Cut to the chase

Boosting productivity in the services sector

May 2014

The Productivity Commission was asked by the Government to build a better understanding of the services sector and find ways to lift its productivity. The final report follows an issues paper and two interim reports. The Commission considered 56 submissions, met with over 60 interested parties, and surveyed 1 526 businesses.

The inquiry examined in depth two topics critical to lifting productivity: stimulating competition and adopting information and communications technology (ICT).

The role and performance of the service sector

The services sector is large, diverse and interlinked with the rest of the economy. New Zealand's economy, like most in the OECD, is services-based. Services account for around 70% of GDP and an even larger share of employment.

Service industries are diverse. Some, such as accommodation and food, are made up of small, dispersed businesses serving local markets. In others, such as media and banking, large and sophisticated businesses serve the national market.

New Zealand's primary and goods producers spend around 40% more on services than on wages and salaries, and could not function without an effective services sector. Services are a major input into the production of other services and contribute more than half of the value of New Zealand's exports.

New Zealand's overall labour productivity has been below the OECD average since the 1970s and shows few signs of catching up. The services sector has contributed to this continuing gap. While performance differs considerably between industries, the sector overall has not achieved the productivity boost observed in the US, Australia and some other OECD economies since the mid-1990s.

Increasing competition in the services sector

Relatively subdued competition in some service industries reduces incentives to innovate and holds back productivity growth. The high costs of trading some services, combined with low population density and economies of scale in production, result in less choice and competition.

The main opportunities to strengthen competition are: reducing barriers to trade; enhancing the capacity of consumers to drive competition; improving occupational regulation; and sharpening competition law.

Reducing barriers to trade

Geographic remoteness reduces New Zealand's exposure to competition from foreign service providers. Small domestic markets also contribute to the relatively low intensity of competition in some New Zealand service markets.

In a 2012 joint study of trans-Tasman economic relations, the Commission and its Australian counterpart recommended reducing barriers to trans-Tasman trade in services. The Government should complete the implementation of those recommendations and build on them by reducing barriers to international trade in services with other countries.

Enhancing the role of consumers

Well-informed consumers, able to switch between suppliers, increase competition. The inquiry considered three ways to reduce search costs (ie, finding a preferred supplier) and switching costs (ie, changing suppliers).

First, comparison websites reduce search costs by comparing prices and other product attributes. While privately-owned sites are less common in New Zealand than in some other countries, governments should only become involved if they are convinced that interventions would increase competition and pass a cost-benefit test.

Second, government-mandated information disclosure can be a light-handed way to reduce search costs provided that information is accessible and understandable, and that business compliance costs are minimised.

Third, recent legislation to prohibit the use of certain "unfair contract terms" should assist competition. However, this law does not apply to businesses as consumers of services and should be reviewed two to four years after coming into effect.

Improving occupational regulation

Occupational regulation regimes are common in the services sector. These regimes help consumers choose a service supplier, but may reduce competition by restricting entry. Activities requiring licensing should be prescribed no more broadly than is needed, and legislation establishing professional bodies should include obligations to support a competitive market for the professional service and to establish a well-functioning complaints resolution and reporting system.

Sharpening competition law

Section 36 of the Commerce Act aims to deter dominant firms from misusing market power. While this section has both supporters and critics, the Commission considers that it should be reviewed, through legal and economic analysis that assesses how reform options would improve dynamic efficiency and benefit consumers.

Competition law should not prevent collaboration among firms that enhances innovation and efficiency. Proposed law changes that are likely to affect business collaboration and innovation should be reviewed two to four years after implementation.

Competition authorities in many countries undertake market studies into the state of competition in markets. The Commerce Commission should be given powers to conduct market studies in any market in the economy.

Accelerating the adoption of ICT

ICT is affecting most service industries, transforming some and creating opportunities to boost productivity. It allows some services to be more easily traded and provides opportunities to expand service exports.

However, New Zealand firms have been relatively slow to adopt ICT, owing in part to difficulties in attracting capital, and to gaps in information and skills. Faster adoption could boost productivity growth.

Improving framework policies

Some government policies focus specifically on ICT. Other "framework policies", such as labour market, education and infrastructure policies, apply more widely but also influence the adoption of ICT.

New Zealand's small size and remoteness means that it needs particularly good policies. For example, although New Zealand's labour market regulation is generally rated as relatively "flexible" in international comparisons, the ICT revolution is likely to place a premium on such flexibility into the future, to make it easier for more innovative firms to grow and less productive ones to exit.

Growth and productivity enhancement require change. So New Zealand needs to find ways to facilitate change in order to encourage growth and productivity.

Improving ICT skills

Skill shortages can lead to low investment in new ICT and less effective use of existing ICT. New Zealand employers compete for ICT skills in a tight international market. New Zealand's immigration policy appears to be working reasonably well in enabling skilled migrants to fill ICT vacancies.

Poor linkages between the business and education sectors make it difficult for tertiary education providers to prepare students for ICT careers. Publishing information about what students can gain from qualifications from particular institutions would increase incentives for educators to tailor their qualifications to the needs of students and industry.

Computer science graduates could be encouraged to undertake a one-year programme in business studies, to prepare them for work in ICT-intensive firms. Closer collaboration among small firms and tertiary education providers could also improve the supply of "work-ready" ICT graduates.

Reducing regulatory barriers to adopting cloud computing

Cloud computing offers many benefits. Its products and services are "scalable", which helps firms that are small and/or variable users. It expands choice and helps to intensify competition and drive down prices.

The Government has been a strong adopter of New Zealand-located cloud services but appears to be missing opportunities to use lower-priced offshore services. It should address data sovereignty, security and privacy risks associated with offshore cloud services through international negotiations, with Australia in the first instance.

The importance and rapid rate of change of cloud computing create regulatory challenges. The Government should pursue free-trade-in-data agreements with other countries, with the aim that data owners' rights and responsibilities are not affected by the data's physical location.

Five themes to guide services sector policy

First, internationalisation expands markets and stimulates competition. Internationalisation requires policy attention to the free flow of goods, services, capital, labour, data, ideas and technologies.

Second, successful innovation requires the flexibility to adjust. Regulation needs to facilitate rather than impede change.

Third, experimentation fosters innovation. Policy that locks in firms, or prescribes business models or market boundaries, can discourage innovation.

Fourth, quality regulation and institutions underpin well-functioning, efficient markets.

Fifth, Government is an important player in the sector, as a regulator, provider and purchaser of services. Many of its actions affect services sector productivity.

Implementation

The recommendations in this report, if implemented effectively, would contribute significantly to lifting the sector's productivity. Cabinet should monitor progress toward implementing accepted recommendations to ensure that they make the largest possible contribution to improving the productivity of this important part of New Zealand's economy. The Commission hopes that this inquiry will stimulate an ongoing conversation about ways to improve productivity in the services sector.

The full version of the report is available at www.productivity.govt.nz.

The **New Zealand Productivity Commission** – an independent Crown Entity – conducts in-depth inquiries on topics selected by the Government, carries out productivity-related research, and promotes understanding of productivity issues.

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