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How do you govern a disrupted world?

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Seismic economic shifts are placing new demands on governments globally. In this excerpt from the new book *No Ordinary Disruption: The Four Global Forces Breaking All the Trends*, its authors explain how policy makers can respond.

The collision of four fundamental economic forces—urbanization, technology, demographics, and globalization—is producing monumental change. Global competition and technological change have sped up creative destruction and outpaced the ability of labor markets to adapt. Job creation is a critical challenge for most policy makers even as businesses complain about critical skill gaps. Graying populations are starting to fray social safety nets, and for debt-ridden societies in advanced economies, the challenge can only get more pressing as the cost of capital starts to rise. Much-needed productivity growth continues to elude the public sector. Income inequality is rising and causing a backlash, in some cases targeted at the very interconnections of trade, finance, and people that have fueled the growth of the past three decades.

Just as many businesses are being forced to reassess their strategy and reimagine their assumptions, government must do the same. The political-leadership challenge triggered by these trend breaks is made even more urgent by the growing number of outlets for public expression and participation. Citizens around the world demand that governments deliver public services in shorter time frames, of consistent quality, and often at lower cost. In times of tightening budgets, short election cycles, and instant feedback loops, the room for error by public-sector leaders is small. From Brazil to Egypt to Hong Kong to Ukraine, it is common to see large groups of citizens taking to the streets, impatient for change.

For public-sector officials, often the challenge isn't lack of vision but short time frames, competing priorities, and flawed delivery. Many governments have risen to the occasion. An Asian country reduced street crime by 35 percent in the first year of a transformation program. A South American government reduced hospital waiting lists by 80 percent and increased by more than 50 percent the number of top graduates choosing to become teachers. An emerging-market government introduced a social-security scheme to hundreds of thousands of workers in two months. In each of these cases, policy makers used what McKinsey calls a Delivery 2.0 approach—a well-designed program with appropriate metrics, experimental "delivery labs," small and high-powered execution teams, visible support from leaders, and a culture of performance accountability.[1]

Implications for future governance

So what makes these efforts different? Can a government prepare its society for difficult decisions and remain accountable while making the long-term changes needed to sustain national prosperity and living standards? We believe it can. And while much attention is given to the money governments have at their disposal—and how they raise it—funding is only one way to measure what a government actually does. Broadly, policy actions geared at achieving desired outcomes tend to fall into one of three categories: *incentives, regulation*, and *information*. Around the world, governments are employing all three approaches to navigate the changing landscape with agility, innovation, and best-in-class implementation.

Using incentives to accelerate change

Typically, we think about incentives as carrots and sticks that the government provides to the private sector. But government can often craft incentives that induce government itself to work more intelligently. Germany's Hartz reforms retooled the country's labor market using incentives such as changing performance goals for caseworkers and more targeted placement and training programs. Along with incentives for companies to hire the long-term unemployed and retain workers in periods of weak demand, these efforts played a crucial role in changing the country's labor-market condition.[2] Other job-creation initiatives under way that utilize incentives in both advanced and emerging economies involve export promotion, infrastructure, social services, and fostering entrepreneurship. The US government's National Export Initiative seeks to promote job creation in domestic services and advanced-manufacturing industries by making it easier for companies to access export markets.

China, which has the world's largest diaspora and largest overseas student population, is using incentives to lure high-skilled professionals back home as part of its National Medium- and Long-Term Talent Development Plan (2010–2020). Meanwhile, the Thousand International Talents Program targets Chinese engineers and scientists living abroad, offering inducements such as large research grants, housing assistance, and tax-free education allowances for the children of those who return and work full-time in China for at least three years. Such incentives, combined with China's formidable economic momentum, encouraged nearly 300,000 students to return in 2012 alone.[3]

Several countries are using incentives to cope with the demographic and economic challenges of an aging population. One key effort toward bolstering the ranks of the employed is to include

[1] *Delivery 2.0: The new challenge for governments*, McKinsey & Company, October 2012, mckinsey.com.
[2] Ulf Rinne, Arne Uhlendorff, and Zhong Zhao, "Vouchers and caseworkers in public training programs: Evidence from the Hartz reform in Germany," IZA discussion paper no. 3910, December 2008, ftp.iza.org.
[3] Huiyao Wang, "China's return migration and its impact on home development," *UN Chronicle*, September 2013, Volume 50, Number 3, unchronicle.un.org.

more women. In 2012, only 51 percent of working-age women participated in the labor force globally, compared with 77 percent of men.[4] Denmark has instituted a host of incentives, including the provision of a child-care facility (such as day care, kindergarten, or a leisure-time center or school-based center) within three months of a parent's request. As a result, more than 80 percent of Danish infants and toddlers and more than 90 percent of Danish children between the ages of three and five years are in regular child care.[5] By 2009, Danish women aged 15 to 64 had a labor-force participation rate of 76 percent, one of the highest in the countries belonging to the Organisation for Economic Co-operation and Development (OECD).[6] Of those women in the labor force, more than 95 percent are employed.[7]

Conditional cash-transfer incentives have proven particularly effective in poverty-reduction efforts. In Mexico, Oportunidades has been credited with a 10 percent reduction in poverty within five years of its introduction,[8] in part because the program is designed to provide cash payments for families who meet certain conditions, such as health-clinic visits and school attendance. More significantly, it has created strong financial incentives for families to invest in efforts that boost human capital over the long term.

Using regulation in direct response to change

Government's power to regulate—to set standards and define the rules of conduct and markets—can play a vital role in modernizing economies and preparing for the future. Regulation can prove a particularly effective tool in places where market failures are obvious and structural issues inhibit adoption of best practices. Shareholders of large financial institutions can't effectively ride herd on the risk-taking actions of executives, so regulators must impose capital standards and undertake careful supervision.

Making buildings more energy efficient requires owners to make up-front investments that they may not be able to pass along directly to renters. As a result, smartly designed industry-wide standards can be useful. To address the problem of aging populations, some countries have extended the legal retirement age, in some cases by up to two years. That's a start, but it's not nearly sufficient to keep pace with the demographic changes the world is seeing. A recent analysis of 43 mostly developed countries found that between 1965 and 2005, the average legal retirement age rose by less than six months.[9] In the same period, male life expectancy rose by nine years. In graying Europe, Danish legislation recognized the impending pension time bomb early, and the country decided to index the pension age to life expectancy and place restrictions on early retirement. As a result, Denmark's population of people aged 55 to 64 has a higher labor-force participation rate (58 percent) than the average EU country (less than 50 percent) and will have the highest retirement age (69 years) among all OECD countries by 2050.[10] In response to the demographic tide, Japan's government in the early 2000s introduced compulsory long-term-care insurance contributions by citizens over age 40.[11]

4 *Pensions at a glance 2013: OECD and G20 Indicators*, Organisation for Economic Co-operation and Development, 2013, oecd.org.

5 *Starting strong II: Early childhood education and care*, Organisation for Economic Co-operation and Development, September 2006, oecd.org.

6 "Table 1368: Female labor force participation rates by country, 1980 to 2010," *Statistical Abstract of the United States 2012*, US Census Bureau, US Department of Commerce, 2012, census.gov.

7 *Denmark in Figures 2013*, Statistics Denmark, February 2013, dst.dk.

8 Theresa Braine, "Reaching Mexico's poorest," *Bulletin of the World Health Organization*, August 2006, Volume 84, Number 8, who.int.

9 David E. Bloom, David Canning, and Günther Fink, *Implications of population aging for economic growth*, NBER working paper no. 16705, January 2011, nber.org.

10 *Pensions at a glance 2013*.

11 "Japan long-term care: Highlights from *Help Wanted? Providing and Paying for Long-Term Care*," May 18, 2011, oecd.org, from Francesca Colombo et al., *Help Wanted? Providing and Paying for Long-Term Care*, Paris: OECD Health Policy Studies, OECD Publishing, 2011.

Countries—particularly countries with underdeveloped financial institutions or specific risk exposures to global flows—use the regulatory approach to manage their vulnerability to global participation. For instance, governments have crafted various regulatory responses to rising capital inflows, ranging from short-term, high-intervention measures to systemic longer-term changes to their financial markets. Regulation is usually most intrusive when markets are least developed.

Chile, whose economy is relatively modern but disproportionately reliant on copper exports, continued its openness to foreign capital but maintained a conservative fiscal-policy stance. In 2007, the government set up the Economic and Social Stabilization Fund with an initial contribution of $2.6 billion. The fund was set up specifically to reduce Chile's dependency on global business cycles and revenue volatility from copper-price fluctuations. It invests primarily in government bonds, and a portion of its assets can be used to finance deficit spending or pay down government debt. The fund's assets have grown to about $15 billion, and Chile has become one of the most financially deepened countries in the region.[12] The International Monetary Fund recently nominated Chile as a representative example of resilience to fluctuations from global flows.[13]

Governments have used regulation to mandate social, environmental, and other broad outcomes in response to global trends, while letting industries sort out the technologies needed to meet the targets. In these cases, there is a social consensus about what needs to happen but no agreement on how to get there. And getting there is most of the battle, because market participants may be wedded to technologies linked to whatever environment preceded the trend break. For example, the advent of sharply higher energy prices caused the promulgation of sharply higher automobile-mileage requirements in the United States. This, in turn, has spurred a host of innovations—electric vehicles, hybrid power trains, replacement of steel with aluminum, and integration of start-stop engine technology. New regulatory requirements on food safety and tracking in the European Union and the United States are generating industry interest in data platforms and advanced analytics throughout the supply chain.

Examples of regulation abound in the policy response to resources. In the United States, Ohio, Pennsylvania, and Texas allowed the deployment of fracking, which the state of New York bans.[14] In Europe, public concerns about the environmental impact of shale gas have led to drilling bans in Bulgaria, France, and Germany.[15] To encourage recycling, Sweden has used landfill taxes and the inclusion of recycling costs in the price of goods. As a result, about 99 percent of household waste is either recycled or burned to create electricity and heat.[16] The German government is using regulation to hasten the transition to renewables and has mandates for electricity efficiency.[17]

Harnessing information to improve productivity

Big data isn't just for apps and e-commerce. Information is a critical tool to improve public-sector productivity, especially in an environment where there is pressure to continually improve

[12] "Financial deepening" is a term that indicates that financial services and access to capital (along with banks, financial institutions, and capital markets) are becoming more accessible in a country.

[13] *World Economic Outlook: Transitions and tensions*, International Monetary Fund, 2013, imf.org.

[14] Sean Cockerham, "New York ruling on fracking bans might send tremors across US," *Miami Herald*, June 30, 2014, miamiherald.com.

[15] "Bulgaria bans shale gas drilling with 'fracking' method," BBC News, January 19, 2012, bbc.com; Jan Hromadko and Harriet Torry, "Germany shelves shale-gas drilling for next seven years," *Wall Street Journal*, July 4, 2014, wsj.com.

[16] *The Swedish recycling revolution*, Swedish Institute, 2014, sweden.se.

[17] For more on these environmental efforts, please visit the Germany Federal Environment Agency, umweltbundesamt.de.

productivity and quality of service. Governments are starting to prioritize information as an effective tool for better management of the resources and tasks they steward, such as education, health care, matching labor supply and demand, and even defense and security. And government is supporting industry in providing information that consumers can use to make better decisions. Central European countries—Austria, Germany, and Switzerland in particular—have long been models of industry-based vocational education. There, vocational programs target more than 200 different occupations and are intended to ensure a match between labor supply and demand. The Swiss government oversees certification, and potential employers help define needed skills and shape curricula. Other countries have similar models, but on a smaller scale and targeting specific sectors. Brazil's government is taking the lead via Prominp (National Oil and Natural Gas Industry Mobilization Program) to convene firms, universities, and unions to improve education and keep Brazil's oil and gas sector competitive.[18]

Under President Nicolas Sarkozy, France launched the General Review of Public Policies. Dubbed "do more with less," it is aimed at reducing the country's public expenditures, providing better service quality for citizens, and promoting a "culture of results." Among other actions, the review promoted service improvements in high-visibility areas associated with greater citizen satisfaction. For example, the review recommended the introduction of 15 quality-of-service indicators, including waiting times in the accident and emergency departments of hospitals.[19]

Another step is identifying and monitoring the economy's main productivity drivers. Even among the best-performing countries, a wide distribution of performance exists within sectors. Within the quasi-public sector, countries have both excellent and poorly performing hospitals and schools. The best performers have usually understood and implemented practices honed in the private sector—lean principles, data analytics, smart procurement, and performance management—to great effect.

Technology and big data provide another avenue for policy makers to unleash productivity improvements across all public services. In Kenya, the national government launched an open data portal to share previously difficult-to-access information spanning realms such as education, energy, and health. This data publication has led to the development of more than 100 mobile applications and an estimated potential savings of $1 billion in procurement costs.[20] Estonia's 1.3 million residents can use electronic ID cards to vote, pay taxes, and access more than 160 services online, from unemployment benefits to property registration; even private-sector firms offer services through the state portal.[21] The Brazilian Transparency Portal publishes a wide range of information that includes federal-agency expenditures, elected officials' charges on government-issued credit cards, and a list of companies banned from contracting work with the government.[22]

[18] Dominic Barton, Diana Farrell, and Mona Mourshed, *Education to employment: Designing a system that works*, McKinsey Center for Government, 2013, mckinsey.com.

[19] Karim Tadjeddine, "'A duty to modernize': Reforming the French civil service," McKinsey & Company, April 2011, mckinsey.com.

[20] *Open data: Unlocking innovation and performance with liquid information*, McKinsey Business Technology Office, McKinsey Center for Government, and McKinsey Global Institute, October 2013, mckinsey.com.

[21] Eric Braverman and Mary Kuntz, "Creating a 'coalition of the positive' in India: An interview with Nandan Nilekani," and Elana Berkowitz and Blaise Warren, "E-government in Estonia," in *Innovation in government: India and Estonia*, McKinsey & Company, June 2012, mckinsey.com.

[22] Marcos Cruz and Alexandre Lazarow, "Innovation in government: Brazil," September 2012, mckinsey.com.

The trend-break era is imposing on governments and policy makers uncertainties and pressures that are as significant and meaningful as those it is placing on companies and executives. Increasingly, public leadership will be judged by its ability to marshal resources and build consensus to face these challenges head-on. Ultimately, it is difficult to prescribe a specific regimen for the appropriate size and shape of government. Each country must make these decisions for itself. But regardless of a government's situation—expanding or contracting, developed or developing, in surplus or in deficit—it must strive to respond quickly and with agility. Doing so will allow governments to insulate and protect themselves from some potentially threatening trends. More significantly, it will allow the public sector to take advantage of the enormous opportunities being presented. The intelligent deployment of incentives, regulations, and data is a requirement for success.

This article is an edited excerpt from *No Ordinary Disruption: The Four Global Forces Breaking All the Trends* (PublicAffairs, May 2015). To learn more about it and order copies, please visit Amazon, Barnes & Noble, or other leading bookstores.

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