Cut to the chase

Boosting productivity in the services sector: Competition and ICT

2nd Interim Report – January 2014

This *Cut to the Chase* summarises the Commission's 2nd interim report on boosting productivity in the services sector. The Commission seeks your input – particularly on the questions and draft findings and recommendations – by 7 March 2014.

The inquiry

The Productivity Commission was asked to find ways to lift productivity in the services sector. The Commission released an issues paper (April 2013) and a 1st interim report (July); considered 34 submissions; met with over 40 interested parties; and surveyed 1,526 New Zealand businesses.

This report examines two topics important to raising services-sector productivity:

- stimulating a more competitive environment; and
- the successful adoption of information and communications technology (ICT) by service firms.

The Commission will consider submissions and talk to inquiry participants in February and March. Government will receive the final report in late April.

Why services?

Services-sector productivity strongly affects the productivity of the economy as a whole and the wellbeing of New Zealanders. Service industries account for nearly three-quarters of GDP – their performance impacts everything from the price households pay for insurance to the quality of financial advice for businesses. Services are critical to the international competitiveness of exporting businesses, as they make up, directly or indirectly, over half the value of New Zealand's exports.

The New Zealand services sector has underperformed. Most of New Zealand's service industries have lower productivity levels than their counterparts in Australia and the United Kingdom. The same is true of productivity growth rates.

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Competition drives productivity

Competition drives efficient resource use and the innovations that sustain productivity growth. Barriers that prevent new firms from entering markets, or prevent low-performing firms from exiting, reduce competition.

Service industries generally experience less intense competition than industries in the goods-producing sector. In addition, competition in New Zealand is often less intense due to our low population and distance from world markets.

Policy changes could encourage greater competition in New Zealand service markets. For example, recognising equivalent foreign standards and greater openness to overseas service providers establishing a local presence would increase competition.

Informing consumers to enhance competition

Confident and well-informed consumers are important for competition. It is in their interests to signal to suppliers what they want and look for the best value for money. Suppliers are prompted to lift their game by offering lower prices, or better quality or innovative products.

To play this role, consumers need to be able to compare what providers are offering and switch between providers. The costs of comparing offers (search costs) and moving to a new provider (switching costs) are particularly high in some service markets.

Good quality information increases transparency and competition, particularly for complex products such as health insurance. There is a case for Government to reduce switching costs or provide information to reduce search costs in some circumstances. Yet private firms increasingly provide such information, for example through comparison websites.

Inaccurate or misleading comparison websites undermine competition. Other countries address this risk through best-practice guidelines and accreditation. These could usefully supplement existing consumer protections in New Zealand. Better design of regulation and standards for professional services, more transparent bank-switching processes and rules to enhance email portability could also improve competition.

Making competition policy more effective

Firm behaviour is strongly influenced by competition laws and institutions. Deterring anti-competitive conduct without discouraging growth, scale or innovation is particularly important for New Zealand, with its relatively small local markets.

Regulation to prevent dominant firms misusing their position is tricky to get right and controversial in many countries. Many commentators, including the Commerce Commission, argue that New Zealand's approach is unconventional, complex and imprecise. The Government should review Section 36 of the Commerce Act to more accurately identify anti-competitive behaviour.

Market studies examining the state of competition in specific markets are a useful tool in many other countries. Market studies could fill a gap in New Zealand between the general competition advocacy role of the Commerce Commission and its formal, narrowly scoped, investigations. However their benefit would need to be weighed against the cost of conducting them.

ICT is revolutionising services

ICT is transforming existing services and creating new ones. The economic and social effects are comparable to those of previous technologies, such as steam and electricity, which transformed manufacturing and agriculture. ICT prices have fallen dramatically while quality has improved. Such effects underpin ICT's strong current and potential future contribution to productivity, economic growth and wellbeing.

But ICT is disruptive. Its effects across the economy are pervasive and impact service industries in particular. Skills, capital, and land need to shift from old to new, more productive, uses. This shifting of resources is the single largest contributor to productivity growth. As with other countries, New Zealand faces choices about policies and institutions to take advantage of the ICT revolution.

ICT investment is lower and adoption is later

New Zealand's ICT investment per person has been increasing since 2000 but remains significantly lower than the United States and United Kingdom. New Zealand has few large firms with revenues that justify the high fixed costs of ICT, leading to lower ICT investment.

Speeding up adoption requires improving the factors that influence firm decision-making such as access to capital and knowledge, and the availability of ICT technical and managerial skills.

ICT in the retail and wholesale industries in larger countries has enabled economies of scale and driven productivity growth. In New Zealand these industries have invested significantly in ICT, but their smaller scale means that returns are lower. The structure of the retail industry is changing rapidly across the globe, particularly with the rise of online shopping.

Business decisions about ICT adoption are based on how they perceive the risks, costs and returns. Smaller businesses, for example, find it difficult to afford to invest in ICT. Also, people management practices in New Zealand appear to be relatively weak and limit firms' ability to fully benefit from ICT. Inflexible regulation of product, labour, capital and land markets can slow the adoption of ICT, by making it difficult for resources to shift to more productive uses.

Exporting to larger markets offers greater business returns from ICT, and operating on a larger scale allows firms to specialise in the things they do most efficiently. Exposure to competition in overseas markets will also increase productivity.

Demand for ICT skills exceeds supply

Skill shortages can lead to low investment in ICT and less effective use of existing ICT. There is a worldwide shortage of ICT professionals, and New Zealand employers seeking ICT skills compete in an international market. Employers are finding it particularly difficult to recruit work-ready graduates.

New Zealand's immigration policy is working reasonably well to make it easy for skilled migrants to fill ICT vacancies. The Commission seeks your views on how the immigration process could be further streamlined.

Current funding arrangements do not give tertiary education providers strong incentives to establish and maintain links with firms. Giving prospective students better information about potential employment and earnings from qualifications gained from particular providers might encourage tertiary education providers to tailor their programmes better to industry needs.

Government should remove barriers to cloud computing

Cloud computing is changing the way ICT services are delivered around the world, creating more product choices for firms, reducing ICT costs and improving the scalability of ICT. It levels the playing field for New Zealand digital exporters.

While small firms should particularly benefit, those in New Zealand appear slow to adopt cloud computing. This is likely due to the costs of complementary investments and obtaining relevant knowledge.

Government policy should aim to reduce regulatory barriers, and increase firms' trust in cloud computing. As a first step, the Government should permit its own agencies to store their data in Australia, rather than solely in New Zealand.

Some commentators have raised concerns about the capacity of New Zealand's international data connections and the prices charged. The Commission has not seen any hard evidence that demand will exceed supply in the near future, or of inflated pricing. It welcomes views on this issue.

Read the full report … and make a submission

Submissions on the 2nd interim report are invited by 7 March 2014. Government will receive the final report by the end of April.

Read the full version of the 2nd interim report and make a submission at www.productivity.govt.nz or call us on 04 903 5150.

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.