Challenges for Business Services in European Economic Growth

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Structure presentation

- Stylised facts on growth of EU business services
- Problem: dynamic, but weak productivity growth
- Direct and indirect growth contributions
- Challenges and opportunities
- Conclusions
### Business services: heterogeneous set of B2B services

#### Business services

<table>
<thead>
<tr>
<th>Knowledge intensive-business services (K.I.B.S.)</th>
<th>Operational business services</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Software and computer services</td>
<td>* Security services</td>
</tr>
<tr>
<td>* Strategy and management consultancy</td>
<td>* Equipment renting</td>
</tr>
<tr>
<td>* Auditing, accountancy, tax and legal advise</td>
<td>* Facility management, cleaning</td>
</tr>
<tr>
<td>* Marketing services, opinion polling</td>
<td>* Administration, bookkeeping</td>
</tr>
<tr>
<td>* Technical services, engineering</td>
<td>* Temporary labour recruitment</td>
</tr>
<tr>
<td>* Personnel training, headhunting</td>
<td>* Other operational services (e.g. catering, translation, call centres)</td>
</tr>
</tbody>
</table>

#### Business services in EU: strong dynamism in two last decades

- **Its dynamism outperformed most other economic sectors:**
  - in value-added growth
  - in employment growth

- **More than half of total net employment growth (EU15, 1979-2003) was in business services (54%)**

- **BS now generates about 12% of total EU15 value added**
  - Is one of the largest sectors in the modern economy
Business services: sloppy productivity growth

- **Disturbing, because:**
  - Concerns 19.5 million jobs in 2003 (EU15)
  - BS is one of the main producers of intermediary inputs in the economy
  - ... increasing use of BS inputs over time
  - Due to productivity stagnation: relative input price increase
    (→ EU competitiveness? Lisbon goals)

- Productivity growth in EU services differs widely, but BS and financial services are consistently poor performers
  ⟨O’Mahony and Van Ark 2003⟩

- Productivity performance worst in operational business services (non-KIBS):
Causes structural BS growth: 2 main explanations

A. Change final demand structure (high income elasticity of services, privatisation, shifting consumer preferences)
   --> although: intermediary status BS

B. Shifts in inter-industry division of labour (technology, organisation):
   - BS growth is optical illusion, caused by outsourced in-house services functions: just a "change of name plates"?
   - New development stage in inter-industry division of labour (specialisation, change in scale economies)?

Which explanation dominates is a matter of empirical research (that to a large extent still has to be done)
Evidence for the "change of name plates theory is not strong

- Number of service-related jobs in manufacturing is increasing rather than decreasing...

Employment share of services-related occupations in manufacturing, EU 1995-2005

Note: Services-related occupations cover ISCO classes 100-500; 833, 910, 933. Data source: EU Labour Force Survey 1995, 2002
Evidence for the "change of name plates" theory is not very strong

- Number of service-related jobs in manufacturing is increasing rather than decreasing

- Moreover, this theory can hardly explain that BS sector itself has become the largest (or one of the largest) users of BS inputs....

Intermediate demand for BS inputs: ranking of the main destination sectors, selected countries, period 1994-1998

<table>
<thead>
<tr>
<th>Rank of business services as destination sector</th>
<th>Five most important destination sectors of intermediate BS inputs, ranked by importance</th>
<th>Share (%) of Business Services in intermediate demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>BS - MFG - PUB - FIN - THC</td>
<td>26.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>BS - MFG - THC - PUB - FIN</td>
<td>24.9</td>
</tr>
<tr>
<td>France</td>
<td>MFG - BS - PUB - FIN - CON</td>
<td>24.2</td>
</tr>
<tr>
<td>Germany</td>
<td>MFG - BS - PUB - REA - THC</td>
<td>17.1</td>
</tr>
<tr>
<td>Italy</td>
<td>MFG - THC - BS - PUB - FIN</td>
<td>14.2</td>
</tr>
<tr>
<td>Spain</td>
<td>MFG - PUB - BS - THC - CON</td>
<td>13.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>CON - THC - PUB - MFG - BS</td>
<td>12.9</td>
</tr>
<tr>
<td>Finland</td>
<td>MFG - PUB - THC - BS - REA</td>
<td>8.1</td>
</tr>
<tr>
<td>Greece</td>
<td>MFG - THC - PUB - CON - TRA</td>
<td>8.1</td>
</tr>
<tr>
<td>USA</td>
<td>THC - BS - PUB - MFG - FIN</td>
<td>17.7</td>
</tr>
</tbody>
</table>

Note: a) The sector codes are: MFG: manufacturing; BS: business services; FIN: financial services; PUB: public sector; THC: trade, hotels and catering; TRA: transport and storage; CON: construction; REA: real estate. Source: The country data are based on the most recent IO table available in the OECD database over the period 1994-1998. OECD input-output tables, OECD/NEI (2004).

Source: Rubalcaba and Kox 2007
Evidence for the "change of name plates" theory is not very strong

- Number of service-related jobs in manufacturing is increasing rather than decreasing
- Moreover, this theory can hardly explain that BS sector itself has become the largest (or one of the largest) users of BS inputs....
- Some researchers find that a substantial part of BS growth did come from final demand, which seems at odds with the 'name plates' theory (assumes intermediate demand)
- If the "change of name plates" applies, it will probably be most important in operational business services where simple outsourcing does occur...

Structural growth of KIBS

- **KIBS outsourcing mostly goes along with:**
  - innovation (products, process)
  - specialisation (in human capital)
  - replacement of *internal* scale ‘indivisibilities’ regarding to human capital by *external* scale economies
  - → especially important for growth of SME

- **KIBS represent change in inter-industry division of labour**
  - growing complexity in intermediate deliveries: "human-capital deepening"
  - 1% growth in final demand necessitates >1% growth in demand for intermediate inputs from KIBS (Nordás & Leecher 2006)
  - allowing a a higher-level growth path:
Correlation between GDP per capita and share of BS in total employment, EU countries 2000

Growth and spillover effects from KIBS use

- Knowledge products typically are non-rival in their use,...
- ... can be copied relatively easy, so that appropriation of full innovation rents is difficult,...
- ... which explains why economic spillover effects from KIBS use are likely to occur:
  - value added of the KIBS sector underestimates the sector's contribution to overall economic growth

- Three types of spillover channels for other industries
  - original innovations (R&D, software, engineering)
  - speeding up of knowledge dissemination ('best practice' consultancy)
  - reducing human capital indivisibilities (especially for SME)
Evidence on spillover effects from KIBS use

- Strong evidence of growth and productivity spillover effects resulting from the use of software and computer services (cf. Rubalcaba & Kox, Palgrave 2007)

- Evidence on growth and productivity spillover effects resulting from the use of Other Business Services (consultancy, legal, accountancy, technical services) is mixed, less convincing

- Moreover, we cannot exclude that some of the recent spillover effects had a temporary or one-off character, or have diminishing returns....

The future growth challenge:

- Will the low productivity growth in BS be compensated by an at least equivalent flow of growth / productivity spillovers to client industries?

- Otherwise, the large BS sector may contribute to 'Baumol disease':
  - economic growth stagnation due to the increasing economic weight of a low-productive services sector

- Critical factors:
  - Flow of original innovations originating from BS firms
  - Are small productivity improvements in BS firms passed on to client industries?  
    --- role of market transparency, pricing, competition
Opportunities (1)

- Evidence that suboptimal firm scale may be an important source of sub-standard productivity performance in European BS industry
  - Minimum-efficient firm size in BS at approx. 20 employed persons, ...
  - ... while 95% of BS firms in Europe has <10 employed persons
  - Hence: role for scale economies within BS sector
  - E.g. supported by policy that lowers administrative burden for smallest firms

Opportunities (2)

- Opening-up of national BS markets: more exposure to international competition:
  - European Services Directive as a first step
  - GATS agreement?
  - Better and less restrictive national product-market regulation

- More policy support for innovation in / by services firms
  - So far emphasis in most EU countries is on supporting innovation in 'goods-producing' industries,...
  - ... so a more balanced approach may be beneficial

- "Offshoring"
  - may create new sources of efficiency growth in BS sector
Conclusions

- Fast growth value-added and employment in BS sector not matched by improvement in productivity
- Problem is largest in operational BS sectors (non-KIBS)
- KIBS growth represent a new stage in social division of labour between sectors (scale and specialisation in human capital)
- KIBS contribution to aggregate economic growth is partly based on spillover effects
- The future challenge is to improve the productivity growth record of the BS sector and to maintain flow of innovations
- Markets can perform better in passing on productivity improvements to clients
- Several policy 'handles' can be used to achieve these goals

Thank you for your attention

"Business services and the changing structure of European economic growth"

available from website:

www.cpb.nl
Relative labour-productivity by firm size

POOLED DATA 12 EU COUNTRIES

benchmark size class

- 1997
- 1999
- 2001

Calcs. from NewCronos data