The Essential Drucker

BOOKS BY PETER F. DRUCKER
MANAGEMENT

The Essential Drucker

Management Challenges for the 21st Century

Peter Drucker on the Profession of Management

Managing in a Time of Great Change

Managing for the Future

Managing the Non-Profit Organization

The Frontiers of Management

Innovation and Entrepreneurship

The Changing World of the Executive

Managing in Turbulent Times

Management: Tasks, Responsibilities, Practices

Technology, Management and Society

The Effective Executive

Managing for Results

The Practice of Management

Concept of the Corporation

ECONOMICS, POLITICS, SOCIETY

Post-Capitalist Society

Drucker on Asia

The Ecological Revolution

The New Realities

Toward the Next Economics

The Pension Fund Revolution

Men, Ideas, and Politics

The Age of Discontinuity

Landmarks of Tomorrow

America’s Next Twenty Years

The New Society

The Future of Industrial Man

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Mobipocket Reader edition v 1. May 2001 ISBN: 0-0607-7132-1

Print edition first published in 2001 by HarperCollins Publishers, Inc.

10 9 8 7 6 5 4 3 2 1

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INTRODUCTION:
THE ORIGIN AND PURPOSE OF
THE ESSENTIAL DRUCKER

The Essential Drucker is a selection from my sixty years of work and writing on management. It begins with my book The Future of Industrial Man (1942) and ends (so far at least) with my 1999 book Management Challenges for the 21st Century.

The Essential Drucker has two purposes. First, it offers, I hope, a coherent and fairly comprehensive Introduction to Management. But second, it gives an Overview of my works on management and thus answers a question that my editors and I have been asked again and again, Where do I start to read Drucker? Which of his writings are essential?

Atsuo Ueda, longtime Japanese friend, first conceived The Essential Drucker. He himself has had a distinguished career in Japanese management. And having reached the age of sixty, he recently started a second career and became the founder and chief executive officer of a new technical university in Tokyo. But for thirty years Mr. Ueda has also been my Japanese translator and editor. He has actually translated many of my books several times as they went into new Japanese editions. He is thus thoroughly familiar with my work—in fact, he knows it better than I do. As a result he increasingly got invited to conduct Japanese conferences and seminars on my work and found himself being asked over and over again—especially by younger people, both students and executives at the start of their careers—Where do I start reading Drucker?

This led Mr. Ueda to reread my entire work, to select from it the most pertinent chapters and to abridge them so that they read as if they had originally been written as one cohesive text. The result was a three-volume essential Drucker of fifty-seven chapters—one volume on the management of organizations; one volume on the individual in the society of organizations; one on society in general—which was published in Japan in the summer and fall of 2000 and has met with great success. It is also being published in Taiwan, mainland China and Korea, and in Argentina, Mexico, and Brazil.

It is Mr. Ueda's text that is being used for the U.S. and U.K. editions of The Essential Drucker. But these editions not only are less than half the size of Mr. Ueda's original Japanese version—twenty-six chapters versus the three-volumes' fifty-seven. They also have a somewhat different focus. Cass Canfield Jr. at HarperCollins in the United States—longtime friend and my U.S. editor for over thirty years—also came to the conclusion a few years ago that there was need for an introduction to, and overview of, my sixty years of management writings. But he—rightly—saw that the U.S. and U.K. (and probably altogether the Western) audience for such a work would be both broader and narrower than the audience for the Japanese venture. It would be broader because there is in the West a growing number of people who, while not themselves executives, have come to see management as an area of public interest; there are also an increasing number of students in colleges and universities who, while not necessarily management students, see an understanding of management as part of a general education; and, finally, there are a large and rapidly growing number of mid-career managers and professionals who are flocking to advanced-executive programs, both in universities and in their employing organizations. The focus would, however, also be narrower because these additional audiences need and want less an introduction to, and overview of, Drucker's work than they want a concise, comprehensive, and sharply focused Introduction to Management, and to management alone. And thus, while using Mr. Ueda's editing and abridging, Cass Canfield Jr. (with my full, indeed my enthusiastic, support) selected and edited the texts from the Japanese three-volume edition into a comprehensive, cohesive, and self-contained introduction to management—both of the management of an enterprise and of the self-management of the individual, whether executive or professional, within an enterprise and altogether in our society of managed organizations.

My readers as well as I owe to both Atsuo Ueda and Cass Canfield Jr. an enormous debt of gratitude. The two put an incredible amount of work and dedication into The Essential Drucker. And the end product is not only the best introduction to one's work any author could possibly have asked for. It is also, I am convinced, a truly unique, cohesive, and self-contained introduction to management, its basic principles and concerns; its problems, challenges, opportunities.

This volume, as said before, is also an overview of my works on management. Readers may therefore want to know where to go in my books to further pursue this or that topic or this or that area of particular interest to them. Here, therefore, are the sources in my books for each of twenty-six chapters of the The Essential Drucker:

Chapter 1 and 26 are excerpted from The New Realities (1988).

Chapters 2, 3, 5, 18 are excerpted from Management, Tasks, Responsibilities, Practices (1974).

Chapters 4 and 19 are excerpted from Managing for the Future (1992), and were first published in the Harvard Business Review (1989) and in the Wall Street Journal (1988), respectively.

Chapters 6, 15, and 21 are excerpted from Management Challenges for the 21st Century (1999).

Chapters 7 and 23 are excerpted from Management in a Time of Great Change (1995) and were first published in the Harvard Business Review (1994) and in the Atlantic Monthly (1996), respectively.

Chapter 8 was excerpted from The Practice of Management (1954).

Chapter 9 was excerpted from The Frontiers of Management (1986) and was first published in the Harvard Business Review (1985).

Chapters 10, 11, 12, 20, 24 were excerpted from Innovation and Entrepreneurship (1985).

Chapters 13, 14, 16, 17 were excerpted from The Effective Executive (1966).

Chapters 22 and 25 were excerpted from Post-Capitalist Society (1993).

All these books are still in print in the United States and in many other countries.

This one-volume edition of The Essential Drucker does not, however, include any excerpts from five important Management books of mine: The Future of Industrial Man (1942); Concept of the Corporation (1946); Managing for Results (1964; the first book on what is now called “strategy,” a term unknown for business forty years ago); Managing in Turbulent Times (1980); Managing the Non-Profit Organization (1990). These are important books and still widely read and used. But their subject matter is more specialized—and in some cases also more technical—than that of the books from which the chapters of the present book were chosen—and thus had to be left out of a work that calls itself Essential.

—Peter F. Drucker

Claremont, California

Spring 2001

I.

MANAGEMENT

1.

MANAGEMENT AS SOCIAL FUNCTION AND LIBERAL ART

When Karl Marx was beginning work on Das Kapital in the 1850s, the phenomenon of management was unknown. So were the enterprises that managers run. The largest manufacturing company around was a Manchester cotton mill employing fewer than three hundred people and owned by Marx’s friend and collaborator Friedrich Engels. And in Engels’s mill—one of the most profitable businesses of its day—there were no “managers,” only “charge hands” who, themselves workers, enforced discipline over a handful of fellow “proletarians.”

Rarely in human history has any institution emerged as quickly as management or had as great an impact so fast. In less than 150 years, management has transformed the social and economic fabric of the world’s developed countries. It has created a global economy and set new rules for countries that would participate in that economy as equals. And it has itself been transformed. Few executives are aware of the tremendous impact management has had. Indeed, a good many are like M. Jourdain, the character in Molière’s Bourgeois Gentilhomme, who did not know that he spoke prose. They barely realize that they practice—or mispractice—management. As a result, they are ill prepared for the tremendous challenges that now confront them. The truly important problems managers face do not come from technology or politics; they do not originate outside of management and enterprise. They are problems caused by the very success of management itself.

To be sure, the fundamental task of management remains the same: to make people capable of joint performance through common goals, common values, the right structure, and the training and development they need to perform and to respond to change. But the very meaning of this task has changed, if only because the performance of management has converted the workforce from one composed largely of unskilled laborers to one of highly educated knowledge workers.

The Origins and Development of Management

On the threshold of World War I, a few thinkers were just becoming aware of management’s existence. But few people even in the most advanced countries had anything to do with it. Now the largest single group in the labor force, more than one-third of the total, are people whom the U.S. Bureau of the Census calls “managerial and professional.” Management has been the main agent of this transformation. Management explains why, for the first time in human history, we can employ large numbers of knowledgeable, skilled people in productive work. No earlier society could do this. Indeed, no earlier society could support more than a handful of such people. Until quite recently, no one knew how to put people with different skills and knowledge together to achieve common goals.

Eighteenth-century China was the envy of contemporary Western intellectuals because it supplied more jobs for educated people than all of Europe did—some twenty thousand per year. Today, the United States, with about the same population China then had, graduates nearly a million college students a year, few of whom have the slightest difficulty finding well-paid employment. Management enables us to employ them.

Knowledge, especially advanced knowledge, is always specialized. By itself it produces nothing. Yet a modern business, and not only the largest ones, may employ up to ten thousand highly knowledgeable people who represent up to sixty different knowledge areas. Engineers of all sorts, designers, marketing experts, economists, statisticians, psychologists, planners, accountants, human-resources people—all working together in a joint venture. None would be effective without the managed enterprise.

There is no point in asking which came first, the educational explosion of the last one hundred years or the management that put this knowledge to productive use. Modern management and modern enterprise could not exist without the knowledge base that developed societies have built. But equally, it is management, and management alone, that makes effective all this knowledge and these knowledgeable people. The emergence of management has converted knowledge from social ornament and luxury into the true capital of any economy.

Not many business leaders could have predicted this development back in 1870, when large enterprises were first beginning to take shape. The reason was not so much lack of foresight as lack of precedent. At that time, the only large permanent organization around was the army. Not surprisingly, therefore, its command-and-control structure became the model for the men who were putting together transcontinental railroads, steel mills, modern banks, and department stores. The command model, with a very few at the top giving orders and a great many at the bottom obeying them, remained the norm for nearly one hundred years. But it was never as static as its longevity might suggest. On the contrary, it began to change almost at once, as specialized knowledge of all sorts poured into enterprise.

The first university-trained engineer in manufacturing industry was hired by Siemens in Germany in 1867—his name was Friedrich von Hefner-Alteneck. Within five years he had built a research department. Other specialized departments followed suit. By World War I the standard functions of a manufacturer had been developed: research and engineering, manufacturing, sales, finance and accounting, and a little later, human resources (or personnel).

Even more important for its impact on enterprise—and on the world economy in general—was another management-directed development that took place at this time. That was the application of management to manual work in the form of training. The child of wartime necessity, training has propelled the transformation of the world economy in the last forty years because it allows low-wage countries to do something that traditional economic theory had said could never be done: to become efficient—and yet still low-wage—competitors almost overnight.

Adam Smith reported that it took several hundred years for a country or region to develop a tradition of labor and the expertise in manual and managerial skills needed to produce and market a given product, whether cotton textiles or violins.

During World War I, however, large numbers of unskilled, preindustrial people had to be made productive workers in practically no time. To meet this need, businesses in the United States and the United Kingdom began to apply the theory of scientific management developed by Frederick W. Taylor between 1885 and 1910 to the systematic training of blue-collar workers on a large scale. They analyzed tasks and broke them down into individual, unskilled operations that could then be learned quite quickly. Further developed in World War II, training was then picked up by the Japanese and, twenty years later, by the South Koreans, who made it the basis for their countries' phenomenal development.

During the 1920s and 1930s, management was applied to many more areas and aspects of the manufacturing business. Decentralization, for instance, arose to combine the advantages of bigness and the advantages of smallness within one enterprise. Accounting went from “bookkeeping” to analysis and control. Planning grew out of the “Gantt charts” designed in 1917 and 1918 to plan war production; and so did the use of analytical logic and statistics, which employ quantification to convert experience and intuition into definitions, information, and diagnosis. Marketing evolved as a result of applying management concepts to distribution and selling. Moreover, as early as the mid-1920s and early 1930s, some American management pioneers such as Thomas Watson Sr. at the fledgling IBM; Robert E. Wood at Sears, Roebuck; and George Elton Mayo at the Harvard Business School began to question the way manufacturing was organized. They concluded that the assembly line was a short-term compromise. Despite its tremendous productivity, it was poor economics because of its inflexibility, poor use of human resources, even poor engineering. They began the thinking and experimenting that eventually led to “automation” as the way to organize the manufacturing process, and to teamwork, quality circles, and the information-based organization as the way to manage human resources. Every one of these managerial innovations represented the application of knowledge to work, the substitution of system and information for guesswork, brawn, and toil. Every one, to use Frederick Taylor’s term, replaced “working harder” with “working smarter.”

The powerful effect of these changes became apparent during World War II. To the very end, the Germans were by far the better strategists. Having much shorter interior lines, they needed fewer support troops and could match their opponents in combat strength. Yet the Allies won—their victory achieved by management. The United States, with one-fifth the population of all the other belligerents combined, had almost as many men in uniform. Yet it produced more war materiél than all the others taken together. It managed to transport the stuff to fighting fronts as far apart as China, Russia, India, Africa, and Western Europe. No wonder, then, that by the war’s end almost all the world had become management-conscious. Or that management emerged as a recognizably distinct kind of work, one that could be studied and developed into a discipline—as happened in each country that has enjoyed economic leadership during the postwar period.

After World War II we began to see that management is not exclusively business management. It pertains to every human effort that brings together in one organization people of diverse knowledge and skills. It needs to be applied to all third-sector institutions, such as hospitals, universities, churches, arts organizations, and social service agencies, which since World War II have grown faster in the United States than either business or government. For even though the need to manage volunteers or raise funds may differentiate nonprofit managers from their for-profit peers, many more of their responsibilities are the same—among them defining the right strategy and goals, developing people, measuring performance, and marketing the organization’s services. Management worldwide has become the new social function.

Management and Entrepreneurship

One important advance in the discipline and practice of management is that both now embrace entrepreneurship and innovation. A sham fight these days pits “management” against “entrepreneurship” as adversaries, if not as mutually exclusive. That’s like saying that the fingering hand and the bow hand of the violinist are “adversaries” or “mutually exclusive.” Both are always needed and at the same time. And both have to be coordinated and work together. Any existing organization, whether a business, a church, a labor union, or a hospital, goes down fast if it does not innovate. Conversely, any new organization, whether a business, a church, a labor union, or a hospital, collapses if it does not manage. Not to innovate is the single largest reason for the decline of existing organizations. Not to know how to manage is the single largest reason for the failure of new ventures.

Yet few management books have paid attention to entrepreneurship and innovation. One reason is that during the period after World War II when most of those books were written, managing the existing rather than innovating the new and different was the dominant task. During this period most institutions developed along lines laid down thirty or fifty years earlier. This has now changed dramatically. We have again entered an era of innovation, and it is by no means confined to “high-tech” or to technology generally. In fact, social innovation—as this chapter tries to make clear—may be of greater importance and have much greater impact than any scientific or technical invention. Furthermore, we now have a “discipline” of entrepreneurship and innovation (see my Innovation and Entrepreneurship, 1986). It is clearly a part of management and rests, indeed, on well-known and tested management principles. It applies to both existing organizations and new ventures, and to both business and nonbusiness institutions, including government.

The Accountability of Management

Management books tend to focus on the function of management inside its organization. Few yet accept it as a social function. But it is precisely because management has become so pervasive as a social function that it faces its most serious challenge. To whom is management accountable? And for what? On what does management base its power? What gives it legitimacy?

These are not business questions or economic questions. They are political questions. Yet they underlie the most serious assault on management in its history—a far more serious assault than any mounted by Marxists or labor unions: the hostile takeover. An American phenomenon at first, it has spread throughout the non-Communist developed world. What made it possible was the emergence of the employee pension funds as the controlling shareholders of publicly owned companies. The pension funds, while legally “owners,” are economically “investors”—and, indeed, often “speculators.” They have no interest in the enterprise and its welfare. In fact, in the United States at least they are “trustees,” and are not supposed to consider anything but immediate pecuniary gain. What underlies the takeover bid is the postulate that the enterprise’s sole function is to provide the largest possible immediate gain to the shareholder. In the absence of any other justification for management and enterprise, the “raider” with his hostile takeover bid prevails—and only too often immediately dismantles or loots the going concern, sacrificing long-range, wealth-producing capacity to short-term gains.

Management—and not only in the business enterprise—has to be accountable for performance. But how is performance to be defined? How is it to be measured? How is it to be enforced? And to whom should management be accountable? That these questions can be asked is in itself a measure of the success and importance of management. That they need to be asked is, however, also an indictment of managers. They have not yet faced up to the fact that they represent power—and power has to be accountable, has to be legitimate. They have not yet faced up to the fact that they matter.

What Is Management?

But what is management? Is it a bag of techniques and tricks? A bundle of analytical tools like those taught in business schools? These are important, to be sure, just as thermometer and anatomy are important to the physician. But the evolution and history of management—its successes as well as its problems—teach that management is, above all else, based on a very few, essential principles. To be specific:

Management is about human beings. Its task is to make people capable of joint performance, to make their strengths effective and their weaknesses irrelevant. This is what organization is all about, and it is the reason that management is the critical, determining factor. These days, practically all of us work for a managed institution, large or small, business or nonbusiness. We depend on management for our livelihoods. And our ability to contribute to society also depends as much on the management of the organization for which we work as it does on our own skills, dedication, and effort.

Because management deals with the integration of people in a common venture, it is deeply embedded in culture. What managers do in West Germany, in the United Kingdom, in the United States, in Japan, or in Brazil is exactly the same. How they do it may be quite different. Thus one of the basic challenges managers in a developing country face is to find and identify those parts of their own tradition, history, and culture that can be used as management building blocks. The difference between Japan’s economic success and India’s relative backwardness is largely explained by the fact that Japanese managers were able to plant imported management concepts in their own cultural soil and make them grow.

Every enterprise requires commitment to common goals and shared values. Without such commitment there is no enterprise; there is only a mob. The enterprise must have simple, clear, and unifying objectives. The mission of the organization has to be clear enough and big enough to provide common vision. The goals that embody it have to be clear, public, and constantly reaffirmed. Management’s first job is to think through, set, and exemplify those objectives, values, and goals.

Management must also enable the enterprise and each of its members to grow and develop as needs and opportunities change. Every enterprise is a learning and teaching institution. Training and development must be built into it on all levels—training and development that never stop.

Every enterprise is composed of people with different skills and knowledge doing many different kinds of work. It must be built on communication and on individual responsibility. All members need to think through what they aim to accomplish—and make sure that their associates know and understand that aim. All have to think through what they owe to others—and make sure that others understand. All have to think through what they in turn need from others—and make sure that others know what is expected of them.

Neither the quantity of output nor the “bottom line” is by itself an adequate measure of the performance of management and enterprise. Market standing, innovation, productivity, development of people, quality, financial results—all are crucial to an organization’s performance and to its survival. Nonprofit institutions too need measurements in a number of areas specific to their mission. Just as a human being needs a diversity of measures to assess his or her health and performance, an organization needs a diversity of measures to assess its health and performance. Performance has to be built into the enterprise and its management; it has to be measured—or at least judged—and it has to be continually improved.

Finally, the single most important thing to remember about any enterprise is that results exist only on the outside. The result of a business is a satisfied customer. The result of a hospital is a healed patient. The result of a school is a student who has learned something and puts it to work ten years later. Inside an enterprise, there are only costs.

Managers who understand these principles and function in their light will be achieving, accomplished managers.

Management as a Liberal Art

Thirty years ago the English scientist and novelist C. P. Snow talked of the “two cultures” of contemporary society. Management, however, fits neither Snow’s “humanist” nor his “scientist.” It deals with action and application; and its test is results. This makes it a technology. But management also deals with people, their values, their growth and development—and this makes it a humanity. So does its concern with, and impact on, social structure and the community. Indeed, as everyone has learned who, like this author, has been working with managers of all kinds of institutions for long years, management is deeply involved in moral concerns—the nature of man, good and evil.

Management is thus what tradition used to call a liberal art—“liberal” because it deals with the fundamentals of knowledge, self-knowledge, wisdom, and leadership; “art” because it is also concerned with practice and application. Managers draw on all the knowledges and insights of the humanities and the social sciences—on psychology and philosophy, on economics and history, on ethics—as well as on the physical sciences. But they have to focus this knowledge on effectiveness and results—on healing a sick patient, teaching a student, building a bridge, designing and selling a “user-friendly” software program.

For these reasons, management will increasingly be the discipline and the practice through which the “humanities” will again acquire recognition, impact, and relevance.

2. THE DIMENSIONS OF MANAGEMENT

Business enterprises—and public-service institutions as well—are organs of society. They do not exist for their own sake, but to fulfill a specific social purpose and to satisfy a specific need of a society, a community, or individuals. They are not ends in themselves, but means. The right question to ask in respect to them is not, What are they? but, What are they supposed to be doing and what are their tasks?

Management, in turn, is the organ of the institution.

The question, What is management? comes second. First we have to define management in and through its tasks.

There are three tasks, equally important but essentially different, that management has to perform to enable the institution in its charge to function and to make its contribution.

Establishing the specific purpose and mission of the institution, whether business enterprise, hospital, or university
Making work productive and the worker effective
Managing social impacts and social responsibilities

Mission

An institution exists for a specific purpose and mission; it has a specific social function. In the business enterprise, this means economic performance.

With respect to this first task, the task of economic performance, business and nonbusiness institutions differ. In respect to every other task, they are similar. But only business has economic performance as its specific mission; it is the definition of a business that it exists for the sake of economic performance. In all other institutions—hospital, church, university, or armed services—economic considerations are a restraint. In business enterprise, economic performance is the rationale and purpose.

Business management must always, in every decision and action, put economic performance first. It can justify its existence and its authority only by the economic results it produces. A business management has failed if it does not produce economic results. It has failed if it does not supply goods and services desired by the consumer at a price the consumer is willing to pay. It has failed if it does not improve, or at least maintain, the wealth-producing capacity of the economic resources entrusted to it. And this, whatever the economic or political structure or ideology of a society, means responsibility for profitability.

Worker Achievement

The second task of management is to make work productive and the worker effective. A business enterprise (or any other institution) has only one true resource: people. It succeeds by making human resources productive. It accomplishes its goals through work. To make work productive is, therefore, an essential function. But at the same time, these institutions in today's society are increasingly the means through which individual human beings find their livelihood, find their access to social status, to community and to individual achievement and satisfaction. To make the worker productive is, therefore, more and more important and is a measure of the performance of an institution. It is increasingly a task of management.

Organizing work according to its own logic is only the first step. The second and far more difficult one is making work suitable for human beings—and their logic is radically different from the logic of work. Making the worker achieving implies consideration of the human being as an organism having peculiar physiological and psychological properties, abilities, and limitations, and a distinct mode of action.

Social Responsibilities

The third task of management is managing the social impacts and the social responsibilities of the enterprise. None of our institutions exists by itself and is an end in itself. Every one is an organ of society and exists for the sake of society. Business is no exception. Free enterprise cannot be justified as being good for business; it can be justified only as being good for society.

Business exists to supply goods and services to customers, rather than to supply jobs to workers and managers, or even dividends to stockholders. The hospital does not exist for the sake of doctors and nurses, but for the sake of patients whose one and only desire is to leave the hospital cured and never come back. Psychologically, geographically, culturally, and socially, institutions must be part of the community.

To discharge its job, to produce economic goods and services, the business enterprise has to have impact on people, on communities, and on society. It has to have power and authority over people, e.g., employees, whose own ends and purposes are not defined by and within the enterprise. It has to have impact on the community as a neighbor, as the source of jobs and tax revenue (but also of waste products and pollutants). And, increasingly, in our pluralist society of organizations, it has to add to its fundamental concern for the quantities of life—i.e., economic goods and services—concern for the quality of life, that is, for the physical, human, and social environment of modern man and modern community.

3. THE PURPOSE AND OBJECTIVES OF A BUSINESS

Asked what a business is, the typical businessman is likely to answer, “An organization to make a profit.” The typical economist is likely to give the same answer. This answer is not only false, it is irrelevant.

The prevailing economic theory of the mission of business enterprise and behavior, the maximization of profit—which is simply a complicated way of phrasing the old saw of buying cheap and selling dear—may adequately explain how Richard Sears operated. But it cannot explain how Sears, Roebuck or any other business enterprise operates, or how it should operate. The concept of profit maximization is, in fact, meaningless. The danger in the concept of profit maximization is that it makes profitability appear a myth.

Profit and profitability are, however, crucial—for society even more than for the individual business. Yet profitability is not the purpose of, but a limiting factor on business enterprise and business activity. Profit is not the explanation, cause, or rationale of business behavior and business decisions, but rather the test of their validity. If archangels instead of businessmen sat in directors' chairs, they would still have to be concerned with profitability, despite their total lack of personal interest in making profits.

The root of the confusion is the mistaken belief that the motive of a person—the so-called profit motive of the businessman—is an explanation of his behavior or his guide to right action. Whether there is such a thing as a profit motive at all is highly doubtful. The idea was invented by the classical economists to explain the economic reality that their theory of static equilibrium could not explain. There has never been any evidence for the existence of the profit motive, and we have long since found the true explanation of the phenomena of economic change and growth which the profit motive was first put forth to explain.

It is irrelevant for an understanding of business behavior, profit, and profitability, whether there is a profit motive or not. That Jim Smith is in business to make a profit concerns only him and the Recording Angel. It does not tell us what Jim Smith does and how he performs. We do not learn anything about the work of a prospector hunting for uranium in the Nevada desert by being told that he is trying to make his fortune. We do not learn anything about the work of a heart specialist by being told that he is trying to make a livelihood, or even that he is trying to benefit humanity. The profit motive and its offspring maximization of profits are just as irrelevant to the function of a business, the purpose of a business, and the job of managing a business.

In fact, the concept is worse than irrelevant: it does harm. It is a major cause of the misunderstanding of the nature of profit in our society and of the deep-seated hostility to profit, which are among the most dangerous diseases of an industrial society. It is largely responsible for the worst mistakes of public policy—in this country as well as in Western Europe—which are squarely based on the failure to understand the nature, function, and purpose of business enterprise. And it is in large part responsible for the prevailing belief that there is an inherent contradiction between profit and a company's ability to make a social contribution. Actually, a company can make a social contribution only if it is highly profitable.

To know what a business is, we have to start with its purpose. Its purpose must lie outside of the business itself. In fact, it must lie in society since business enterprise is an organ of society. There is only one valid definition of business purpose: to create a customer.

Markets are not created by God, nature, or economic forces but by businesspeople. The want a business satisfies may have been felt by the customer before he or she was offered the means of satisfying it. Like food in a famine, it may have dominated the customer's life and filled all his waking moments, but it remained a potential want until the action of businesspeople converted it into effective demand. Only then is there a customer and a market. The want may have been unfelt by the potential customer; no one knew that he wanted a Xerox machine or a computer until these became available. There may have been no want at all until business action created it—by innovation, by credit, by advertising, or by salesmanship. In every case, it is business action that creates the customer.

It is the customer who determines what a business is. It is the customer alone whose willingness to pay for a good or for a service converts economic resources into wealth, things into goods. What the customer buys and considers value is never just a product. It is always a utility, that is, what a product or service does for him.

The Purpose of a Business

Because its purpose is to create a customer, the business enterprise has two—and only these two—basic functions: marketing and innovation.

Despite the emphasis on marketing and the marketing approach, marketing is still rhetoric rather than reality in far too many businesses. "Consumerism" proves this. For what consumerism demands of business is that it actually market. It demands that business start out with the needs, the realities, the values, of the customers. It demands that business define its goal as the satisfaction of customer needs. It demands that business base its reward on its contribution to the customer. That after twenty years of marketing rhetoric consumerism could become a powerful popular movement proves that not much marketing has been practiced. Consumerism is the “shame of marketing.”

But consumerism is also the opportunity of marketing. It will force businesses to become market-focused in their actions as well as in their pronouncements.

Above all, consumerism should dispel the confusion that largely explains why there has been so little real marketing. When managers speak of marketing, they usually mean the organized performance of all selling functions. This is still selling. It still starts out with “our products.” It still looks for “our market.” True marketing starts out the way Sears starts out—with the customer, his demographics, his realities, his needs, his values. It does not ask, What do we want to sell? It asks, What does the customer want to buy? It does not say, This is what our product or service does. It says, These are the satisfactions the customer looks for, values, and needs.

Indeed, selling and marketing are antithetical rather than synonymous or even complementary.

There will always, one can assume, be the need for some selling. But the aim of marketing is to make selling superfluous. The aim of marketing is to know and understand the customer so well that the product or service fits him and sells itself.

Marketing alone does not make a business enterprise. In a static economy there are no business enterprises. There are not even businesspeople. The middleman of a static society is a broker who receives his compensation in the form of a fee, or a speculator who creates no value.

A business enterprise can exist only in an expanding economy, or at least in one that considers change both natural and acceptable. And business is the specific organ of growth, expansion, and change.

The second function of a business is, therefore, innovation—the provision of different economic satisfactions. It is not enough for the business to provide just any economic goods and services; it must provide better and more economic ones. It is not necessary for a business to grow bigger; but it is necessary that it constantly grow better.

Innovation may result in a lower price—the datum with which the economist has been most concerned, for the simple reason that it is the only one that can be handled by quantitative tools. But the result may also be a new and better product, a new convenience, or the definition of a new want.

The most productive innovation is a different product or service creating a new potential of satisfaction, rather than an improvement. Typically this new and different product costs more—yet its overall effect is to make the economy more productive.

The antibiotic drug costs far more than the cold compress, which was all yesterday’s physician had to fight pneumonia.

Innovation may be finding new uses for old products. A salesman who succeeds in selling refrigerators to Eskimos to prevent food from freezing would be as much of an innovator as if he had developed brand-new processes or invented a new product. To sell Eskimos a refrigerator to keep food cold is finding a new market; to sell a refrigerator to keep food from getting too cold is actually creating a new product. Technologically there is, of course, only the same old product; but economically there is innovation.

Above all, innovation is not invention. It is a term of economics rather than of technology. Nontechnological innovations—social or economic innovations—are at least as important as technological ones.

In the organization of the business enterprise, innovation can no more be considered a separate function than marketing. It is not confined to engineering or research but extends across all parts of the business, all functions, all activities. It cannot be confined to manufacturing. Innovation in distribution has been as important as innovation in manufacturing; and so has been innovation in an insurance company or in a bank. Innovation can be defined as the task of endowing human and material resources with new and greater wealth-producing capacity.

Managers must convert society’s needs into opportunities for profitable business. That, too, is a definition of innovation. It should be stressed today, when we are so conscious of the needs of society, schools, health-care systems, cities, and environment.

Today’s business enterprise (but also today’s hospital or government agency) brings together a great many men of high knowledge and skill, at practically every level of the organization. But high knowledge and skill also mean decision-impact on how the work is to be done and on what work is actually being tackled.

As a result, decisions affecting the entire business and its capacity to perform are made at all levels of the organization, even fairly low ones. Risk-taking decisions—what to do and what not to do; what to continue work on and what to abandon; what products, markets, and technologies to pursue with energy and what markets, products, and technologies to ignore—are in the reality of today’s business enterprise made every day by a host of people of subordinate rank, very often by people without traditional managerial title or position, e.g., research scientists, design engineers, product planners, and tax accountants.

Every one of these men and women bases their decisions on some, if only vague, theory of the business. Every one, in other words, has an answer to the question, What is our business and what should it be? Unless, therefore, the business itself—and that means its top management—has thought through the question and formulated the answer—or answers—to it, the decision-makers in the business, will decide and act on the basis of different, incompatible, and conflicting theories. They will pull in different directions without even being aware of their divergences. But they will also decide and act on the basis of wrong and misdirecting theories of the business. Common vision, common understanding, and unity of direction and effort of the entire organization require definition of “what our business is and what it should be.”

Nothing may seem simpler or more obvious than to know what a company’s business is. A steel mill makes steel, a railroad runs trains to carry freight and passengers, an insurance company underwrites fire risks, and a bank lends money. Actually, What is our business? is almost always a difficult question and the right answer is usually anything but obvious.

The answer to the question, What is our business? is the first responsibility of top management.

That business purpose and business mission are so rarely given adequate thought is perhaps the single most important cause of business frustration and business failure. Conversely, in outstanding businesses such as the Telephone Company or Sears, success always rests to a large extent on raising the question, What is our business? clearly and deliberately, and on answering it thoughtfully and thoroughly.

With respect to the definition of business purpose and business mission, there is only one such focus, one starting point. It is the customer. The customer defines the business. A business is not defined by the company's name, statutes, or articles of incorporation. It is defined by the want the customer satisfies when he or she buys a product or a service. To satisfy the customer is the mission and purpose of every business. The question, What is our business? can, therefore, be answered only by looking at the business from the outside, from the point of view of customer and market. All the customer is interested in are his or her own values, wants, and reality. For this reason alone, any serious attempt to state "what our business is" must start with the customer's realities, his situation, his behavior, his expectations, and his values.

Who is the customer? is thus the first and most crucial question to be asked in defining business purpose and business mission. It is not an easy, let alone an obvious, question. How it is being answered determines, in large measure, how the business defines itself.

The consumer—that is, the ultimate user of a product or a service—is always a customer. But there is never the customer; there are usually at least two—sometimes more. Each customer defines a different business, has different expectations and values, buys something different.

Most businesses have at least two customers. The rug and carpet industry has both the contractor and the homeowner for its customers. Both have to buy if there is to be a sale. The manufacturers of branded consumer goods always have two customers at the very least: the housewife and the grocer. It does not do much good to have the housewife eager to buy if the grocer does not stock the brand. Conversely, it does not do much good to have the grocer display merchandise advantageously and give it shelf space if the housewife does not buy.

It is also important to ask, Where is the customer? One of the secrets of Sears's success in the 1920s was the discovery that its old customer was now in a different place: the farmer had become mobile and was beginning to buy in town.

The next question is, What does the customer buy?

The Cadillac people say that they make an automobile, and their business is called the Cadillac Motor Division of General Motors. But does the man who buys a new Cadillac buy transportation, or does he buy primarily prestige? Does the Cadillac compete with Chevrolet, Ford, and Volkswagen? Nicholas Dreystadt, the German-born service mechanic who took over Cadillac in the Great Depression years of the 1930s, answered: "Cadillac competes with diamonds and mink coats. The Cadillac customer does not buy 'transportation' but 'status.' " This answer saved Cadillac, which was about to go under. Within two years or so, it made it into a major growth business despite the depression.

Most managements, if they ask the question at all, ask, What is our business? when the company is in trouble. Of course, then it must be asked. And then asking the question may, indeed, have spectacular results and may even reverse what appears to be irreversible decline. To wait until a business—or an industry—is in trouble is playing Russian roulette. It is irresponsible management. The question should be asked at the inception of a business—and particularly for a business that has ambitions to grow. The most important time to ask seriously, What is our business? is when a company has been successful.

Success always makes obsolete the very behavior that achieved it. It always creates new realities. It always creates, above all, its own and different problems. Only the fairy tale ends, "They lived happily ever after."

It is not easy for the management of a successful company to ask, What is our business? Everybody in the company then thinks that the answer is so obvious as not to deserve discussion. It is never popular to argue with success, never popular to rock the boat.

Sooner or later even the most successful answer to the question, What is our business? becomes obsolete. Very few definitions of the purpose and mission of a business have anything like a life expectancy of thirty, let alone fifty, years. To be good for ten years is probably all one can normally expect.

In asking, What is our business? management therefore also needs to add, And what will it be? What changes in the environment are already discernible that are likely to have high impact on the characteristics, mission, and purpose of our business? and How do we now build these anticipations into our theory of the business, into its objectives, strategies, and work assignments?

Again the market, its potential and its trends, is the starting point. How large a market can we project for our business in five or ten years—assuming no basic changes in customers, in market structure, or in technology? And, what factors could validate or disprove those projections?

The most important of these trends is one to which few businesses pay much attention: changes in population structure and population dynamics. Traditionally businessmen, following the economists, have assumed that demographics are a constant. Historically this has been a sound assumption. Populations used to change very slowly except as a result of catastrophic events, such as major war or famine. This is no longer true, however. Populations nowadays can and do change drastically, in developed as well as in developing countries.

The importance of demographics does not lie only in the impact population structure has on buying power and buying habits, and on the size and structure of the workforce. Population shifts are the only events regarding the future for which true prediction is possible.

Management needs to anticipate changes in market structure resulting from changes in the economy, from changes in fashion or taste, and from moves by competition. And competition must always be defined according to the customer’s concept of what product or service he buys and thus must include indirect as well as direct competition.

Finally, management has to ask which of the consumer's wants are not adequately satisfied by the products or services offered him today. The ability to ask this question and to answer it correctly usually makes the difference between a growth company and one that depends for its development on the rising tide of the economy or of the industry. But whoever is content to rise with the tide will also fall with it.

What Should Our Business Be?

What will our business be? aims at adaptation to anticipated changes. It aims at modifying, extending, and developing the existing, ongoing business.

But there is need also to ask, What should our business be? What opportunities are opening up or can be created to fulfill the purpose and mission of the business by making it into a different business?

Businesses that fail to ask this question are likely to miss their major opportunity.

Next to changes in society, economy, and market as factors demanding consideration in answering the question What should our business be? comes, of course, innovation, one's own and that of others.

Just as important as the decision on what new and different things to do is planned, systematic abandonment of the old that no longer fits the purpose and mission of the business, no longer conveys satisfaction to the customer or customers, no longer makes a superior contribution.

An essential step in deciding what our business is, what it will be, and what it should be is, therefore, systematic analysis of all existing products, services, processes, markets, end uses, and distribution channels. Are they still viable? And are they likely to remain viable? Do they still give value to the customer? And are they likely to do so tomorrow? Do they still fit the realities of population and markets, of technology and economy? And if not, how can we best abandon them—or at least stop pouring in further resources and efforts? Unless these questions are being asked seriously and systematically, and unless managements are willing to act on the answers to them, the best definition of “what our business is, will be, and should be,” will remain a pious platitude. Energy will be used up in defending yesterday. No one will have the time, resources, or will to work on exploiting today, let alone to work on making tomorrow.

Defining the purpose and mission of the business is difficult, painful, and risky. But it alone enables a business to set objectives, to develop strategies, to concentrate its resources, and to go to work. It alone enables a business to be managed for performance.

The basic definitions of the business, and of its purpose and mission, have to be translated into objectives. Otherwise, they remain insights, good intentions, and brilliant epigrams that never become achievement.

1. Objectives must be derived from “what our business is, what it will be, and what it should be.” They are not abstractions. They are the action commitments through which the mission of a business is to be carried out, and the standards against which performance is to be measured. Objectives, in other words, represent the fundamental strategy of a business.

2. Objectives must be operational. They must be capable of being converted into specific targets and specific assignments. They must be capable of becoming the basis, as well as the motivation, for work and achievement.

3. Objectives must make possible concentration of resources and efforts. They must winnow out the fundamentals among the goals of a business so that the key resources of men, money, and physical facilities can be concentrated. They must, therefore, be selective rather than encompass everything.

4. There must be multiple objectives rather than a single objective.

Much of today’s lively discussion of management by objectives is concerned with the search for the “one right objective.” This search is not only likely to be as unproductive as the quest for the philosophers’ stone; it does harm and misdirects. To manage a business is to balance a variety of needs and goals. And this requires multiple objectives.

5. Objectives are needed in all areas on which the survival of the business depends. The specific targets, the goals in any area of objectives, depend on the strategy of the individual business. But the areas in which objectives are needed are the same for all businesses, for all businesses depend on the same factors for their survival.

A business must first be able to create a customer. There is, therefore, need for a marketing objective. Businesses must be able to innovate or else their competitors will render them obsolete. There is need for an innovation objective. All businesses depend on the three factors of production of the economist, that is, on human resources, capital resources, and physical resources. There must be objectives for their supply, their employment, and their development. The resources must be employed productively and their productivity has to grow if the business is to survive. There is need, therefore, for productivity objectives. Business exists in society and community and, therefore, has to discharge social responsibilities, at least to the point where it takes responsibility for its impact upon the environment. Therefore, objectives in respect to the social dimensions of business are needed.

Finally, there is need for profit—otherwise none of the objectives can be attained. They all require effort, that is, cost. And they can be financed only out of the profits of a business. They all entail risks; they all, therefore, require a profit to cover the risk of potential losses. Profit is not an objective but it is a requirement that has to be objectively determined in respect to the individual business, its strategy, its needs, and its risks.

Objectives, therefore, have to be set in these eight key areas:

Marketing
Innovation
Human resources
Financial resources
Physical resources
Productivity
Social responsibility
Profit requirements

Objectives are the basis for work and assignments.

They determine the structure of the business, the key activities that must be discharged, and, above all, the allocation of people to tasks. Objectives are the foundation for designing both the structure of the business and the work of individual units and individual managers.

Objectives are always needed in all eight key areas. The area without specific objectives will be neglected. Unless we determine what will be measured and what the yardstick of measurement in an area will be, the area itself will not be seen.

The measurements available for the key areas of a business enterprise are still haphazard by and large. We do not even have adequate concepts, let alone measurements, except for market standing. For something as central as profitability, we have only a rubber yardstick; and we have no real tools at all to determine how much profitability is necessary. In respect to innovation and, even more, to productivity, we hardly know more than that something ought to be done. In the other areas—including physical and financial resources—we are reduced to statements of intentions; we do not possess goals and measurements for their attainment.

However, enough is known about each area to give a progress report at least. Enough is known for each business to go to work on objectives.

We know one more thing about objectives: how to use them.

If objectives are only good intentions, they are worthless. They must be transformed into work. And work is always specific, always has—or should have—clear, unambiguous, measurable results, a deadline and a specific assignment of accountability.

But objectives that become a straitjacket do harm. Objectives are always based on expectations. And expectations are, at best, informed guesses. Objectives express an appraisal of factors that are largely outside the business and not under its control. The world does not stand still.

The proper way to use objectives is the way an airline uses schedules and flight plans. The schedule provides for the 9:00