



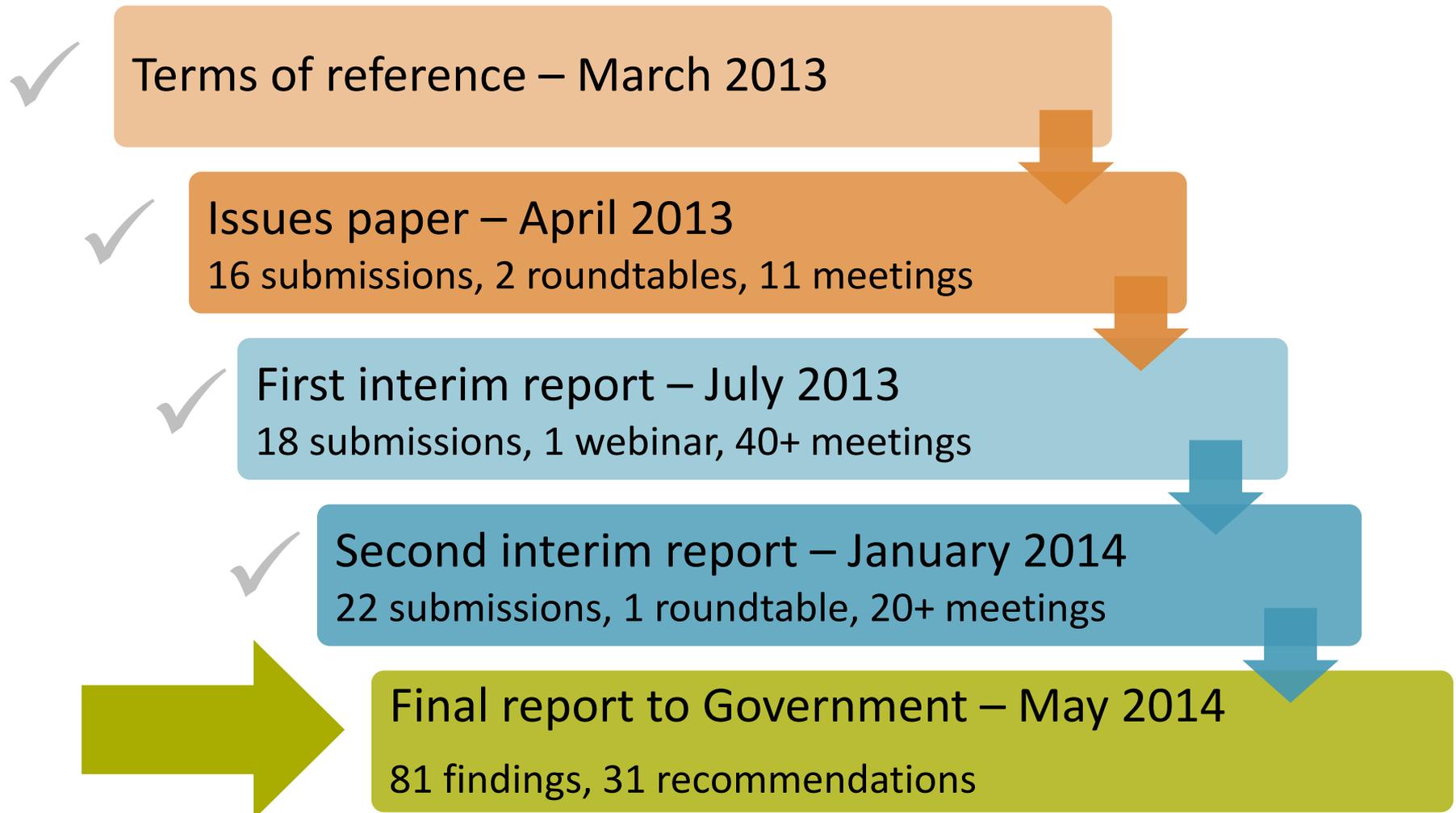
Boosting productivity in the services sector

Final report
May 2014

Terms of Reference

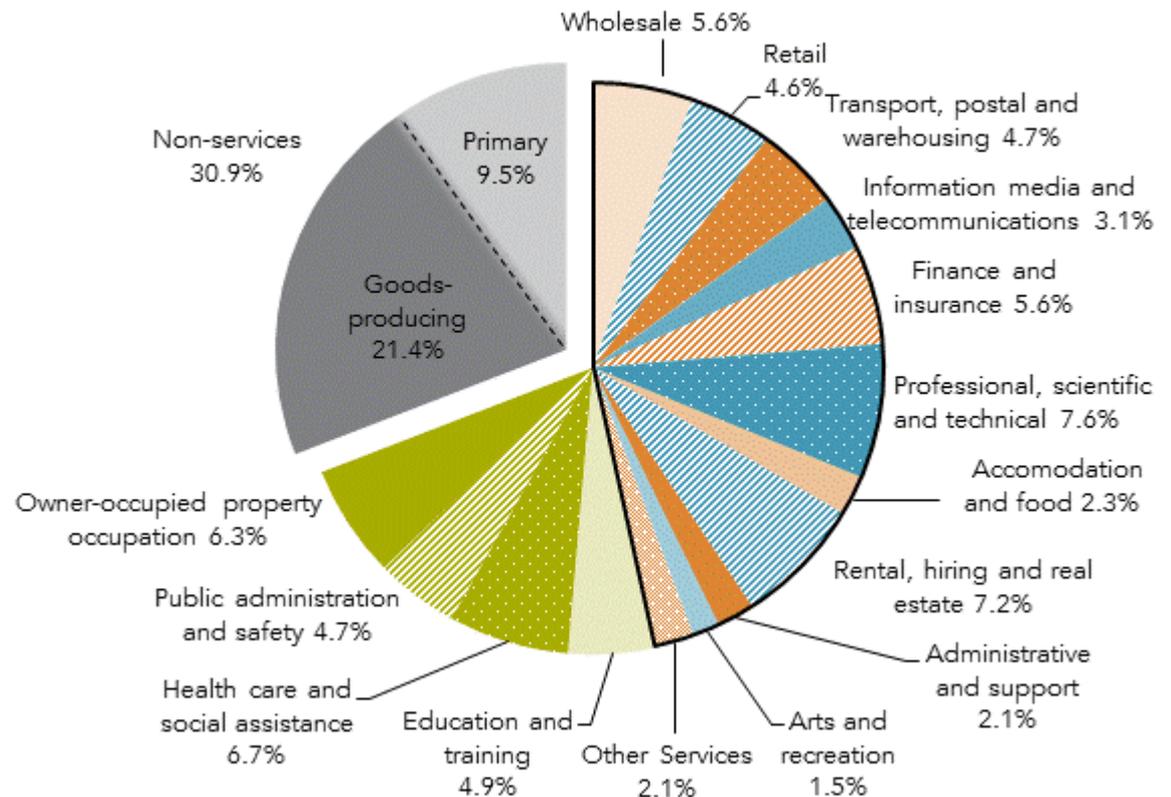
- Part A – an overall assessment of the role and performance of the services sector including:
 - What’s the role of services in the economy and what’s been their impact?
 - How has the sector performed relative to other OECD countries?
 - Has employment shifted to low-productivity industries?
- Part B – a deeper examination of selected topics which:
 - Have a significant impact on New Zealand’s productivity.
 - Lead to recommendations for changes to government policy.

Inquiry process



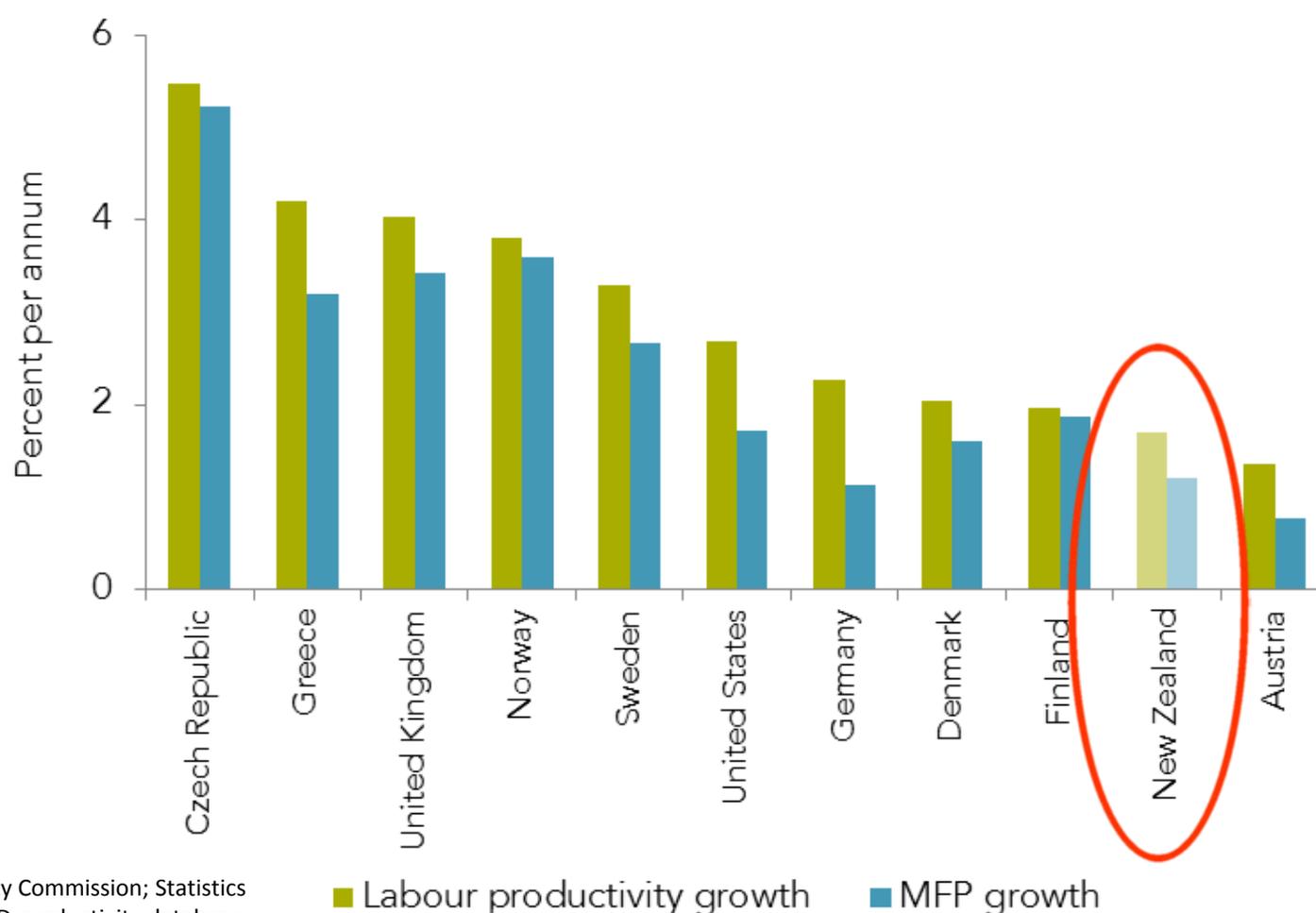
Context – Why the services sector?

- Around 70% of New Zealand's GDP.
- Policy attention tends to focus on primary and goods-producing sectors.
- Service industries have driven productivity growth in some other countries.

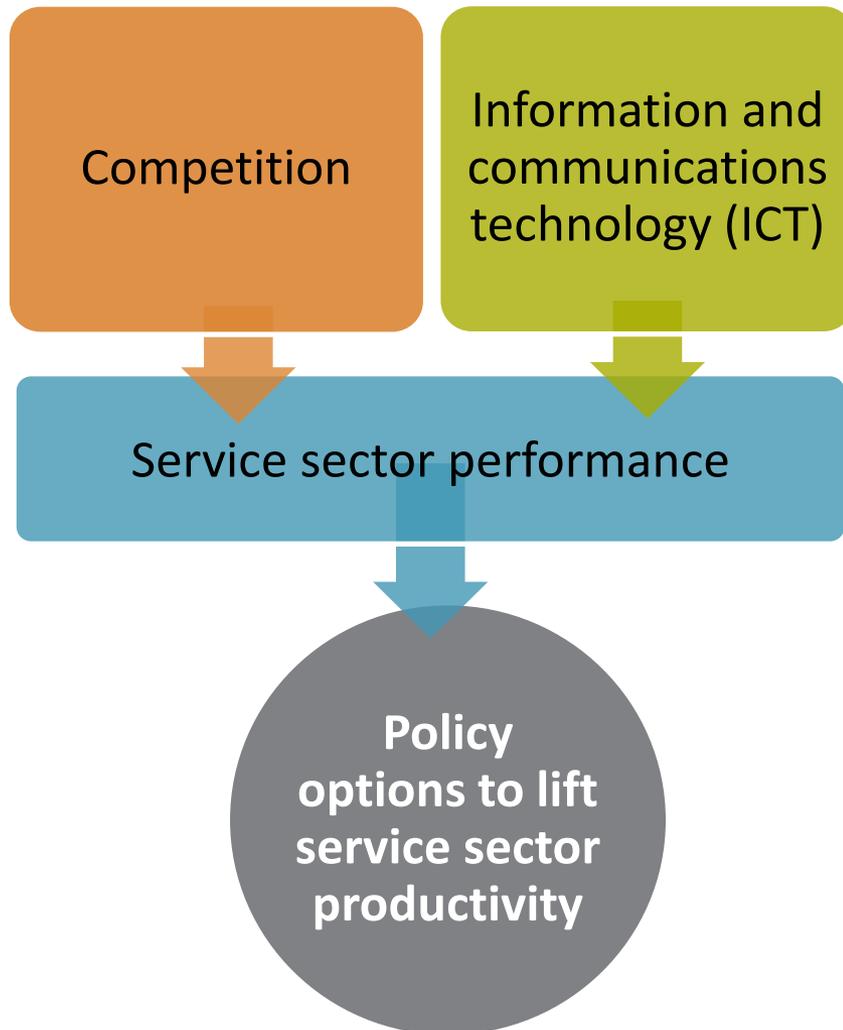


Part A - Service sector performance

NZ and OECD labour-productivity and MFP growth in business services, 2000-2007



Part B – Deeper examination of two issues



- Both are key drivers of productivity growth.
- Changes in both can help boost productivity across the services sector.
- Scope to boost the low intensity of competition in services
- ICT is revolutionising services

Key themes of the 2nd interim report

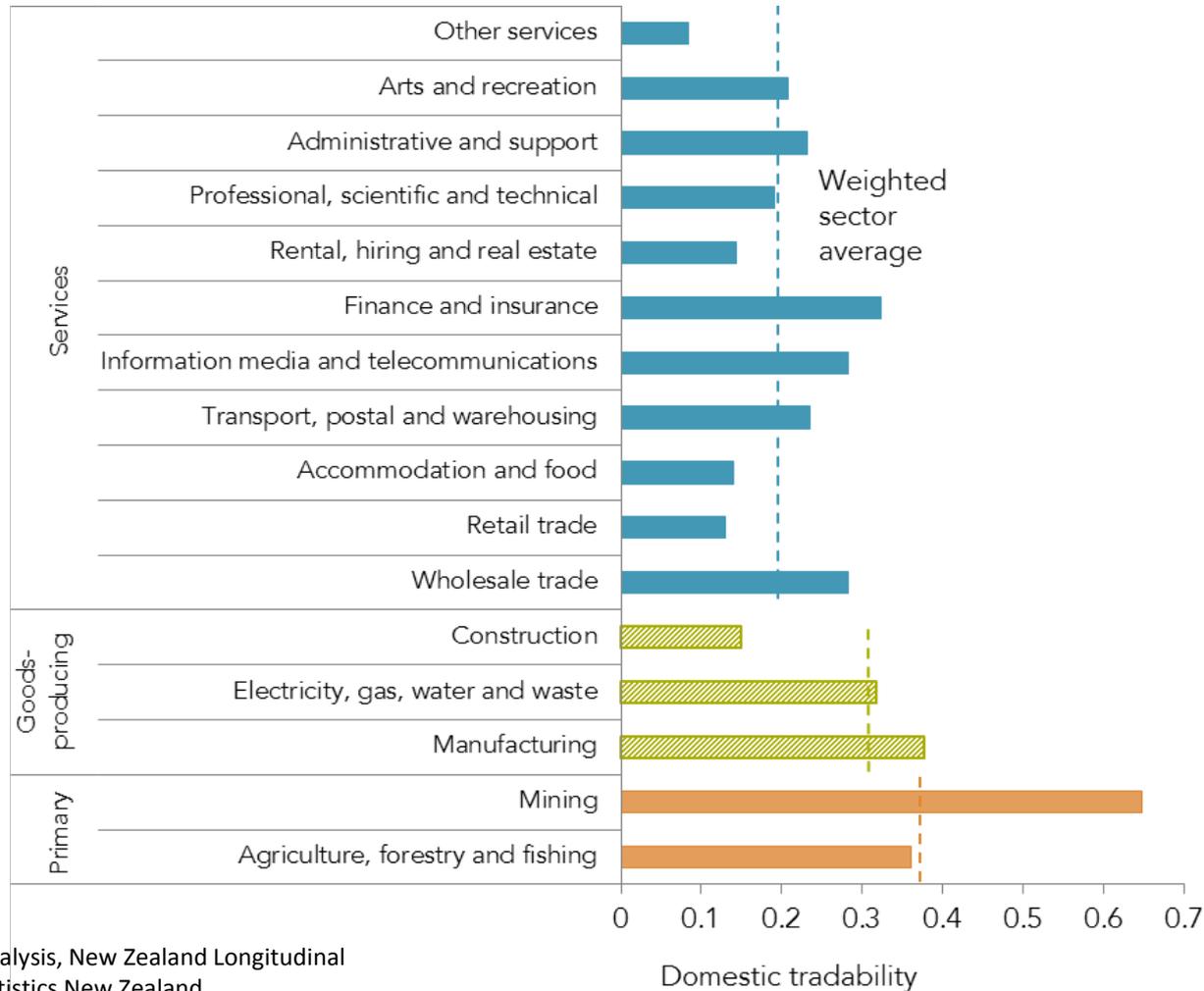
- Scope to sharpen competition in service industries:
 - i. Competition from overseas suppliers is important
 - ii. Informed consumers can enhance competition
 - iii. Competition law could be improved
- ICT is revolutionising services:
 - iv. NZ firms investment in ICT is lower and slower
 - v. ICT skills are in short supply
 - vi. Employers struggle to find the right mix of ICT and business skills
 - vii. Government should remove barriers to cloud computing

Competition less intense in the services sector

- Strong evidence that competition lifts productivity – drives efficiency and innovation.
- Certain characteristics of services (face-to-face, hard to check quality), diminish competitive intensity in many service markets.
- No single best measure of intensity of competition.
- The level of competition varies across service industries, but overall, services have less intense competition than the goods-producing and primary sectors.

i. One measure of intensity of competition

Domestic tradability by industry (2007)



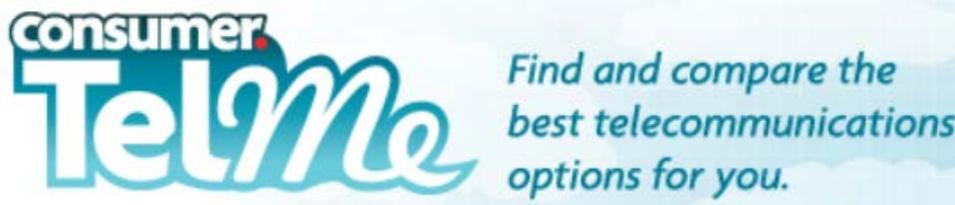
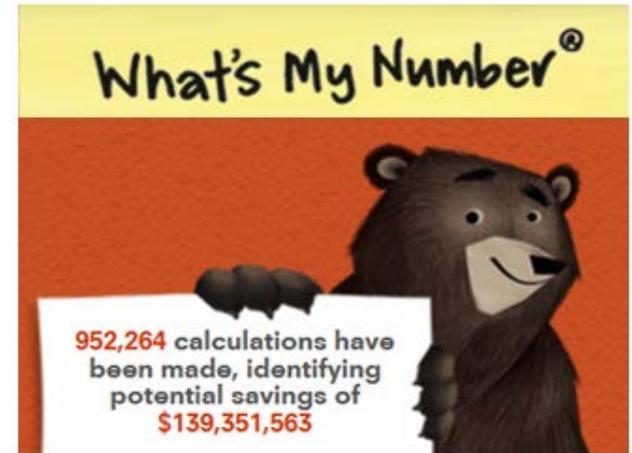
Source: Commission analysis, New Zealand Longitudinal Business Database, Statistics New Zealand.

ii. Informed consumers can enhance competition

- Confident and well-informed consumers advance their own interests, and stimulate businesses to keep on their toes and provide value.
- But consumers' contribution to driving competition muted when they can't easily compare offerings of different providers or change to a better provider.
- The costs of finding and comparing a supplier (**search costs**), and the costs of changing suppliers (**switching costs**) are significant in some parts of the New Zealand services sector.

Enhancing the role of consumers: comparison websites and professional bodies

- Comparison websites are under-developed in NZ
- Current law ok to enable action against inaccurate or misleading websites
- Govt should use regulation of professional standards to promote more competition in professional services



iii. Competition law could be improved

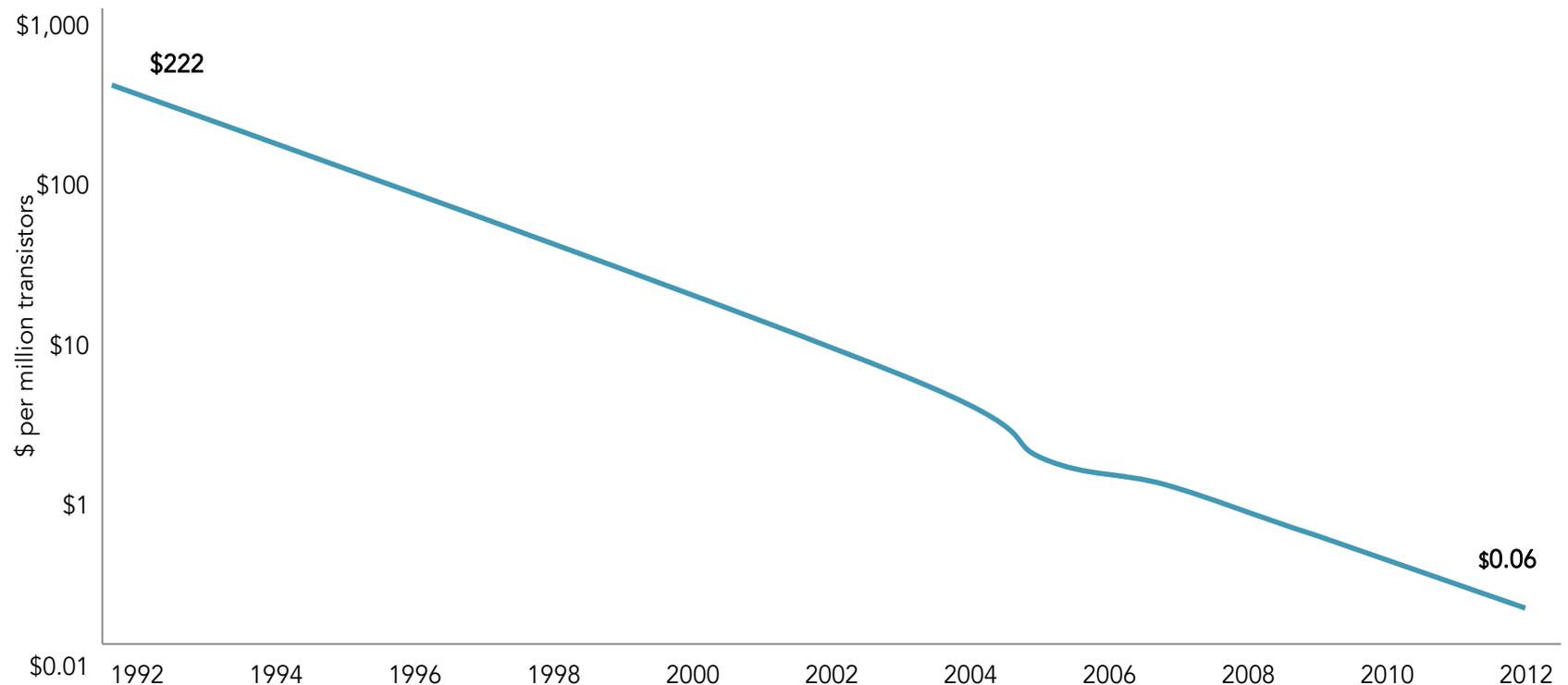
- Competition laws and institutions have a strong influence on the behaviour of firms and competition outcomes.
- New Zealand's approach to determining a **misuse of market power** is unusual, complex and imprecise.
- Difficult area to get right, and views divided on current approach. Enough grounds to justify a review of section 36 of the Commerce Act.
- Commerce Commission should have the ability to undertake **market studies** in any market – similar to its existing power under the Telecommunications Act.

ICT is revolutionising services

- ICT is a ‘general purpose technology’ (GPT) like steam, electricity and internal combustion engine in earlier eras.
- GPTs have widespread uses, get better over time, and spawn many innovations (spin-off technologies)
- ICT is highly disruptive of existing industries, employment, skills and business models. This puts a premium on adaptability and flexibility.
- Biggest impact on productivity comes from moving assets to new, more valuable uses.

Costs of ICT have fallen dramatically while quality has improved

Falling costs of transistors (US \$ per million), 1992 - 2012



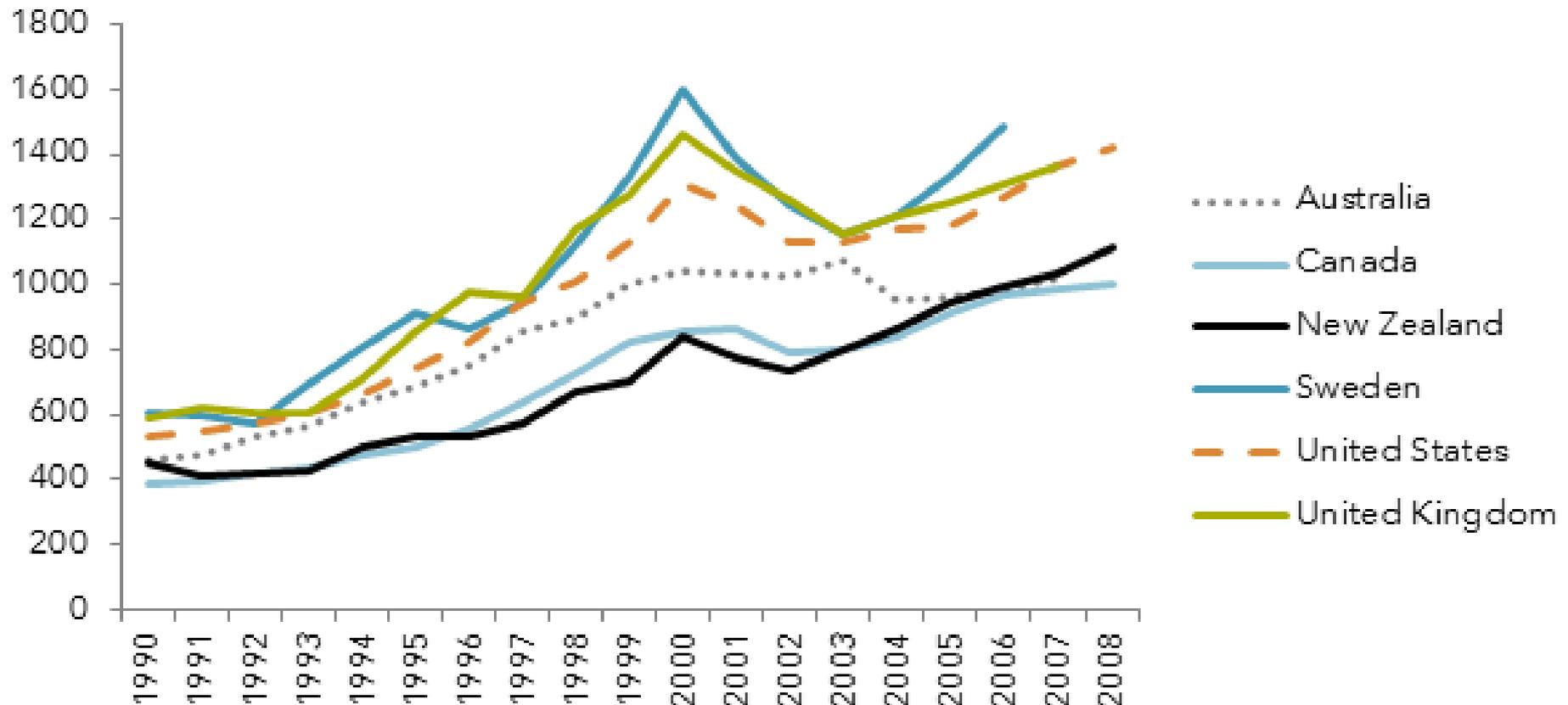
Source: Deloitte (2013)

iv. New Zealand firms ICT investment is lower and slower

- Research shows strong links between ICT and productivity in services, in both ICT's contribution to traditional service industries (eg., retail and wholesale) and in spawning new industries.
- Costs of ICT adoption are mostly high fixed costs. This makes ICT investment in smaller scale businesses (as in NZ) less attractive.
- ICT investment per person is lower than the US, UK and Sweden.
- To speed up firms' ICT adoption, policies and institutions need to enhance benefits and lower costs , e.g. by improving access to capital, knowledge and the availability of ICT technical and managerial skills.

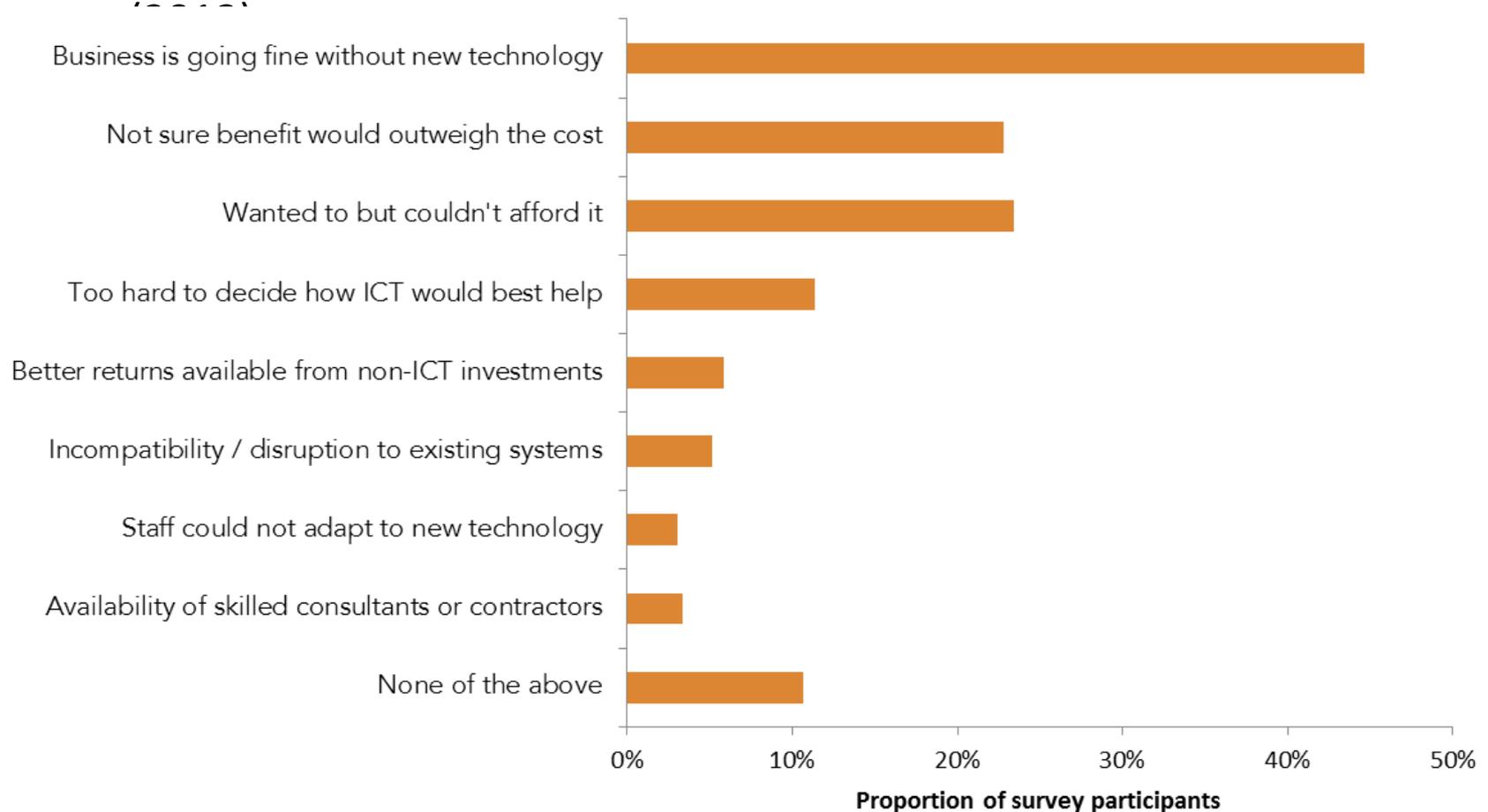
iv. New Zealand's ICT investment is lower and slower

ICT investment per capita (\$US)



iv. New Zealand firms' ICT investment is lower and slower

Why New Zealand firms that did not invest in ICT chose not to do so

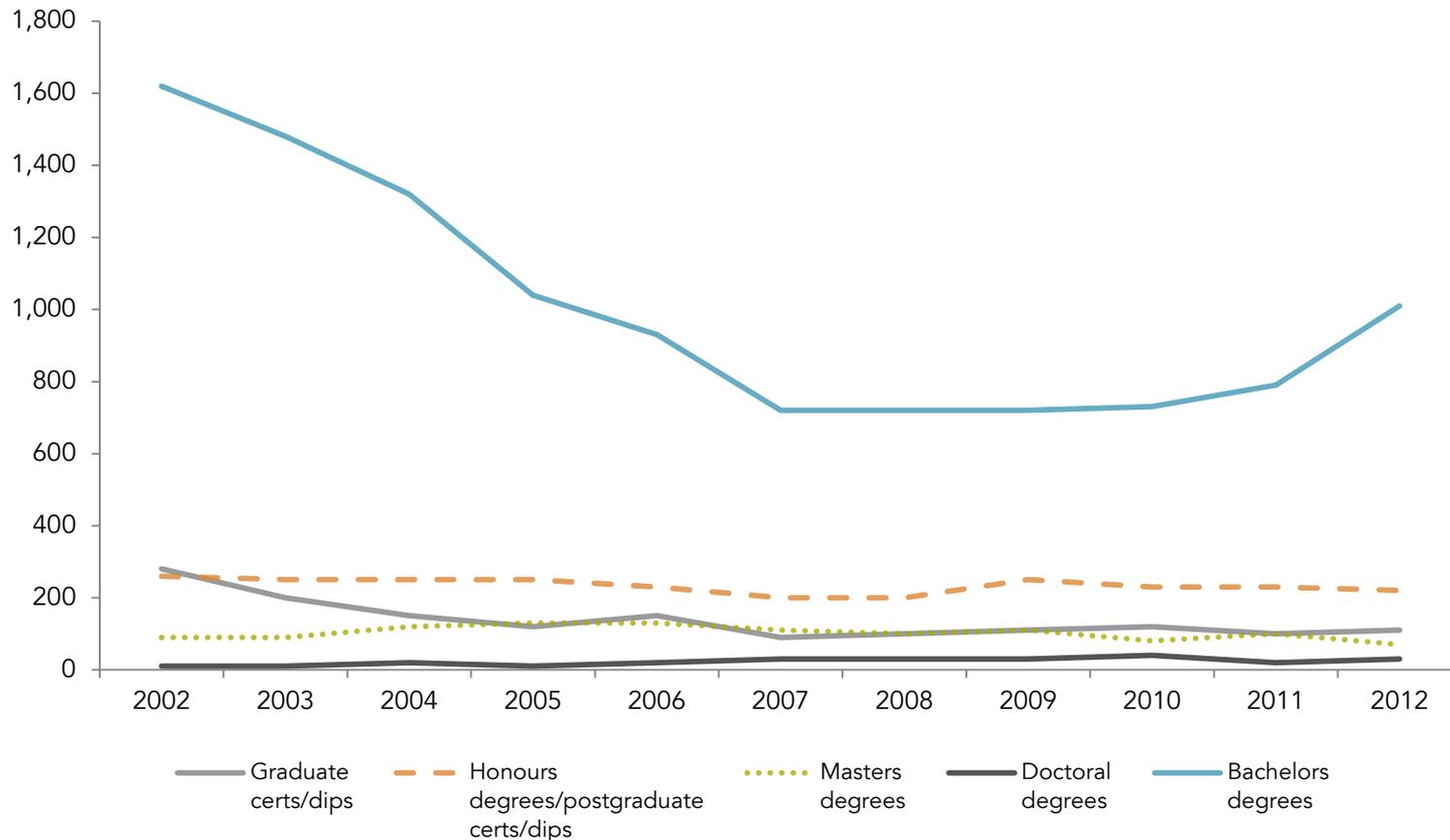


v. ICT skills are in short supply especially the right mix of ICT and business skills

- Skill shortages can lead to low investment in new ICT and less effective use of installed ICT.
- Shortage of ICT professionals world-wide, and New Zealand employers seeking ICT skills compete in an international market.
- Difficulties in recruiting could be alleviated through:
 - providing better information for intending students about employment outcomes of graduates from particular providers;
 - more one-year graduate diploma courses in business for computer science graduates – better prepare them for work in firms whose business strategy is based on IT.
 - TEC and MBIE encouraging greater collaboration among small firms and tertiary education providers.

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Trends in ICT degree completions by domestic students



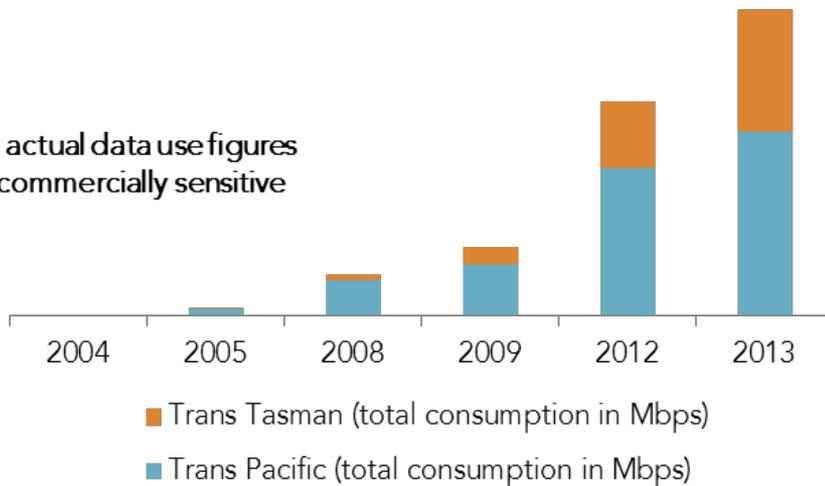
vi. Remove barriers to the uptake of cloud computing

- Cloud computing is changing the way in which ICT services are delivered around the world.
- It improves the scalability of ICT products – better for firms using ICT in smaller amounts, and creating a more level playing field for small, data-intensive New Zealand firms offshore (e.g. Xero).
- Small firms in NZ appear slow adopters of cloud computing - likely due to the costs of complementary investments and obtaining the relevant knowledge.
- No evidence international data connectivity is limiting adoption of ICT by New Zealand firms.

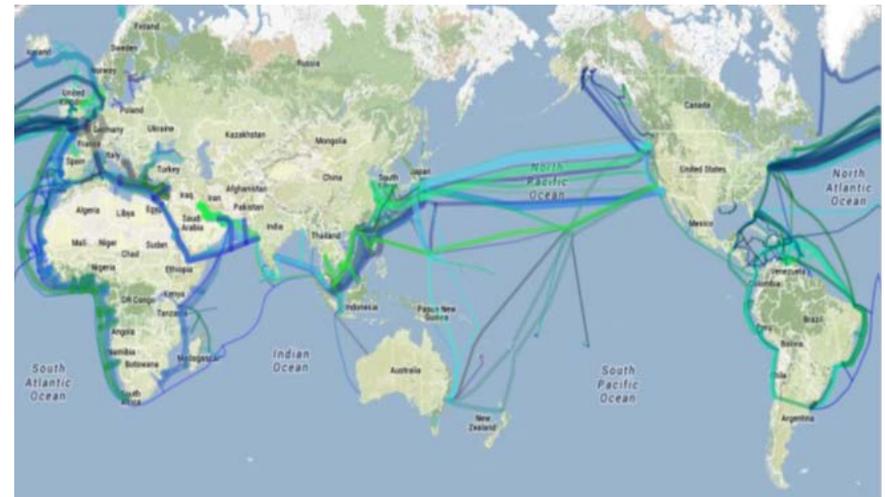
International data traffic and cables

Telecom international cable data traffic trends

* actual data use figures
commercially sensitive



Undersea data cables



vii. Remove barriers to uptake of cloud computing

- Economies of scale dictate that cloud services are international; eg., US-hosted services particularly with high volumes of disk space and bandwidth - about 1/6 price of NZ-hosted services.
- Government policy should aim to increase the trust that New Zealand firms have in cloud computing:
 - Regulatory issues around security, privacy, data ownership
 - Improve balance in guidance to public agencies on use of offshore cloud. Current advice over-weights risks, underweights benefits.
 - Give priority in international trade negotiations to internet issues. Free flow of data across borders is a 21st century trade issue.

Five overall themes for policies to boost services productivity

1. **Internationalisation** expands markets and stimulates competition
2. Success requires **new skills** and the **flexibility** to adjust
3. **Experimentation** fosters innovation – policy should provide the scope for it
4. **Quality regulation and institutions** underpin well-functioning and efficient markets
5. **Government** is an important player, as a service regulator, supplier and customer, all of which can affect services productivity

The recommendations in the report, effectively implemented, will contribute significantly to lifting service-sector productivity.