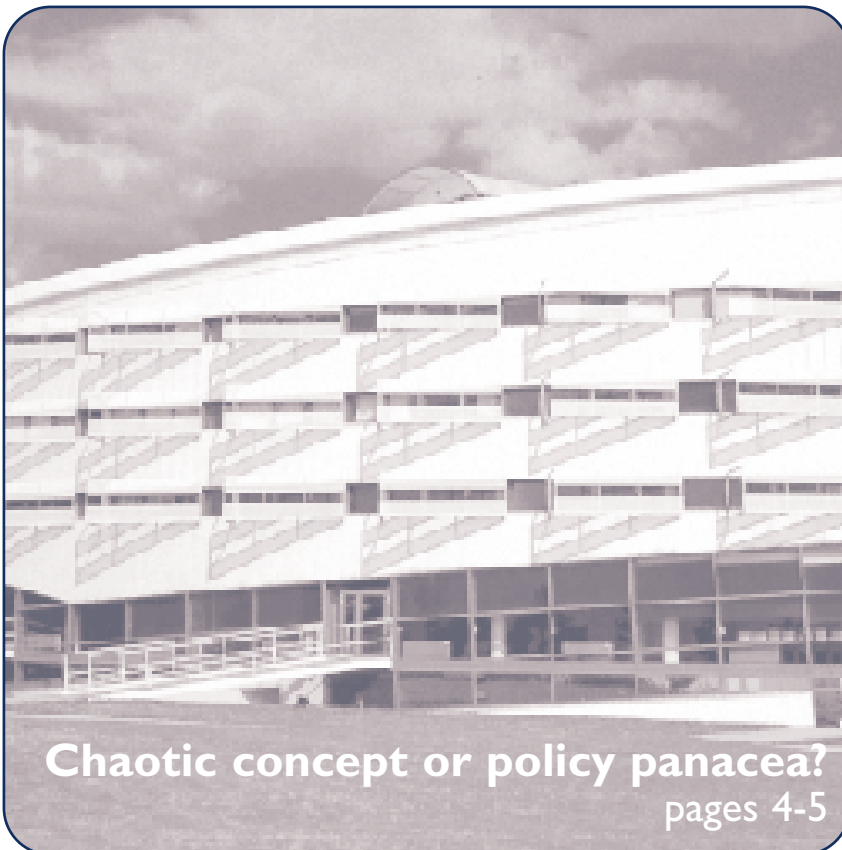


TOP FLOOR

News from the Centre for Business Research, University of Cambridge

Issue 5: Autumn 2002

Business clusters – are they all they're cracked up to be?



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CBR News



Putting small firms first

The Secretary of State for Trade and Industry, the Rt Hon Patricia Hewitt MP, visited Cambridge during the summer to speak at a conference jointly organised by the CBR and the Centre for Corporate and Commercial Law at the University.

Trade Secretary
Patricia Hewitt.

The conference was entitled: "Using Law to Promote Competitiveness and Enterprise: Will Corporate Law Reform Deliver?", and debated issues around the biggest review of company law in 150 years. In her speech, the Trade Secretary focused particularly on small companies, and why she felt company law needed to change in order to help them.

Describing small firms as "the engine of the economy, employing 12 million people in the UK", she went on to describe how bad company legislation can have a huge impact on small and medium-sized enterprises and the wider economy. "An unnecessary burden of £100 per company per year costs our business sector £150 million a year. So we need to look rigorously at regulation," she said, "and ensure we only keep that regulation which is vital to market confidence."

After her speech, she told Top Floor that it was absolutely right that the Company Law Review had taken small and growing business as its starting point. "If you are expecting them to fit into a framework of law designed for larger companies, you are imposing extra costs on them, and that is not as it should be.

She added, "I know that some entrepreneurs have been deterred from setting up a limited company – even though that would be the right thing to do for the business at the time – because of the complexity of the laws involved."

Editor's note

The year 2002 has been an 'annus horribilis' for corporate America. The collapse of Enron and WorldCom (amongst other companies) sparked an accompanying collapse in investor confidence - and subsequently a much closer scrutiny of corporate accounting standards and behaviour. How timely, then, that Palgrave Macmillan has just published "**Understanding How Issues in Business Ethics Develop**", edited by the CBR's own Ian Jones and Michael Pollitt, and previewed on page 3. Arising from their long-running CBR research into business ethics, the book's discussion – with contributions from a number of senior industrialists - of how issues including corporate governance and executive pay can suddenly develop, is highly topical.

It all shows that work ain't what it used to be. And that was also the theme of "Modernising Employment for the 21st Century", a conference held during the summer at TUC Congress Centre in London organised by the CBR and the Cambridge-MIT Institute.

The conference – which, to give it its full title, debated "Partnership at Work, the Work-Life Balance and Corporate Governance in America and Britain" – is a good example of the increasingly collaborative nature of the work in which the CBR gets involved. There was a wide range of research presented on the changing nature of work and the workforce. Speakers discussed ESRC-funded studies of the effects of recent changes to UK and EU laws on union recognition and employee representation, as well as research from the USA on new initiatives in partnership and work-family benefits.

And on page 6, we examine how law affects entrepreneurs, Prof. Simon Deakin – who leads the CBR's programme of research on corporate governance, contracts and incentives, and who was co-organiser of this event – writes about his views on partnership and investors. Prof. Deakin is conducting research in this area with Prof. Tom Kochan of the Massachusetts Institute of Technology (MIT).

And on page 7, John Monks, General Secretary of the Trades Union Congress, who came to open the conference, writes the guest article on Partnership and the benefits that can be harnessed when companies and their staff work in agreement rather than acrimony. Meanwhile, the trend for some firms to work closely together, in clusters, is put under the spotlight on pages 4 and 5. As ever, we welcome your feedback.

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Business ethics under the spotlight

By Rachel Simpson

Corporate governance, executive pay, child labour and the control of industrial pollution are issues that all companies must face. While the issues themselves have been widely debated, the process by which they develop is a much less discussed area. A key to being a sustainable company is the capacity to understand and predict how such issues develop...

So starts **"Understanding how Issues in Business Ethics Develop"**, a new book edited by Professor Ian Jones and Dr Michael Pollitt. Just published by Palgrave Macmillan, it arises from their long-running CBR project, an ESRC-funded study of "Ethics, Regulation and Globalisation" which seeks to further the understanding of how business ethics and related regulations are developing in an era of globalisation.

The book examines the development of a number of high profile issues, including the public outcries over GM foods and the use of child labour in Third World workforces. And it contains contributions from a number of people who have frontline experience of dealing with ethical business dilemmas.

One of them is Sir Mark Moody-Stuart, former chairman of Shell. He writes candidly about how the company undertook change after 1995, a year in which two major controversies erupted: the campaign by Greenpeace against Shell's decision to dispose of the disused Brent Spar oil storage platform in the North Sea, and the public uproar over the execution of environmental campaigner Ken Saro-Wiwa in Nigeria.

As Sir Mark makes clear, those two issues came as a surprise to a company which always considered that it had acted responsibly. "In each case", he says, "we felt we had done all the consultation and that we had understood the government positions, and then all of a sudden you are in deep trouble."

And it is the question of how such business ethics issues suddenly arise that the book studies. After all, as the editors point out, it is at first glance puzzling to see that while GM crops, the use of child labour, the control of industrial pollution and corporate bribery have turned into major issues, "other issues, such as tobacco advertising or defence sales by advanced-country companies to dubious Third World regimes, have not taken off in the same way, in spite of the best efforts of activists."

The editors, in their own research, suggest that unravelling the different strands in a campaign – identifying the key actors, and the stages in the development of an ethical issue – can help. They point out that there may be a very disparate group of actors involved in an ethics issue, from the business community to regulatory authorities to international organisations like Greenpeace or the OECD.

But it is events, they say, that have a crucial part to play in drawing attention to particular issues and precipitating action. For example, the spectacular failure of Robert Maxwell's business empire, along with Asil Nadir's Polly Peck, BCCI and Coloroll helped trigger a major review of corporate governance in the early 1990s, followed by significant changes to the way companies structure their boards, and their degree of reporting on issues of audit, remuneration and the process of the appointment of directors. (Ten years later, the wheel appears to have come full circle, with authorities bringing in rapid regulatory changes following the major corporate scandals in the US at companies like Enron and WorldCom.)

In a detailed analysis of the ensuing development of corporate governance in the UK, Jones and Pollitt discuss and identify the different stages of the debate process. First, there is awareness where a matter (like the collapse of a large company) becomes part of the public debate. Then there is



Sir Mark Moody-Stuart, (centre), with the editors Pollitt and Jones (2nd and 3rd from right) and contributors to the book.

the education stage where the issue can be considered in a professional and detailed way. The editors suggest that there are clear examples here in the work of the Cadbury Committee (and others) in looking beyond the immediate crisis, and analysing the responsibilities of executive and non-executive directors, the case for audit committees of the board, and the principal responsibilities of auditors, before developing solutions. Finally, they say, there is the implementation process, when selected strategies can be put into practice.

In the closing chapter of the book, Jones and Pollitt suggest that business has most to gain during the education phase "because it involves problem solving, which is a fundamental business skill". They point out that in the corporate governance debate, professional problem solving by the Cadbury Committee was effective in finding approaches to the problem that would be widely acceptable. But "not engaging the debate in a problem solving way may have cost Monsanto dear in the GM foods debate", they conclude.

"Understanding how Issues in Business Ethics Develop"

Edited by Ian Jones and Michael Pollitt, is published by Palgrave Macmillan. As a **LIMITED OFFER** and for a short time only, the CBR is offering a discount of **50% off the recommended price, and making it available for only £25 per copy, including postage and packing.**

To order your copy, send a cheque for **£25 to the Centre for Business Research** - please make cheques payable to the University of Cambridge. For further information please email: publications@cbr.cam.ac.uk Please note, supplies are limited.

Are business clusters really such a good thing?

It seems a strange question to ask in Cambridge - a formerly relatively poor agricultural region that is now 'Silicon Fen', thanks to a cluster of high-tech and biotech firms that has sprung up around the city and University of Cambridge, bringing significant wealth to the local economy.

Deconstructing Clusters

Everyone seems to love business clusters. Policy-makers everywhere from the OECD and the World Bank to national governments, regional development agencies, and city governments are seizing upon them as a tool for promoting competitiveness, innovation and growth.

But in a new Working Paper just published by the Centre for Business Research – entitled **Deconstructing Clusters: Chaotic Concept or Policy Panacea?** – two economic geographers urge a more cautious approach.

In their paper – which will also appear in the *Journal of Economic Geography* next year – Ron Martin from the University of Cambridge, and his colleague Peter Sunley from the University of Edinburgh, point out that there are many issues involved in embracing cluster theory so enthusiastically. These include the variety of definitions of a 'business cluster', which can mean anything from an area where businesses are located close together, to a network where firms are geographically much more widely spread. There is also rather mixed evidence to support claims for the benefit of business clusters.

"Seductive though the cluster concept is, there is much about it that is problematic," they warn, "and the rush to employ 'cluster ideas' has run ahead of many fundamental conceptual, theoretical and empirical questions. While we do not wish to debunk the cluster idea outright, we do argue for a much more cautious and circumspect use of the notion."

Clusters have costs as well as benefits

Claimed advantages	Potential disadvantages
Higher growth	Labour cost inflation
Higher productivity	Inflation of land and housing
Increased profitability	Widening of income disparities
Increased competitiveness	Over-specialisation
Higher new firm formation	Institutional lock-in
High job growth	Foreign take-over

Regional economies

'Cluster theory' – much promoted by business economist Michael Porter – has become popular for a variety of reasons. One is the view that in the era of globalisation, regional economies are actually becoming

more, not less, important. "It is alleged that increasing global economic integration itself leads to heightened regional and local specialisation, as falling transport costs and trade barriers allow firms to agglomerate with other similar firms in order to benefit from local external economies of scale", say Martin and Sunley.

Another factor is the increasing association between clusters and what is called the 'knowledge economy'. "A key argument here," the authors explain, "is that the processes driving the new 'knowledge-based economy' – technological know-how, innovation and information creation – appear to be most favourable precisely when such development is localised."

But, they point out, for all the apparent advantages, there can also be disadvantages to clusters. Martin and Sunley quote a DETR (2000) report on clusters which noted that the growth of industrial concentrations tightens the labour market, leads to increased congestion and puts pressure on the housing stock. It adds, "There is a real danger that the unplanned growth of a cluster may destroy the very features conducive to the development of the cluster in the first place'.

They argue that local and regional specialisation can also represent a risky strategy. "The risk of decline and profound instability in specialised regional economies is well known and its relevance has been underlined by the recent downturn in Silicon Valley," they say. "Economic landscapes are littered with local areas of industrial specialisation that were once prosperous and dynamic but have since gone into relative or even absolute decline."

So what should be done? The authors argue that "given these potential disadvantages, it would seem more advisable for local and regional authorities to concentrate on encouraging productivity improvements in *all* local firms, as well as improving their business environments, without committing to a cluster mind-set.

They add, "Just because there is an association between some high-growth industries and various forms of geographical concentration does not mean that this concentration is the main cause of their economic growth or relative success. The empirical case for clustering remains in its infancy," the authors say, "and repeatedly makes the mistake of jumping from particular associations to general causality."



Photograph courtesy of Mark Mniszko

← Cambridge – home to a high-tech business cluster (left)

Co-authors of the research, Ron Martin (right) and Peter Sunley (top) →



"Deconstructing Clusters: Chaotic Concept or Policy Panacea?"

CBR Working Paper No. 244, is available to download free online from the CBR website www.cbr.cam.ac.uk or can be purchased by mail from the CBR at a cost of £5 per copy, including postage.

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Another Working Paper published in September by the CBR is a study that takes us back 200 years in history to see what happened to banks in the 1820s after they became the first business sector in Great Britain and Ireland to be allowed to form freely on an unlimited liability joint stock basis.

In 'The Trading of Unlimited Liability Bank Shares: The Bagehot Hypothesis', the authors explain that these changes were severely criticised at the time of their introduction by the political economist Walter Bagehot. The crucial question was how to secure the banks' deposit liabilities. Because shareholders had unlimited liability, it was their personal wealth, in the final analysis, that supported the

bank. But unlimited liability also meant that poorer shareholders could free ride on the wealthier ones. As a result, Bagehot argued, wealthier shareholders would have every incentive to sell their shares, and these were likely to end up in the hands of widows, orphans and the impecunious, leaving the bank's deposits unsecured.

The authors of the paper, which was presented to a CBR seminar in the spring of 2002, test the Bagehot hypothesis by studying the archives of the Ulster Banking Company for the 1870s. They show that shares in the bank, contrary to Bagehot, continued to be owned by wealthy individuals over time. The bank's governing body operated a minimum wealth requirement for share ownership

which overcame the problem Bagehot identified. The paper is of considerable significance for understanding the origins of the modern business corporation, in which shareholders have *limited* liability. This means that shareholders' *individual* wealth no longer matters. Thus as limited liability became widespread at the turn of the twentieth century, it was no longer necessary for share ownership to be confined to a privileged few. Our modern shareholder democracy can be traced to this change.

For further information, please contact the authors by email: c.hickson@qub.ac.uk and j.turner@qub.ac.uk

The Partnership Agenda – An Issue for Investors

By Simon Deakin

As John Monks's article on the next page shows, a growing body of evidence suggests that companies can improve their performance by involving employees and their representatives in the way businesses are run. Thanks to changes in corporate governance practice and pensions law, this is becoming an issue for institutional investors too.

Over 70% of UK equities are held by institutions (mostly pension funds, insurance companies and mutual funds). Until recently, the typical reaction of fund managers to poor corporate performance would be to sell their shares in the company concerned. A falling share price is meant to put managers under pressure and might trigger a hostile takeover bid. However, hostile takeovers have proved to be a very expensive and haphazard way to rectify managerial failure. Target shareholders win in the short term but many mergers fail to produce efficiency gains. As a result, tracker funds holding shares across the market as a whole have come to realise that what they gain

on the swings (as shareholders in the target) they often lose on the roundabouts (as shareholders in the bidder).

This is one of the reasons for the rise of institutional shareholder activism, which requires the institutions to engage actively with management in an effort to improve corporate performance. Part of this agenda involves persuading managers that the best interests of the company lie in maintaining good relations with stakeholders and in meeting high standards of social and environmental responsibility.

In 2000 an amendment to UK pensions law came into effect, requiring institutional shareholders to state how far social, ethical and environmental considerations play a part in their investment strategies. The Myners report, published in 2001, would go further in requiring the institutions to treat the right to vote in company meetings as a fiduciary asset, to be deployed in the interests of their beneficiaries. These beneficiaries are



Simon Deakin

mostly employees whose savings are invested in the stock exchange through the medium of pension funds and insurance policies.

In modern stakeholder capitalism, us versus them has been replaced by us versus us – the ultimate owners of corporate enterprises are the very same employees whose cooperation is needed to make those enterprises successful. Thus the institutions have a pivotal role to play in spreading good practice by managers in the matter of employee relations.

*This article is a summary of a longer paper which will appear as: 'Squaring the Circle? Shareholder Value and Corporate Social Responsibility in the UK' in the *George Washington Law Review*, vol. 70, 2002.



John Armour

Many venture capitalists have argued that we need to change UK laws and attitudes to business failure by entrepreneurs. In the United States, for an entrepreneur to fail in his first or second venture is often seen not as a mistake, but as a valuable part of the learning process. In the UK, where insolvency law is stricter than in the US, it is not.

This difference in law and attitudes interests CBR Senior Research Fellow

How law affects entrepreneurs

John Armour, whose Working Paper on "Law, Innovation and Finance" has just been published by the CBR. In it, Armour notes evidence suggesting demand for venture capital finance is lower in the UK than in the US because of the more liberal insolvency laws there.

However, this situation is changing. Armour writes: "The UK's Enterprise Bill 2002 contains a number of features designed to reduce the harshness of personal insolvency for individuals who have become bankrupt simply because of bad luck, as opposed to irresponsible risk taking on their part. Under the new legislation, the time to automatic

discharge will be reduced, unless fraud is shown. Furthermore, the legal disabilities associated with the status of an undischarged bankrupt will be scrapped, as a bid to send a signal to society that bankruptcy should carry less stigma."

Armour notes that that the European Commission is also debating the "softening of bankruptcy laws, to allow failed entrepreneurs a second chance". So it is ironic then, as he points out, that "proposed reforms in the US will move personal bankruptcy law in the opposite direction... which may have the effect of making entrepreneurship less attractive at the margins."



John Monks, General Secretary of the Trades Union Congress.

Working in Partnership

John Monks takes the floor.

The TUC has long argued for a mutual gains agenda for industrial relations. We believe that partnership is a natural way for the two sides of industry to relate to each other – every bit as natural as conflict.

In this article I want to expand on that position to argue that the partnership approach to industrial relations is most likely to succeed when unions are strong and independent. Contrary to the arguments you find at both ends of the spectrum, sweetheart deals and weak unions are bad news for employers, as well as workers.

For a long time commentators have debated whether work organisation reforms can improve business performance. Evidence to support this claim is now emerging, (for instance, Cully et al or Sisson et al) and measures to promote an atmosphere of trust and employee participation in decision-making seem to be essential.

Employee participation offers important advantages:

- It provides an early-warning system when problems are approaching.
- It reassures employees that their interests have been taken into account fairly.
- This feeds through to a greater staff commitment to company plans and policies, and hence to less need for supervision.
- This in turn frees managers from having to attend to minor problems, so they can deal more expertly with serious and strategic issues.

Some employers can be persuaded by this argument, but still don't want

to work with unions. The notion has therefore developed that there is a tension between the direct involvement of workers as individuals, and indirect participation, involving employees' representatives. Some organisations have then concentrated on direct participation, believing that it does away with the need for a union.

The difficulty with this approach is that it can only take you so far: Building an atmosphere of trust partly depends on sharing information, but support for decisions usually also demands an understanding of important business judgements.

These can be difficult to explain, and the information underlying these judgements can often be abstract, complex and dense. Understanding vital decisions often requires sophisticated understanding and expertise – that, after all, is one reason why the people who make these decisions are highly valued within the business.

Sharing this information and the reasoning around it with each individual employee may simply not be appropriate. What is more, important decisions are usually hard to understand without access to commercially sensitive information, and senior managers can have reasonable concerns about letting everyone know their plans. But many of these decisions are precisely those that cry out for employee involvement.

The obvious solution is to work with employees' representatives. And the evidence is that this works. Alex Bryson's analysis of the British Social Attitudes Survey, for instance, found that *strong* unions are the key. Where unions were strong, effective and supported by management, trust in the firm's managers was at least as high as in non-unionised workplaces. But it was much lower where the union was weak.

Work organisation reforms to promote trust and employee involvement are increasingly seen as key features of high performance workplaces. But their full effects depend on combining direct and indirect participation. Companies that try to get round this and do without unions will never get the most out of their investment in these reforms.

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John Monks will be a Distinguished Panellist at the annual meeting of the US Industrial Relations Research Association, in January. At the event, the Partnership research being jointly conducted at the CBR and at the Massachusetts Institute of Technology, with the support of the Cambridge-MIT Institute, will be presented by Prof. Deakin and his CBR colleague Suzanne Konzelmann, and Prof. Tom Kochan from MIT.

A space will be open in every issue for a guest contributor to air their views. The editor welcomes submissions.



Hail and farewell

Congratulations to CBR Senior Research Fellow Lilach Nachum who has recently been appointed Assistant Professor of International Business at Baruch College, City University of New York. An expert on foreign direct investment and international competitiveness, during her time at the CBR, Lilach worked on numerous projects. These included, most recently, a study of the International Competitiveness of the UK and its Multinational Corporations. It was as part of this that she published her work on the City of London and the impact of the growing foreign ownership of financial services firms there, which was featured in a previous issue of Top Floor.



Globalisation and finance

CBR project researcher Amanda Dickins spoke on the policy challenges of developing local capital markets in emerging economies at the Cambridge Seminar on Financial Regulation in September. Sponsored by the Ford and Rockefeller Foundations, the seminar brought together senior regulators from South East Asia to discuss the role played by financial regulation, and the theory and practice of prudential regulation in an international context. Amanda, who works on governance issues in international finance and is affiliated with the Cambridge Endowment for Research in Finance explored the challenges posed by regulatory convergence and technological developments and, in particular, the challenge that increased use of international listings poses for the maintenance of liquidity in local stock exchanges. In her talk – "Financial Systems and Growth: The Impact of Globalisation and the Role of the State" - she argued that improvements in regulation are of key importance for the development of capital markets in emerging economies and that, once these were in place, Euronext's multi-jurisdictional regulatory framework would be a fruitful model for East Asian markets responding to the challenge of maintaining liquidity in the context of globalisation. Amanda spoke alongside other researchers from the CBR who are currently working together on the International Financial Regulation project.



International enterprise

The international impact of CBR work on small businesses and entrepreneurship continues to increase. In September, CBR Director Alan Hughes visited Shanghai at the invitation of Shanghai Jiao Tong University and the Zhang Jiang Hi-Tech Park. He held a full day seminar on *Enterprise Innovation and the Growth of Small Firms*, and along with Cambridge colleagues, Professors Andy Hopper, Peter Guthrie, Sir Tom Blundell, Sir Gabriel Horn and Alan Windle, gave a public lecture on *High-Tech Firms and Industrial Policy* to over 1200 students at the Jiao Tong University Campus.



Gold medal

Many congratulations to Dr David Keeble, who this summer was awarded the Royal Geographical Society's Patron's Medal 2002 "for advancing knowledge in economic and industrial geography". David helped found the CBR, and until his recent retirement, ran the CBR's programme of research on small and medium-sized enterprises. We are proud to note that he is the second geographer associated with the CBR to be honoured in this way, as in 1998 another of the RGS's Gold Medals – the Founder's Medal – went to our colleague, Professor Bob Bennett, who has directed a number of CBR research projects.

CBR work judged 'of international excellence'



The Centre for Business Research received a very important compliment on the quality of its work earlier this year, when it underwent a major international peer groups' evaluation by its main sponsors, the Economic and Social Research Council (ESRC). The ESRC provides the CBR's core funding, and has supported it so far for two, five-year terms of research. In the evaluation earlier this year, after a detailed scrutiny of our increasingly collaborative work, the CBR was judged to be making a major contribution to interdisciplinary research with work of international excellence in corporate governance, innovation and the analysis of small and medium-sized firms. The review panel concluded by recommending that the CBR should bid for an exceptional third term of core funding from the ESRC – a tremendous tribute to the work that has been carried out here for the last seven years.