Growth in Services

Fostering Employment, Productivity and Innovation

Meeting of the OECD Council at Ministerial Level, 2005

At its meeting in May 2003, the Ministerial Council asked the OECD to analyse the contribution made by the services sector to employment growth, productivity and innovation, and to identify factors, institutions and policies that could enhance the growth prospects of this sector. In response to this request, the OECD launched a study involving the Economics Department (Economic Policy Committee), the Directorate for Science, Technology and Industry (Committees for Information, Computer and Communications Policy, Scientific and Technological Policy, Industry and Business Environment), and the Trade Directorate (Trade Committee). The Center for Tax Policy and Administration, the Directorate for Employment, Labour and Social Affairs, the Directorate for Public Governance and Territorial Development, and the Directorate for Education also made helpful contributions to the study.

This report draws the main policy conclusions from the project. It complements the OECD report on Trade and Structural Adjustment, which provides policy directions on how OECD countries can adjust to international trade. Together, these reports present a concrete policy agenda on how to strengthen growth performance and address globalisation, structural change and the shift to services. The findings and policy implications of the work are summarised below.

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Executive Summary

The services sector now accounts for over 70% of total employment and value added in OECD economies. It also accounts for almost all employment growth in the OECD area. But despite its growing weight, productivity growth in services has been slow in many OECD countries and the share of the working-age population employed in services remains low in many countries. If policy makers wish to strengthen economic growth and improve the foundations for the future performance of OECD economies, the services sector will need to do better. But strengthening growth performance is not the only challenge facing policy makers; OECD countries are also confronted with the growing globalisation of services and manufacturing and with rapid technological change. This has raised doubts about the capacity of OECD economies to create new jobs, while at the same time offering new opportunities for international trade and investment. Addressing these challenges and strengthening the potential of services to foster employment, productivity and innovation will need to build on sound macroeconomic fundamentals and involve a combination of structural policies. The OECD report on services encourages policy makers to take action in the following areas:

- ***Open domestic services markets to create new job opportunities and foster innovation and productivity.*** Further regulatory reform of services markets will create fresh opportunities for firms to develop new services, meet emerging global demands and increase employment. It will also increase the incentives for companies to innovate and improve productivity growth. While much progress has been made in opening services markets, further steps are needed, *e.g.* in reducing the degree of public ownership in competitive industries such as air transport, in addressing anti-competitive practices in professional services, and in reducing barriers to entrepreneurship.
- ***Take unilateral and multilateral steps to open international markets to trade and investment in services.*** OECD work shows that the benefits of international trade and investment in services are highly significant, for both OECD economies and developing countries. Policy makers can take unilateral steps to open markets to international competition, for instance by reducing barriers to foreign direct investment. At the same time, multilateral action is needed to ensure a broad opening of markets and a wide distribution of the benefits. OECD members should therefore seize the opportunities offered by the ongoing WTO Doha negotiations to open their services markets.
- ***Reform labour markets to enable employment creation and adjustment to a growing services economy.*** Effective labour and social policies are essential to help OECD economies adjust to globalisation, structural change and the shift to services. To strengthen employment creation in services, policy makers should address high labour taxes that affect the job prospects for low-skilled workers and the development of personal services in OECD

economies. Employment protection legislation should be reformed in countries where it is overly strict, to help improve the capacity of these economies to create employment and enhance productivity growth in services.

- ***Adapt education and training policies to rapidly changing requirements for new skills.*** Since most services involve direct contact with customers, human resources are key to services sector performance. Education policies are important to help workers adjust to globalisation and structural change and should help provide the qualifications that are needed in services. However, they need to be supplemented with actions, partnerships and co-financing by firms, workers and governments to foster life-long learning. This will require improved incentives for private financing of life-long learning and actions to ensure equitable access to formal and on-the-job learning.
- ***Adapt innovation policies to the growing importance of services innovation.*** Innovation policies remain ill adapted to the growing importance of innovation in services, and to the new potential for product and process innovation that is due to information and communications technology (ICT). Policy makers should consider how existing public R&D can better address the needs of the services sector and improve the links between services sector firms and public research. In modifying policies related to intellectual property in services, governments will need to strike a careful balance between innovation and the diffusion of service innovations to other industries.
- ***Remove impediments that prevent services firms from seizing the benefits of ICT.*** To seize the benefits of ICT for services, governments should continue to encourage effective competition in ICT infrastructure, network services and applications, notably for broadband. They will also need to increase the trust in electronic business, *e.g.* by developing effective regulatory frameworks. Regulatory barriers, *e.g.* to digital delivery and digital content, also require reform, as they are not adapted to the new potential offered by electronic business. Moreover, governments can take action themselves, by developing public services and digital content.
- ***Provide a fiscal environment which is conducive to the growth of services.*** Governments will need to avoid that the interaction between the application of EU and non-EU value added taxes, as well as sales taxes, leads to new tax barriers to cross border services. Tax treaties should be reviewed to avoid such activities being subject to double taxation. Tax dispute settlement procedures should be accelerated and reinforced, notably for cross border services and intangibles.

Reform of services sector policies provides an important opportunity for policy makers to strengthen employment, productivity and innovation. It will also help in strengthening the capacity of OECD economies to adjust to economic globalisation in services and to the growing importance of services to future growth in OECD economies. The policies advocated in this report are mutually reinforcing. This is important since seizing the new growth opportunities in the services sector and adjusting to globalisation will be possible only through a comprehensive strategy based on a policy mix that is suited to each country or circumstance.

With so many policy areas affecting the services sector, priorities are essential, however. Moving quickly towards more open and competitive services markets, at both the national and international level, is of the greatest importance to foster new employment opportunities and increase innovation and technology diffusion. This also means providing more scope for entrepreneurs to explore the new business opportunities in the services sector, in particular at the global level, and providing a fiscal environment that is conducive to the growth of services. At the same time, improvements in the functioning of labour markets and institutions are urgently needed to help OECD economies adjust to globalisation and the shift to services. Education and training policies clearly have a key role in providing workers with the new skills they will require in an increasingly global service economy. Also, much can be done to improve policies related to innovation and ICT in services, as the combination of ICT and process innovation holds the key to generating more rapid innovation and productivity growth in the services sector. In all these areas, it will also be important to account for the large diversity of the services sector and the resulting variety in policy challenges and growth prospects.

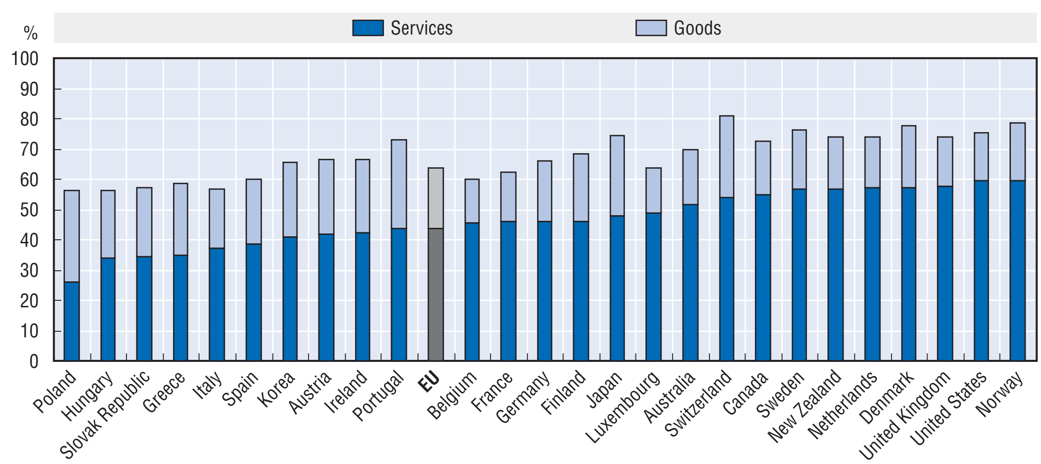
Introduction

The services sector is the key to stronger growth and employment performance

The need for a stronger and more dynamic services sector arises primarily from the growing weight of services in OECD economies. If policy makers wish to increase labour utilisation and productivity growth, the services sector will need to make a larger contribution than is currently the case. The experience of several OECD countries shows that this is feasible; in Australia, Canada, Luxembourg, the Slovak Republic and the United States, the services sector has made a large contribution to both employment and productivity growth over the past decade. Many of the jobs that have been created involved high-skilled workers, in particular in finance, business services, education and health. However, in several other OECD countries, such as Italy, Korea, Poland and Spain, the contribution of the services sector to employment rates remains limited (Figure 1), whereas in others, such as France, Italy, the Netherlands and Spain, their contribution to productivity growth has been low (Figure 2).

Figure 1. **The services sector accounts for most of the variation in employment rates across OECD countries**

Share of the working-age population employed in goods and services,[1] 2002, percentages



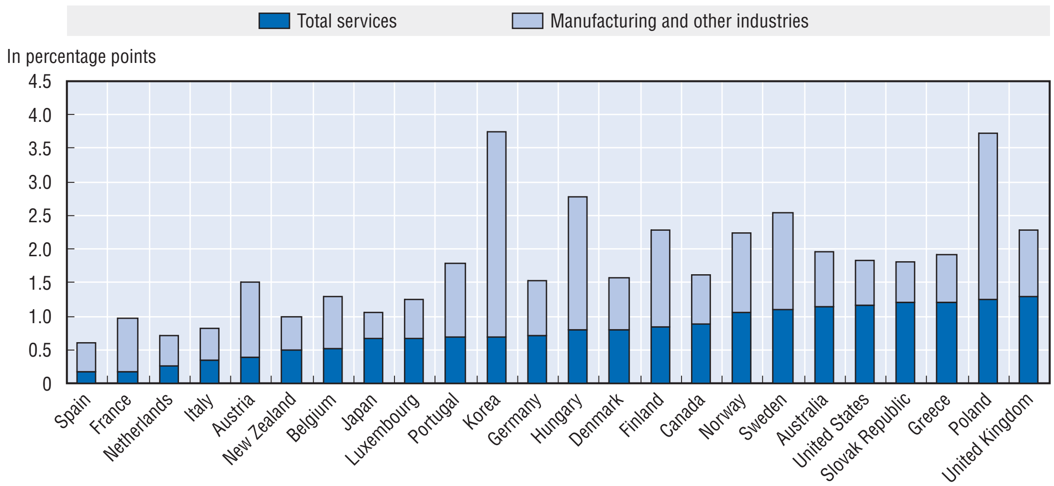
1. Covers all services, including community, social and personal services.

Source: OECD, STAN database and Labour Force Statistics.

This variation in the growth performance of the services sector can partly be attributed to differences in policies and institutions; in many OECD countries, policy makers will need to take further action to help seize the

Figure 2. **Contribution of the services sector to productivity growth, 1990-2002**[1]

Contribution to growth of value added per person employed, percentage points



1. Or latest available year.

Source: OECD STAN database.

potential for growth and innovation that has become increasingly apparent in the services sector. Unleashing this potential, by a combination of structural policies, can help create more employment, enhance productivity and increase aggregate incomes.

But strengthening growth performance is not the only challenge. OECD countries are also confronted with a growing globalisation of services and rapid technological change, which has raised doubts about the capacity of economies to create new jobs (Box 1). Addressing the globalisation challenge, which is now affecting a large and growing part of the economy, raises new questions about the ability of OECD economies to adjust to structural change, an issue which is also addressed in the MCM paper on Trade and Structural Adjustment.

The services sector – diverse, but facing common policy challenges

Many services sectors have experienced rapid employment growth, though only some have also experienced rapid productivity growth

The rapid employment growth in the services sector of several OECD countries over the past decade results primarily from the strong performance of certain market services, notably telecommunications, transport, wholesale and retail trade, finance, insurance and business services. Over the past decade, these services accounted for around 60% of all employment created in the OECD area. Moreover, they are characterised by a growing use of productivity-enhancing technologies, such as ICT, and accounted for the bulk of labour productivity growth in Australia, Japan and the United States over the past decade (Figure 2). Some of these services, notably telecommunications and business services, have also been characterised by a high level of business dynamics, as demonstrated by high rates of new firm

Box 1. **The globalisation of services**

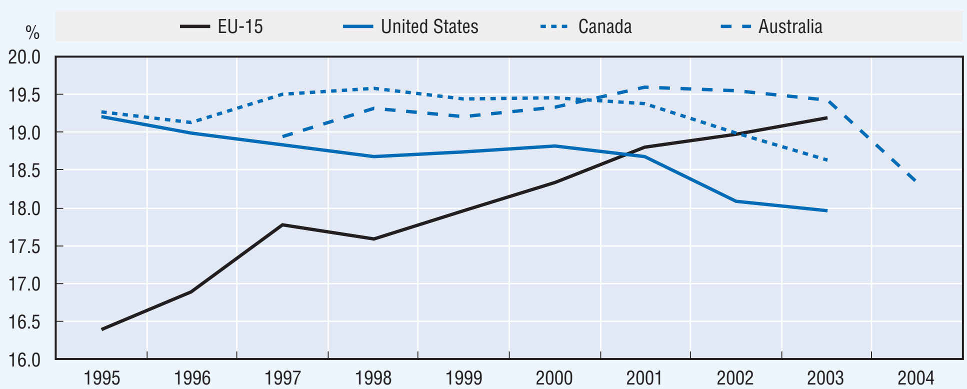
Among the main drivers of the strong performance of services sectors in recent years is the growing importance of globalisation for many services. Part of the growing globalisation of services is increased international sourcing of service inputs from abroad. This trend is relatively recent compared to the well-established practice of offshoring parts of the production chain in manufacturing. It reflects changing business models where companies source intermediate services from specialised firms – both at home and abroad – as an alternative to in-house production. This development has been triggered by technological advances, such as the development of broadband networks and the growing scope for digitisation of services, and supported by regulatory reform and trade liberalisation in both OECD and developing economies, as well as by the emergence of a global labour market of highly skilled workers. Such buying-in of services is still largely a domestic affair, but is becoming more international.

Although there are no official statistics measuring the extent of international sourcing, estimates suggest it will accelerate in most OECD countries in coming years. It generally involves functions which are easy for companies to purchase from outside due to their intensive use of information technology and low need for face-to-face contact; many such functions are no longer linked to a specific location. This includes work by clerks and computer operators, data handlers and claims processors as well as programmers and certain types of scientists and engineers, *i.e.* both high- and low-skilled white-collar jobs. OECD estimates place the total number of jobs that could potentially be affected by domestic or global outsourcing at close to 20% of employment in certain countries (Figure A1). Such international sourcing, however, is currently primarily occurring in markets which are expanding in the OECD. The employment impacts have thus far been limited compared to aggregate economic activity and normal job "churning".

The direct benefits of international sourcing are currently accruing to a number of OECD countries (*e.g.* Ireland, Czech Republic) and non-OECD countries (*e.g.* India) which have become highly competitive in business services. Indirect benefits may be realised by other countries, due to lower costs and increased productivity. Consumers may benefit directly from lower prices and indirectly from enhanced efficiency. In this way, sourcing business services from lower-wage countries could reduce the prices of services as diverse as finance, transportation and health. However, the gains and associated adjustment costs of international sourcing may not be equally distributed across workers, industries and countries. More competition in service markets will foster restructuring, which can be painful for affected individuals. In countries with structural rigidities and poorly functioning labour markets, workers may have difficulties finding new employment at equal or higher wages. This underlines the importance of structural reforms in OECD countries (as outlined in this report and the Ministerial report on Trade and Structural Adjustment) which can ease the adjustment process while fostering growth and innovation.

Figure A1. **The share of occupations potentially affected by offshoring in total employment**

EU-15, United States, Canada, and Australia 1995-2003/4,[1] percentages



1. Includes OECD estimates. Due to differences in classifications, levels are not directly comparable.

Source: OECD estimates based on EU Labour Force Survey, US Current Population Survey, Statistics Canada and Australian Bureau of Statistics.

creation, rapid growth of successful new firms, and reallocation of resources from declining to growing firms. The strong performance of these services is not only important for their own sake; it also helps underpin growth in those sectors, including manufacturing, that use services as an input.

Community, social and personal services, including health and education, accounted for the remaining 40% of employment creation in the OECD area. Some of these services, notably health and personal services are faced with growing demand, due to factors such as the ageing of OECD populations, changes in life styles, growing incomes and resulting demands for quality, as well as the spread of health-improving technologies. These services have thus far experienced little measurable productivity growth, however. In some areas, this is because there are inherent limitations to productivity growth. In other sectors, such as health, there is little doubt that technological change has already had impacts on performance, but this has not yet shown up in the – still inadequate – productivity measures.

All services can benefit from a more dynamic business environment and effective innovation policies

The challenges and growth prospects for the services sector therefore differ across activities. They depend on the structural characteristics of different services markets, including their potential for technological change and productivity growth, their current degree of regulation and inherent scope for domestic and international competition, as well as the relative roles of the public and private sectors in each activity. This diversity is compounded by a large variation in the development of the services sector across OECD countries, which is partly linked to differences in the demand for services. Despite this diversity, two broad policy challenges can be identified that are the key to fostering growth in services:

- How to foster a more dynamic and competitive business environment that encourages services firms to enhance productivity, offer new services and create new employment.
- How to complement such structural reforms with effective innovation and technology diffusion policies that can overcome barriers to innovation and technological change in the services sector.

In developing policies for the services sector, policy makers will also need to consider carefully the rationale and efficiency of their efforts in these two areas.

Improving the business environment for services

Competitive pressures on services firms have increased, spurring greater uptake of technology, as well as productivity and employment growth

The strong growth of services in certain OECD countries results from a combination of factors. Among the most important is the growth in competitive pressure that has occurred over the past decades. Regulatory reform of markets for transport, communication, finance and certain business services, combined with a reduction in international barriers to trade and investment in services, as well as the growing scope for competition and international cross-border trade thanks to technological change and the growing tradability of services, have opened up service markets that were previously sheltered from competition. This has increased the incentives for firms to increase efficiency through greater use of advanced technologies, notably ICT, which has enabled innovation and productivity growth in many services, and has also forced firms to make greater efforts in introducing innovative products and processes throughout the value chain. In countries where this process has advanced furthest, such as Australia and the United States, the resulting boost to productivity has contributed to lower prices and growing demand for service products, and to strong employment creation in certain services sectors, notably business services. The experience of these countries shows that employment and productivity growth can go hand-in-hand.

The growth of competition in services sectors is important for another reason; it fosters the growth and new entry of firms that are particularly innovative and successful in meeting consumer demand. OECD economies benefit if new and successful firms flourish and thrive, and if less successful firms decline or close down. Firm-level evidence shows that successful and innovative firms can be found in the services sector in all OECD countries (Box 2), but the business environment in OECD countries is not equally geared towards the creation and prosperity of such innovative firms in large numbers. This is where policy can make a difference.

Reform regulations in services to enhance performance and create new opportunities

Reform of regulations in the services sector is highly important and has fewer adverse consequences than expected

A key element in improving the business environment is better regulation. A broad range of OECD work, including that carried out in the context of its work on regulatory reform, shows that the reform of regulatory structures, *e.g.* regulations on entry or operations, is the key to creating new opportunities in services sectors (Box 2). The current reform process is driven by a recognition that certain regulations may no longer be needed, *e.g.* because technological change has enabled competition in markets that were previously considered natural monopolies, such as telecommunications.

The evidence from OECD countries shows that well-designed reform of regulations, and the opening of markets to competition, can be highly beneficial. The liberalisation of the Large-Scale Retail Store Law in Japan in the early 1990s, for example, resulted in higher labour productivity, lower prices and higher retail employment, arguably boosting economy-wide GDP by around 1%. In the Netherlands and the United Kingdom, liberalisation of shop opening-hours in the mid-1990s led to a significant increase in employment and a sharp increase in value added. Similarly, regulatory reform in air passenger transportation and road freight has been associated with substantial welfare gains in the form of lower prices, new services and higher productivity.

The experience with regulatory reform also suggests that the feared adverse effects of liberalisation often do not materialise. Regulatory reform in air and road transport has not led to a decline in safety levels or to a decline of air services to remote communities. Moreover, the experience in

Box 2. **Determinants of success in services – some findings from case studies**

The success of certain well-known services firms can illustrate the analysis in this paper. OECD case studies of some international services firms show that a number of factors are common to their success:

1. Open markets. Many successful services companies examined owe their existence and success to the opening up of markets. Several of the most successful airline companies (*e.g.* Southwest Airlines and EasyJet) in recent years would not have existed if formal entry barriers to airline markets had not been removed. Many other successful services companies were able to expand into new markets thanks to regulatory reforms (*e.g.* AXA into pension funds; Endemol into foreign TV markets). In certain other cases, *e.g.* Carrefour, the threat of foreign competition and the ability to expand in international markets thanks to open borders acted as a powerful incentive to grow, expand internationally and raise productivity.

2. Innovation and ICT. The opening up of markets may enable new entrants to take another step towards success, *i.e.* in doing something completely new and different. Such innovation – either in terms of processes or products – helps firms to differentiate themselves from other, often more traditional firms. Examples are the development by FedEx of a hub-and-spoke model for overnight package delivery or the development by Southwest of a business model for passenger transportation at low cost. The strong focus on innovation is often associated with an important role for venture or risk capital, *e.g.* in companies such as eBay and JetBlue. In many cases, successful services firms were also pioneers in introducing ICT and developing applications, such as airline reservations without physical sales points, interactive TV (Endemol) or digital tracking of packages (FedEx). The innovations pioneered by such firms often lead to additional productivity effects, due to the entry of other firms and responses by incumbent firms.

3. Work organisation and human resources. Firm case studies also highlight the importance of factors internal to a firm, notably the organisation of work, the motivation and skills of workers, and the company culture. These factors differ considerably across firms, but may include the decentralisation of responsibilities and flat hierarchies, compensation according to performance or compensation aimed at achieving worker loyalty (*e.g.* through profit sharing or stock options). Together, these features may lead to a high-skill, high-trust environment that underscores the key role of human resources for services sector performance.

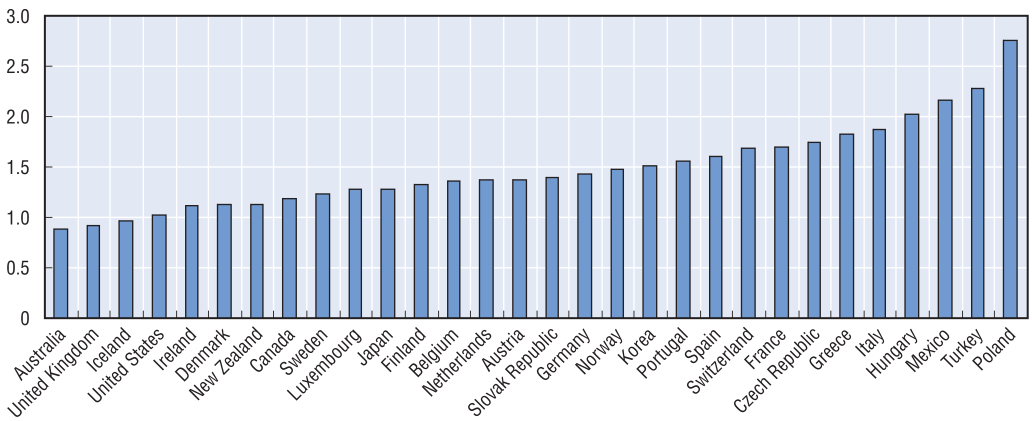
On the whole, the case studies confirm that policies to establish an open and competitive business environment are, without doubt, the key requirement for improved performance in the services sector. Policies (or lack of them) related to innovation, ICT, work organisation or human resources, were considered important for company success in some cases, but almost always in a context of open and contestable markets.

telecommunications suggests that the introduction of competition and cost-reflecting tariff structures can go hand-in-hand with the fulfilment of universal service obligations. Experiences with regulatory reform of electricity and railways have been mixed, however. On the whole, the evidence suggests that well-designed regulatory reform can improve performance in specific sectors without creating significant long-term adverse effects. Moreover, whenever adverse consequences do occur, *e.g.* disruptions in service or lowering of quality standards, policy makers should continue to evaluate how these can be addressed and avoided in future reform efforts.

Differences in the state of regulation across OECD countries point to an unfinished reform agenda

Much progress has been made over the past decade in reducing the degree of regulation in OECD services sectors. However, despite such progress, high levels of product market regulation continue to stifle growth and innovation, notably in many European countries (Figure 3). Further regulatory reform should be complemented by strong competition policy, as this can help ensure that effective competition develops in liberalised sectors of the economy. Moreover, further regulatory changes need to be supported by institutional reforms, to ensure that the regulatory system is effective in making markets work. This includes better use of alternatives to regulation, impact analysis, stakeholder consultation, and well-designed and adequately supported institutions and regulatory bodies.

Figure 3. **Product market regulation in OECD countries, 2003**[1]



1. The scale of indicators is 0-6 from least to most restrictive.

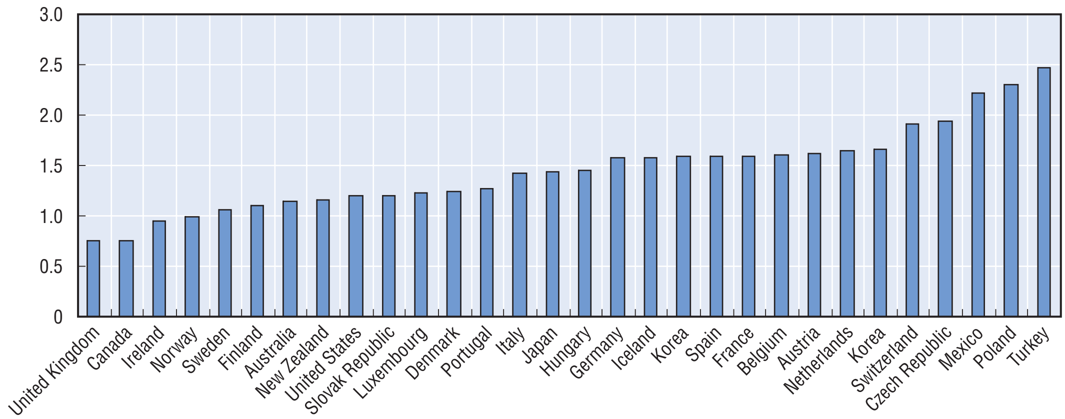
Source: OECD, Product Market Regulation Database, March 2005.

Peer reviews in the OECD have recommended that anti-competitive regulations in service markets be reviewed in many countries. This includes re-evaluating the role of public ownership in most EU countries, notably in inherently competitive industries like air and bus transport and financial services. It also includes reconsidering restrictions on large-scale retail outlets (*e.g.* in several Asian and European countries), as well as regulations on price setting. Moreover, regulations permitting anti-competitive practices in professional services, *e.g.* those allowing professional associations to regulate entry, conduct and prices, should be carefully re-examined. Reforming such regulations, notably those particularly affecting foreign providers, might also provide scope for international competition.

Policy can help foster new firm creation and entrepreneurship

Fostering entrepreneurship and the creation and growth of new firms are also important for employment creation. Moreover, innovation and growth of services often requires that firms can experiment in the market with new products, processes and business models. Allowing scope for experimentation may allow new ideas and innovations to appear more rapidly, benefiting growth and technology diffusion. There is much scope for action in this area; OECD estimates show that barriers to firm creation remain prevalent in many countries (Figure 4). OECD peer reviews have recommended to several countries, notably in Europe, to reduce regulatory barriers to business start-ups and to reduce compliance costs, especially for small businesses. The OECD's Istanbul Declaration of June 2004 points to a range of other policy measures that can be taken to enhance the level of entrepreneurship.

Figure 4. **Barriers to entrepreneurship, 2003**[1]



1. The scale of indicators is 0-6 from least to most restrictive.

Source: OECD, Product Market Regulation Database, March 2005.

Governments can make a direct contribution to better services sector performance by improving public services

Several important services, such as health, education and social services, are often provided in a non-market environment, although with considerable variation across countries. The absence of a price mechanism implies that it is difficult for the – often non-profit – providers of these services to gauge demand, which is sometimes reinforced by the absence of competition between providers and reliance on public funding. As a result of this environment, producers may have difficulties in responding adequately to evolving users needs, such as the growing demand for long-term health care. Suitable policy measures, which could be explored in several public services, include the opening up of markets to private providers, the introduction of user choice, linking public funding more closely to performance as well as user payments. While such measures may not be suitable for all public services, for example, because they conflict with fundamental equity objectives, such policy changes may contribute to better and more targeted services in several areas, and may help enhance efficiency while also achieving key public policy objectives.

National and international efforts are needed to open markets to international trade in services

Growing international trade in services offers the prospect of large economic benefits

The potentially beneficial impacts of regulatory reform in domestic services markets are compounded by the growing scope for international competition in services. International trade and investment in services is growing steadily and technological change, such as the integration of value chains thanks to ICT and the growing scope for digital delivery, is opening new services markets to the potential of international trade and competition (Box 1). While there are concerns about the structural adjustment associated with international trade, as discussed in the paper on Trade and Structural Adjustment for the 2005 OECD Ministerial, the overall benefits of international trade and investment are clearly highly significant.

International trade can help countries in strengthening their respective comparative advantage in services. Moreover, the stronger competition associated with international trade can reduce costs and prices, increase efficiency and innovation, and broaden the range of services being offered. It can also reduce the fragmentation of services markets. Recent OECD work demonstrates that the growth of trade in services benefits both developed and developing countries. In addition, a reduction in trade barriers for services also benefits goods- and services-producing industries that use services in the production process.

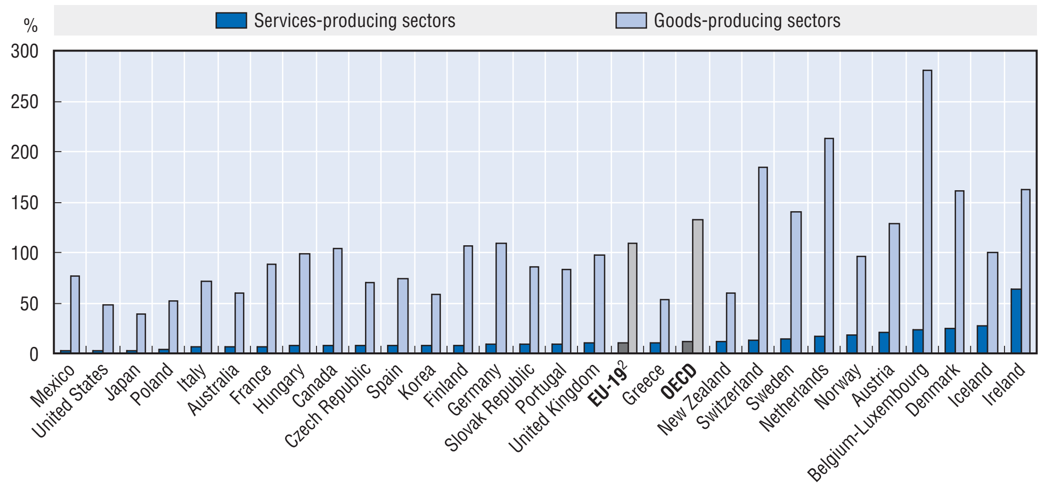
Barriers to trade in services persist

However, while the potential for trade in services has grown substantially, notably in certain business services, the trade to value added ratio of the services sector remains quite low compared to that of the goods-producing sector (Figure 5), and services trade accounts for only about 20% of total OECD trade. This is not only because services are still more difficult to trade internationally than goods, but also results from the policy environment for trade in services, which has not kept pace with the growing potential for such trade.

Trade in services can occur in several ways, and the General Agreement on Trade in Services (GATS) distinguishes four different modes of services delivery; cross-border trade, consumption abroad, commercial presence and movement of natural persons. Each of these modes of trade is affected by rules and regulations. For example, market access through cross-border trade may be restricted through rules stipulating that commercial presence or residency in the country is required. Regulations in services markets, as discussed above, may also limit international trade, in particular when they discriminate between domestic and foreign firms. Most OECD countries also have specific restrictions on foreign direct investment, such as limits on the amount of foreign equity or screening and approval rules. Services trade involving the temporary movement of natural persons to provide a service in another country is also affected by rules, *e.g.* limitations on the number of persons that may be temporarily employed in a particular sector.

Figure 5. **Trade in services remains under-developed compared to trade in goods**

Trade to value added ratios of the services- and goods-producing sectors,[1] 2002, percentages



1. Average of exports and imports of goods and services as a share of value added in the goods- and services-producing sectors. The goods-producing sector includes agriculture, mining, manufacturing, electricity, gas and water; the services-producing sector covers all other industries.
2. Includes intra-EU trade; EU-19 refers to all EU countries that are also members of the OECD.

Source: IMF, *Balance of Payments Statistics*, OECD, STAN database and Annual National Accounts database.

Countries should take unilateral and multilateral action to draw greater benefits from trade in services

For many of these measures affecting trade in services, countries can take unilateral steps to change the rules and open their economy to international trade. OECD work demonstrates that autonomous liberalisation in many services markets can be highly beneficial to the country taking such steps, in both OECD and developing economies, and generally exceeds the benefits from reform in agriculture or manufacturing. The potential gains may be particularly large in sectors such as distribution and business services, where trade barriers typically tend to drive up costs, but are also important in sectors such as banking and telecommunications. Countries should therefore not feel obliged to wait for progress in multilateral forums; they can take action immediately.

Certain measures affecting trade in services, *e.g.* those related to occupational licensing, may require co-operation between countries, however. Multilateral action can also ensure a broadening of the opening of services markets across countries, sectors and modes, resulting in a wider distribution of the benefits. By ensuring that measures taken by partner countries are binding and reciprocal, multilateral action can assist in providing the transparency and predictability sought by globally mobile service companies. Progress in international trade negotiations is therefore also needed. OECD Members should seize the opportunity provided by the ongoing WTO Doha negotiations to open their services markets. They should submit initial and revised GATS offers by the agreed deadline and intensify their efforts to conclude parallel negotiations on rule-making under the GATS.

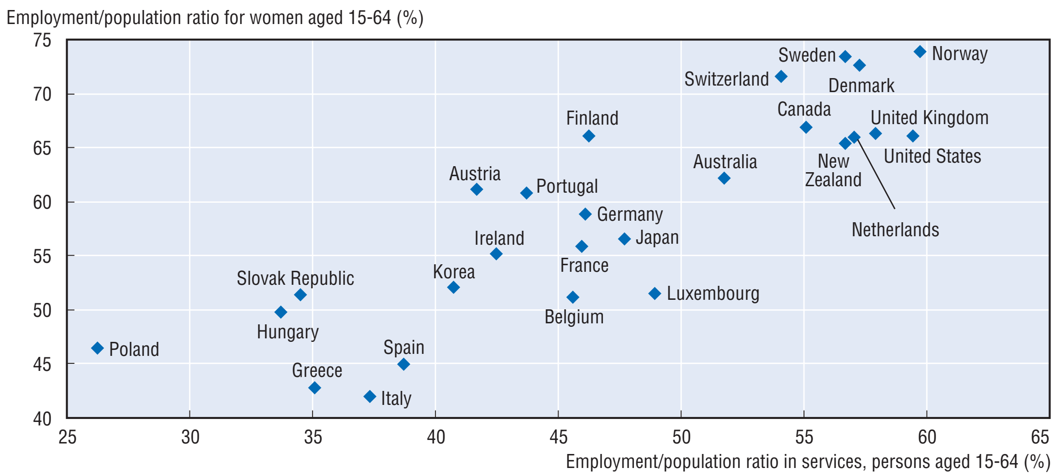
Labour markets require reform to create new employment opportunities in services

Inappropriate labour and social policies may hold back the adjustment of OECD countries to a services economy

Policies and institutional arrangements linked to the labour market may also hold back the creation of new services. OECD work shows that there is a strong relationship between services sector employment and overall employment rates (Figure 2). Moreover, countries with a high share of the population employed in services tend to have the highest participation of women in the labour market (Figure 6). The growth of services is the key to enhancing labour force participation, notably by providing the kind of jobs that are needed to attract new worker groups (*e.g.* part-time, evening, night as well as low-skilled workers). At the same time, high labour force participation may give an impetus to the development of the services sector.

Figure 6. **High employment in services goes hand-in-hand with high employment for women**

Employment/population ratios in services and for women, 2002, percentages



Source: OECD, STAN database and *Labour Force Statistics*.

Labour market institutions play an important role in helping countries adjust to structural change, as discussed in the Ministerial paper on Trade and Structural Adjustment. Unemployment and related benefits should promote job-search, rather than providing passive support and thus slowing down adjustment to structural change. Effective re-employment services and schemes that make work pay can make it easier for displaced workers to find new jobs in growing parts of the economy. A wage setting system capable of providing appropriate price signals also helps facilitate structural adjustment. Flexibility in relative wages is particularly important, as it provides incentives for workers to react to structural changes that require them to change industry, to move to another region and to invest in training. Similarly, relatively high statutory or bargained minimum wages may hold back the development of low productive service activities. The *OECD Jobs*

Study, which is currently in the process of being reassessed for the 2006 Ministerial Council Meeting, points to a range of policy measures that can be taken to address these issues and help the labour market adjust to structural change.

Overly strict employment protection legislation may slow down adjustment and affect certain services

Labour market institutions may also directly affect the services sector. For example, overly strict employment protection legislation (EPL) may limit the development of services sector activities that are subject to large variations in demand, such as tourism and certain producer services, which can slow down the shift to services. Overly strict EPL may also have adverse effects on labour mobility and productivity growth by reducing the capacity of firms' to reorganise, experiment with new ideas or implement new technologies. This could reduce the growth of new jobs, thus hampering the re-integration of displaced workers. An easing of EPL has been recommended for several countries in OECD peer reviews, with the aim of finding an appropriate balance between worker's need for protection and economies' capacity to adjust and create new jobs.

High labour taxes may limit the expansion of personal services

Developments in services sectors may also be obstructed by high labour taxes or by indirect taxes. Labour taxes create a wedge between private and social returns on work and between do-it-yourself or informal work and market-based deliveries. High labour taxes may thus lower labour supply and encourage in-house or informal production. The personal services sector is likely to be most effected by high tax rates, as it relies disproportionately on workers with elastic labour supply (*e.g.* low-skilled workers and second income earners). Moreover, in-house or informal production of these services is often a viable alternative.

Addressing the tax burden may provide more jobs for low-skilled workers and would thus help facilitate labour market participation. Policy makers have several options; they can, for instance, lower labour taxes or reduce taxes on specific income groups that are particularly affected, such as low incomes or second income earners. They may also consider employment subsidies or other make-work-pay policies, which have proven effective in certain cases. Several countries have recently also introduced tax credits or subsidies for households employing domestic workers. Family-friendly policies, *e.g.* better access to child-care facilities or more flexible working time arrangements, are also important; they can help enhance labour force participation in the services sector, notably of women, and may have the additional effect of creating new services to help reconcile work and family life, *e.g.* in child care centres. The OECD peer reviews have provided recommendations to several OECD countries in these areas. The budgetary costs and possible distortionary effects of these policies must be acknowledged, however, and traded off against their potential benefits in enhancing labour market participation.

The services economy will require changing worker skills and organisational structures

The shift towards a service economy may also require changes to human resource and educational policies, as service firms may require skills that are currently in short supply, *e.g.* those required for specific trades or sectors, such as tourism, or for specific needs, such as ICT or innovation. Human resources are of great importance to services, as services delivery typically requires close interaction with customers. Many services sectors, for example, heavily rely on both ICT specialists and qualified ICT users. Moreover, services firms regard training as a key element of their innovation efforts. Having a good supply of qualified personnel is important, since many services sectors require highly-skilled workers, but education policies need to be supplemented with actions and co-financing by firms, workers and governments to foster life-long learning. Best policy practices to foster new (services) skills need to be developed, *e.g.* on improving the incentives for private financing of life-long learning and on ensuring equitable access to both formal and on-the-job learning. The development of quality certificates (*e.g.* of professional qualifications) and skills accreditation mechanisms are also important.

Stronger performance of services companies also often requires organisational change, as shown in Box 2. While organisational change is primarily a task for firms, governments can help reduce obstacles to workplace changes, *e.g.* by diffusing information on good practices widely. This may also require greater employee involvement in workplace change and ensuring that working time legislation and employment regulations support organisational innovation.

Removing tax obstacles to the expansion of the service sector

Cross-border trade in services raises difficult issues for tax policy

Governments will also need to re-examine potential tax barriers to cross border services and intangibles. A recent OECD survey shows that the interaction of EU and non-EU VAT systems and sales taxes may lead to unintentional double taxation. This is partially because there is no OECD-wide agreement on the application of basic consumption tax concepts that apply to the service sector (*e.g.* place of consumption of services) and no generally agreed principles to guide governments. The OECD has recently launched a study to examine how greater coherence can be achieved in this area.

A significant number of cross border services are provided by one part of a multinational group to another part. This raises difficult issues as to how the tax base associated with the services should be allocated between the countries in which the group operates. The OECD 1995 Transfer Pricing Guidelines provide guidance for governments and business on how to resolve these issues.

Despite the guidance provided in the OECD Model Tax Convention, tax disputes will arise between countries as to how to allocate the income associated with cross border services and intangibles. Such disputes are currently dealt with under the Mutual Agreement Procedures (MAP) of the OECD Model Convention. However, the number and complexity of cases giving rise to tax disputes is increasing, which can act as a barrier to the development of the service sector. OECD has recently launched a project to improve the MAP and to examine supplementary dispute procedures, including arbitration.

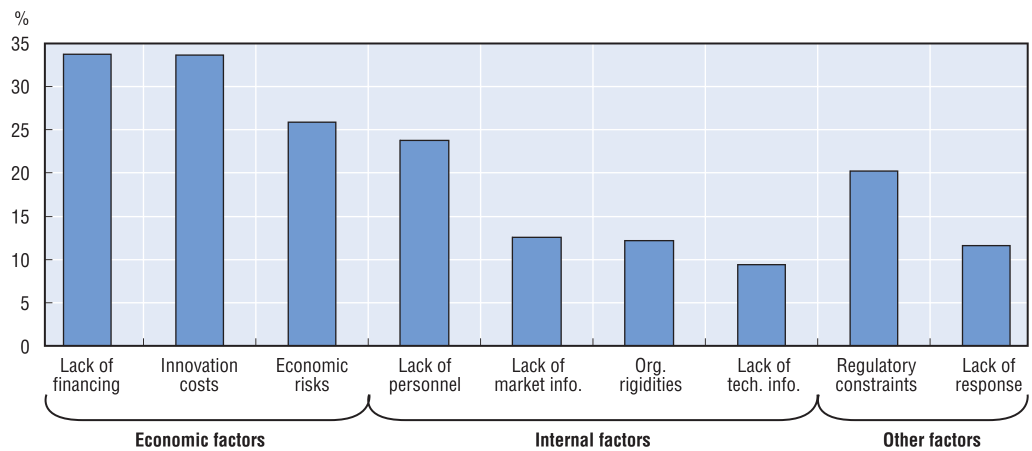
Adapting innovation policies to the growth of services

Improving the business environment may not be enough to stimulate services-sector innovation

While a more dynamic business environment for services firms, including greater openness to international competition, should do much to encourage greater uptake of advanced technologies and foster innovative activities, additional efforts may also be needed. As shown in recent OECD work on benchmarking, innovation in knowledge-based economies increasingly depends on the combination of entrepreneurship, ICT, innovation and human capital. ICT is particularly important for services sector innovation, as it is enabling firms in a wide variety of services industries to engage in process innovations throughout the value chain, develop new applications, and raise productivity. However, despite a high degree of innovation in the services sector, notably in financial and business services, innovation policies have thus far focused primarily on the manufacturing sector. Services firms face several barriers to innovation, however, some of which may be susceptible to policy action (Figure 7). While few OECD countries currently have policies specifically aimed at fostering innovation in services, the experience of countries such as Denmark, Finland and Norway, that have recently launched new initiatives, may help develop good policy practices.

Figure 7. **Services firms face several barriers to innovation**

Percentage of European firms identifying a factor as highly relevant, as a share of all firms expressing relevance, 1998-2000



Source: OECD, based on Eurostat, Third Community Innovation Survey, 2004.

Public R&D should more explicitly address services sector needs

The financing of innovation remains an important barrier for services firms, perhaps more so than for manufacturing firms. This is partly because firms in certain service industries, such as business services, are quite small, which typically implies more restricted access to private financing.

Well-developed and regulated financial markets are crucial to improve access to private finance. At the same time, there are good reasons to expect that private firms may sometimes invest less in innovation than would be socially desirable. Governments may therefore look to provide support, *e.g.* through tax credits or grants schemes. Such schemes are well established in most OECD countries. However, most services firms spend little on formal R&D, but innovate through deployment of new technology, notably ICT, training and investment in intangible assets, *e.g.* design, marketing or organisational change. These intangible investments are typically poorly reflected in business accounts, which may limit the access of service firms to financial markets and may also make it difficult to benefit from government support, *e.g.* R&D tax credits. Work to address this issue, including how to account for intangible assets, is currently underway at OECD and will be reported to the 2006 Ministerial.

Public spending on basic R&D, in both public laboratories and universities, does not typically address the long-term knowledge requirements for services, *e.g.* in improving the understanding of how technology should be deployed and used or of how people work in groups. Developing such long-term research needs would benefit from a greater involvement of services firms in the formulation and implementation of research. Funding for long-term research should be allocated by competitive procedures, with scientific excellence, relevance and merit as the main conditions. Partnerships between the public and private sector, competitive funding mechanisms, and regular evaluation of support are some ways to make such research effective.

Technology diffusion policies need to be broadened

Since co-operation between firms is of growing relevance to innovation, policy should also aim to improve networks between services firms and within the economy-wide innovation system. It is also important to broaden technology diffusion policies, as these sometimes focused on manufacturing firms. Stronger links to public research institutions could improve the innovative capabilities of service firms and the relevance of public research to service needs.

IPR plays a limited, but growing role

Intellectual property rights are of limited but growing importance to innovation in services – especially in knowledge intensive business services like software, computing, R&D services and communications. Services firms typically do not regard weak protection of intellectual property as a major barrier to innovation; they rely more on secrecy and lead time to protect their competitive advantage. Nevertheless, IPR could become more important as competition increases and market fragmentation declines; already the number of patents filed by innovative services firms has grown. In some OECD countries, patent protection has been extended to service-related inventions, such as software and business methods, creating differences in the international treatment of such inventions and leading to concerns about the balance between innovation and technology diffusion. Greater harmonisation could reduce uncertainty for patent holders, but policy makers should be aware that changes in the patentability of software and business methods often have implications on innovation in other industries. Ensuring that the patent system continues to serve its dual role of providing incentives to invention and facilitating technology diffusion will require continued vigilance by policy makers.

Another important barrier to innovation that may require action relates to standards. The quality of a service can often only be judged when it is being consumed. National and international services standards may help improve the quality of services, may help consumers in making an informed choice between different services, and can also increase market transparency and competition. They may also help establish larger and sufficiently integrated markets. Standards are usually best developed by business, but governments can provide frameworks to facilitate co-operation and information exchange.

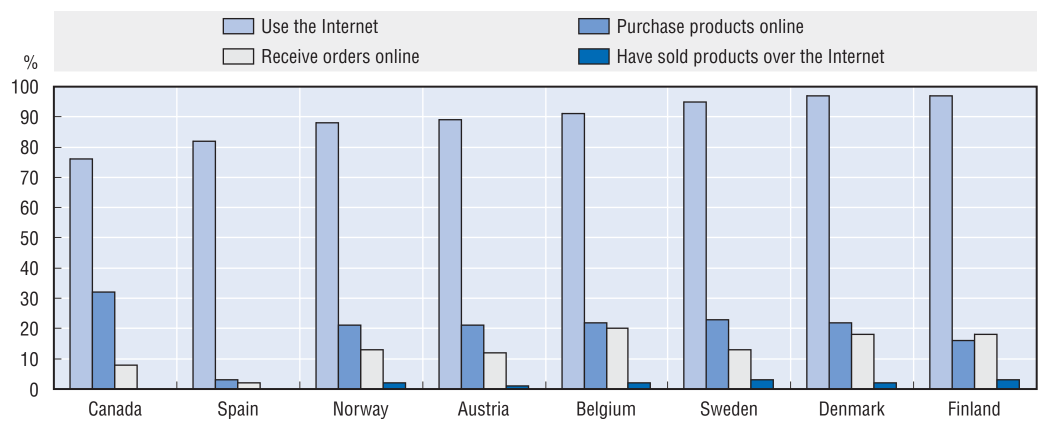
Seizing the benefits from ICT in services

Further efforts are needed to seize the benefits of information and communications technology in the services sector

Governments can also help firms in seizing greater benefits from ICT. OECD work has shown that much of the services sector is being transformed by ICT. ICT-related changes are closely integrated with other factors identified in the OECD work on benchmarking, *e.g.* entrepreneurship, innovation, human capital and organisational change. ICT can help services firms to introduce new business models, develop new applications, improve and re-invent business processes, enhance customer services and raise efficiency throughout the value chain. However, despite increased ICT use, the uptake and integration of more sophisticated electronic business applications remains relatively limited (Figure 8). While a sophisticated use of ICT may not be required in all firms, inappropriate rules and regulations may also contribute to the lack of integration.

Figure 8. **High business connectivity but low e-commerce adoption, 2003 or most recent year**

Percentage of all firms



Source: OECD Information Technology Outlook 2004.

While ICT has already spread widely in many OECD countries, the development of efficient, low-cost and broadly diffused networks remains a high priority. This will require continued efforts to improve competitive conditions for telecommunication services. Broadband networks are particularly important, as they offer new opportunities for many services, including health, education and government. As set out in the OECD Council Recommendation on Broadband Development, government policy needs to encourage effective competition and continued liberalisation in infrastructure, network services and applications to foster broadband networks. It also needs to maintain transparent, technologically neutral and non-discriminatory market policies that encourage R&D and investment in new technological infrastructure, content and applications.

Regulatory barriers impede electronic business and digital delivery of services

Further efforts will also be required to develop regulatory frameworks and technological solutions (*e.g.* certification, authentication) that can enable electronic business and the digital delivery of services, *e.g.* health, financial services, tourism, distribution or logistics, and that foster a "culture of security". In many OECD countries, surveys show that privacy and security concerns remain among the key barriers to ICT use. Much work is currently underway at the OECD and elsewhere to develop and adopt information security strategies to ensure that users have sufficient trust in using network services and applications. An important challenge is to ensure the adherence to regulatory frameworks and the effective enforcement of privacy and consumer protection. Achieving these goals will require strong cross-border co-operation between all stakeholders.

Regulations and administrative rules, often dating from a time that electronic business and digital delivery were not yet an option, may also affect the ability of firms to develop ICT services or deliver services through digital means. For example, the regulatory treatment of physical and non-physical products often differs, and insurance and payment schemes are often ill adapted to the digital delivery of healthcare. Similar regulatory barriers exist in many other services where electronic business and digital delivery have become possible.

Further consideration should be given to policies that can foster electronic content

The development of digital content and services, thanks to the diffusion of high-speed broadband, also raises new challenges. Policies in this field should ideally focus on removing obstacles for firms entering this market and addressing regulatory challenges in the field of intellectual property, digital rights management and inter-operability. The development of content and related services will require regulatory frameworks that carefully balance the interests of suppliers and users, *e.g.* as regards the protection of intellectual property and the management of digital rights. Such regulatory frameworks should be sufficiently flexible and not disadvantage innovative business models.

Governments can also take action themselves. Developing public services and digital content, *e.g.* providing public information, collecting taxes or procuring goods and services on line, fostering e-health and e-education can help increase government efficiency and transparency and enhance access to public services, while having the additional benefit of fostering use and building public confidence.

Conclusions

A well-functioning services sector is key to the overall economic performance of OECD countries and to the welfare of its citizens. Reform of services sector policies provides an important opportunity for policy makers to strengthen employment, productivity and innovation. It will also help in strengthening the capacity of OECD economies to adjust to economic globalisation in services and to the growing importance of services for the future growth of OECD economies. The policies outlined in this report can contribute to such reform and are mutually reinforcing. This is important since seizing the new growth opportunities in the services sector will be possible only through a comprehensive strategy based on a policy mix that is suited to each country or circumstance.

Several OECD countries have already undertaken reforms and have achieved stronger growth performance in services. This has resulted in more jobs, stronger productivity growth and higher incomes. Moreover, a more productive services sector also underpins better performance of other sectors, notably the manufacturing sector, as this increasingly relies on support and inputs from efficient and cost-effective producer services. While not all services sectors have expanded and some have declined in size, the overall impacts of reform have been very positive.

Enhancing the performance of services will require further consideration by policy makers. In areas where best policy practices are still being developed, it is important that governments tread carefully and avoid actions that could harm service sector growth. Moreover, further improvements in the knowledge and statistics about the drivers of performance in different services sectors would help in developing, monitoring and evaluating suitable policies for the services sector.

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