

A Matter of Power

The past was a simpler time undeniably, but undeserving of the nostalgia often ascribed to it. Many people in the old days had more "leisure time" than we have today, but when we speak of leisure in this context, it's far from the idea of leisure we have today. It's not the time we take to pursue cultural, sporting, and social activities. Well into the nineteenth century, the great majority of people on earth lived lives that were little better than those of our Stone Age ancestors. Often lacking the calories needed for a full and productive life and the consumer goods that offer pleasure and comfort, they did little more than survive.

Sometimes, not even that. Even in relatively rich countries like France, large swathes of the population were never more than one bad harvest away from famine. Indeed, the lingering effects of this threat and the persistent fear of hunger could be found in the many proverbs and ritual phrases in use well into the twentieth century: *"Don't eat everything at once," "You've got to stretch things out,"*[17] and so on.

Even as conditions improved, entrenched habits of conservation and frugality died hard. Historian Eugen Weber noted that many peasants in France around the turn of the twentieth century continued to eat inferior barley bread even as white bread became more plentiful and less expensive.

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[15] G. Robb, "The Big Sleep", *New York Times*, 2007, http://www.nytimes.com/2007/11/25/opinion/25robb.html

[16] Ibid., http://www.nytimes.com/2007/11/25/opinion/25robb.html

[17] Eugen Weber, *From Peasants to Frenchmen: The Modernization of Rural France, 1870–1914*, (Stanford (CA): Stanford University Press, 1976), p. 137.

They feared they would eat the white bread *"with too much pleasure, and hence consume too much."*[18]

In the Netherlands, old habits linger even to this day, despite the fact that the country has for centuries been one of the world's richest. The Dutch are still reluctant to light candles until after sunset, evoking a cultural memory in which saving candles mattered. What's more, they still re-use teabags and coffee grounds as a matter of course.[19] Tony Judt reminds us that for *"the overwhelming majority of the [west] European population up to the middle of the twentieth century, 'disposable income' was a contradiction in terms."*[20] It's jarringly easy to forget just how recently the grinding routines of material scarcity held sway over every aspect of human life.

People were less economically active in pre-modern societies in part because there was so little to buy – assuming one could even get one's hands on some money. Why was there so little stuff available? Two reasons. First, in most societies, multiple unseen forces were marshaled against change to the prevailing social order. Second, and critically for this book, there was no mechanism to enable the people with the ideas and inventions to help us survive and make us happy – today we call them entrepreneurs – to get the financial backing they needed to see their ideas to fruition.

Put more simply, there was no way to make sure we got our stuff. Historians tend to ignore the role consumers played in human development, but we see it differently. Consumerism, by spurring the desire for us to earn money, was powerful enough to subvert a traditional hierarchy that had lasted for centuries and generate an endless upward spiral of improvement in the human condition as entrepreneurs and companies became able to provide us with what we needed to make our lives better.

What sort of forces had conspired to keep humankind in servitude? For many centuries, entrepreneurs, at least the sort that tried to com-

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[18] Ibid.

[19] Deirdre N. McCloskey, *The Bourgeois Virtues: Ethics for an Age of Commerce*, (Chicago: University of Chicago Press, 2006), p. 425–426.

[20] Tony Judt, op cit., p. 337.

mercialize innovations and make them available to the wider public, were frowned upon. There are only two ways to make money. The first is to improve the world and take a cut in the process. The second is to rip people off. Let us call the first method Productive Entrepreneurship and the second Conscious Fleecing. For a long time, it stood to reason that Productive Entrepreneurship was not viewed as a reasonable path to riches or status. Economist William Baumol pointed out that for the Romans, *"As long as it did not involve participation in industry or commerce, there was nothing degrading about the wealth acquisition process."*[21] Those who did acquire their wealth via industry or commerce were typically freedmen – former slaves – and therefore socially stigmatized.

In medieval Europe, it wasn't that enterprise was frowned on; it was merely considered a waste of time unless it helped promote warfare or aided in capturing a neighbor's castles and lands. Ideas for better siege machines or more sophisticated weaponry had a good chance of seeing the light of day, but those ideas aimed at improving the lot of the common man made little headway.

The ancient Chinese had a similarly unenthusiastic view of commerce. Instead of inventing things and working to make everyone's lives better, thousands of men sought advancement by sitting the imperial examinations and becoming bureaucrats. If they passed, they moved into a position of power with access to tax and other legal and not-so-legal revenues. Even in the twenty-first century, such behavior is not uncommon. Practices similar to those of the Chinese mandarins have emerged in Russia, where government officials – dubbed *"bureaucrat-entrepreneurs"* by *The Economist* – exploit a weak Russian state through a combination of racketeering and outright theft of budget revenues.[22]

Throughout history, sumptuary laws – laws regulating consumption – were also used to restrict what certain people could buy or wear, therefore maintaining social rank, privilege, and discrimination. The Romans had

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[21] W.J. Baumol, "Entrepreneurship: Productive, Unproductive, and Destructive", *Journal of Political Economy*, 1990, 98(5), part 1., p. 899.

[22] "Frost at the Core", *The Economist*, December 11, 2010, pp. 25–28.

rules about how many stripes you could have on your toga and who was allowed to don silk. In ancient Greece, only prostitutes could model embroidered robes in public. In Imperial China, only those of noble blood were permitted to wear yellow. Even in late nineteenth-century France, the bourgeoisie and intellectual classes frequently expressed contempt for those peasants and working-class folk who tried to emulate the dress of their social betters.

But history teaches us something else: that laws or social norms designed to try to control what people can do or get, don't work. Human ambition and the drive for entrepreneurship will come to the fore time and time again. Did Prohibition in the United States work? Of course not. Creating rules that prevent people from getting access to the stuff they want doesn't stop them from wanting it. Or from finding ways to get it.

The problem throughout all these generations was that though entrepreneurship is a relentless human drive, it requires a system to make it work. While it is romantic to think that money doesn't make the world go round, it does. If innovative ideas can't get funded, they can't transform from ideas into reality – they never become the stuff that makes our lives better.

For thousands of years, the chances of an entrepreneur realizing his dreams were extremely limited. Capital allocation – funding – was driven purely by relationships. Because assessing the true value of an idea was so difficult, investors made decisions based not on whether an idea had merit but whether they thought the person behind the idea was trustworthy.

But there was a larger problem. For most of our history, in most places where we existed, the wealth was held by a select few, and these few were very hard to reach, unless you had the right contacts. For those with innovative ideas, procuring the funding necessary to create their new machine or product was next to impossible. The investment environment was, in other words, extraordinarily inefficient. The funds that were available systematically went to the wrong people because they were the relatives, friends, or friends of friends of those in power; or because they were politically shrewd; or because they were good at passing exams; or because they were good at killing more people than the next man, or perhaps the right people at the right time.