

Subject: FW: Services Productivity Growth
Date: Thursday, 1 April 2010 1:53:43 PM
Attachments:

From: Andrew McCredie
Sent: Wednesday, 31 March 2010 5:34 PM
To: Committee, Economics (REPS)
Subject: Services Productivity Growth

Dear Committee

I appreciate that you have almost completed draft your report and I am sorry that I only recently became aware of your Inquiry. A broad overview of the Services sectors, their importance to the economy, exports and innovation and productivity growth is in the attached Services Roadmap headline results paper.

The services sectors make up some 80 per cent of the Australian economy, so if they are not everything their productivity growth is nearly everything when it comes to revitalising Australian productivity.

Illustrating this point, the Productivity Commission in its submission notes that MFP growth by the services sector, specifically the wholesale sector, was the most significant contributor to Australia's remarkably high aggregate MFP growth during the 1993-94 to 1998-99 cycle. Wholesale sector productivity was 5.8 per cent through this cycle. The PC states that developments within the sector consistent with this productivity acceleration include:

- the widespread adoption of productivity-enhancing technologies (for example, barcoding, paperless pick systems and automatic re-ordering processes) which moved the sector from a storage-based system to a fast flow distribution network
- greater competition, providing a catalyst for rationalisation (through mergers, acquisitions and firm exits) and outsourcing of non-core functions.

While not wrong, the PC's attribution risks missing the wood for the trees. The growth in the world's leading wholesale company, Li & Fung over the 1990s provides a deeper understanding of how this sector has raised its productivity. Li & Fung has been described as effectively the largest manufacturer in the world, without owning a single factory. As described by the Fung brothers in their book, *Competing in a Flat World* (see Box below) Li & Fung in the 1980s

and 1990s managed to avoid disintermediation by their major brand customers dealing directly with Chinese and other manufacturers by in their words “orchestrating the supply chain”. The activities orchestrated include high value work such as research and product development, quality assurance and testing, customer relationship management and brand management, well beyond the simple distribution network activities referred to by the PC. The Fung brothers report that: “each of the company’s employees generates about US\$1 million in sales, earning a return on equity of more than 38 percent per year”.

It is Li & Fung’s role in orchestrating increased value across the whole value chain that is responsible for the company’s productivity growth.

Major US wholesale companies that are “network orchestrators” include Dell, CISCO and Apple. Unlike Li & Fung these companies own the brands that the products they orchestrate are sold under, but similarly to Li & Fung they do not own any factories. Australian wholesalers that are network orchestrators include Billabong, GUD Holdings (Sunbeam) and Breville. Blundstone and Pacific Brands are more recent examples of firms adopting the wholesale model after largely closing their manufacturing operations in Australia. Country Road is an example of a company that also operates the network orchestrator business model but which is classified in the retail sector. Note that Billabong is by far the most successful Australian apparel company, even though as a ‘wholesaler’ it is ineligible for any of the Government assistance that has been provided to the TCF industries.

‘Network orchestration’ is an example of a business process innovation that has led to services sector productivity growth with economy-wide impact.

At present ASR members are telling me about the potential for similar business process innovation in Australia’s health system which comprises about 7 per cent of GDP and which indirectly contributes to the productivity of other sectors through the health and work capacity of the workforce. The development of eHealth will not just offer the opportunity to introduce barcodes and automatic re-ordering systems, but has the potential to make the entire health value chain transparent and contestable, including via international trade. The potential for productivity gains in health are likely to be as large as for wholesale trade, communications and banking were in previous decades.

These productivity gains will not be realised simply by waiting passively for technology and business process innovation to arrive. Underlying eHealth systems such as individual health identifiers need to be introduced, as do processes and charging mechanisms that would enable growth in Australia’s international trade in health services.

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Box 1

COMPETING IN A FLAT WORLD: BUILDING ENTERPRISES FOR A BORDERLESS WORLD

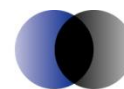
by Victor K. Fung, William K. Fung, and Yoram (Jerry) Wind

Li & Fung produces more than two billion pieces of apparel, toys and other consumer items every year. Li & Fung now accounts for more than US\$8 billion in garments and consumer goods for some of the best brands in the world. By the time of its one-hundredth anniversary in 2006, Li & Fung had become the world's largest sourcing company, growing at a compound annual rate of 23 percent for the last 14 years.

Yet Li & Fung does not own a single factory. It is a flat business for a flat world. The company started as a trading broker in Guangzhou (Canton) in 1906 during the Qing Dynasty and transformed itself into a Hong Kong-based exporter and then into a multinational corporation. Finally, the company reinvented itself for the flat world in a new role, as a "network orchestrator." It is now the orchestrator of a network of more than 8,300 suppliers served by more than 70 sourcing offices in more than 40 countries and territories. The company indirectly provides employment for more than two million people in its network of suppliers, but only less than half a percent of these are on Li & Fung's payroll. With this lean structure, each of the company's own employees generates about US\$1 million in sales, earning a return on equity of more than 38 percent per year.



Australian Services
Roundtable



ACIL Tasman
Economics Policy Strategy

Services Roadmap – Scoping and Feasibility Study – Headline Results

Overview

The headline results of the scoping and feasibility study confirm the important role of the services sectors in Australia’s economy, trade, and business innovation. To date, the extent of this role has been masked by historical statistics that only take into account the characteristics of manufacturing companies, which tend to export goods – rather than sell through foreign affiliates – and innovate through research and development (R&D). This study uncovers the real contribution of services to the Australian economy, identifying the following top-line findings:

Services comprise about 80 % of Australia’s economy.¹

In 2008-09, the GDP contribution of the largest services sector, Financial Services, was bigger than Manufacturing and bigger than Agriculture and Mining combined.

Sector	GDP Contribution
Financial Services	10.8%
Manufacturing	9.4%
Mining	7.7%
Agriculture	2.6%

Services’ share of Australia’s international business sales is around 46%², taking into account all modes of exporting, particularly the sales of the foreign affiliates of Australian headquartered companies, of which around 70% are from services sector businesses. Sales by foreign affiliates were just under the value of credits for goods and services in the Balance of Payments in 2002-03 (latest data) and are expected to have grown substantially since that time.

Services’ share of innovation expenditure is about 70 %.³ While the services sector only represents around 46% of business expenditure on R&D, it accounts for 84% of non-R&D innovation expenditure. This strong contribution to innovation is being driven by the services sector becoming increasingly knowledge intensive, employing 90% of Australia’s university graduates.

¹ Data source: ABS 5204.0 Australian System of National Accounts, 2008-0, services defined as all sector except agriculture, mining and manufacturing

² Calculation based on inclusion of sales of foreign affiliates from ABS 5495.0, 2002 – 03, export credits for goods and services from ABS5302.0 - Balance of Payments and International Investment Position, Australia, data from 2002-03 for comparability. Note a foreign affiliate is an overseas business that is more than 50% owned by an Australian resident enterprise. This includes offshore subsidiaries, branches and majority-owned foreign joint ventures.

³ Taking into account both R&D and non-R&D innovation expenditure, innovation expenditure data supplied to ASR by ABS from 8158.0 - Innovation in Australian Business, 2003 (Reissue) for the figure CONTRIBUTION TO EXPENDITURE ON INNOVATION (a), 2002-03, by industry. R&D sectoral expenditure from ABS 8104.0 2004 – 05, RESEARCH AND EXPERIMENTAL DEVELOPMENT, BUSINESSES data for 2002-03 for comparability.

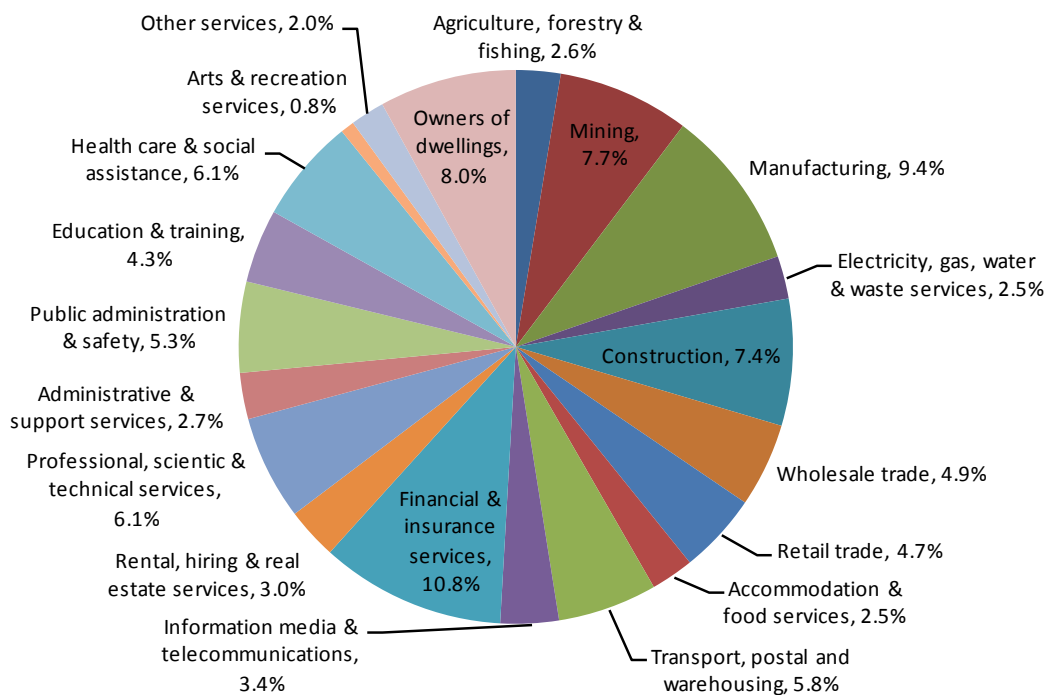
Services role in the economy

In assessing the role of the services sector in the economy, the study found much confusion arising from different definitions. For example, historically, the government-owned part of the services sector was not included in the industry value-add data. However, recent privatisation has blurred this distinction. National accounts data, commonly excludes construction and utilities (gas, water, electricity etc); but the 1995 General Agreement on Trade in Services, included construction and environmental services, and since the Doha negotiations started in 2000, energy services have also been included by the WTO in Trade in Services.

This report includes construction and utilities in the services sector, so that the services sector comprises all those parts of the economy that are not manufacturing, mining or agriculture.

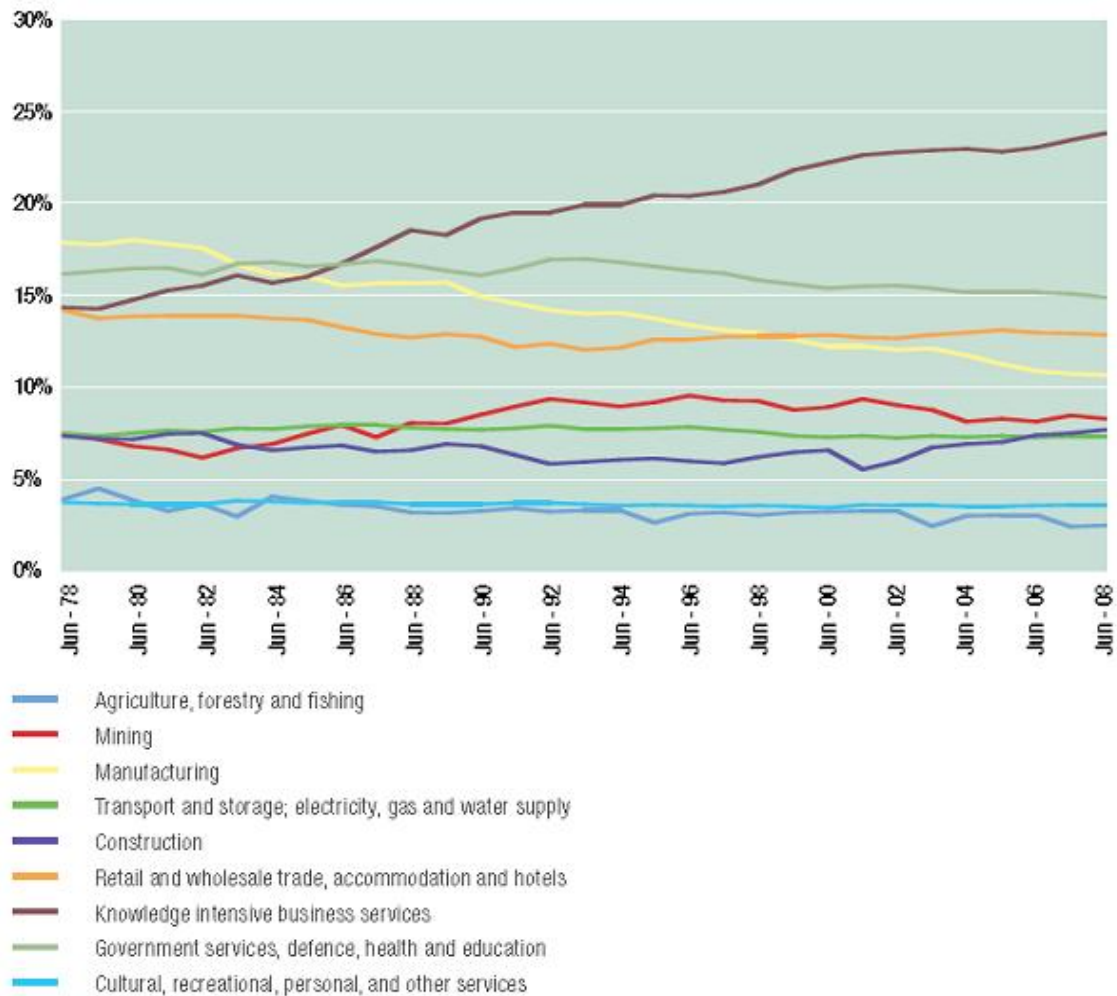
On this basis, services comprises 80.3% of Australia's industry value add, see Figure 1, with the knowledge intensive sectors of the services economy growing fastest, see Figure 2.

Figure 1 **Gross value added of services in Australia, 2008-09**



Data source: ABS 5204.0 Australian System of National Accounts, 2008-09

Figure 2 Australian Gross Value Added (GVA) by industry, 1978-2008



Source: ABS 5204.0, 2007-2008. Table 5. GVA by industry.

Services role in trade and international business

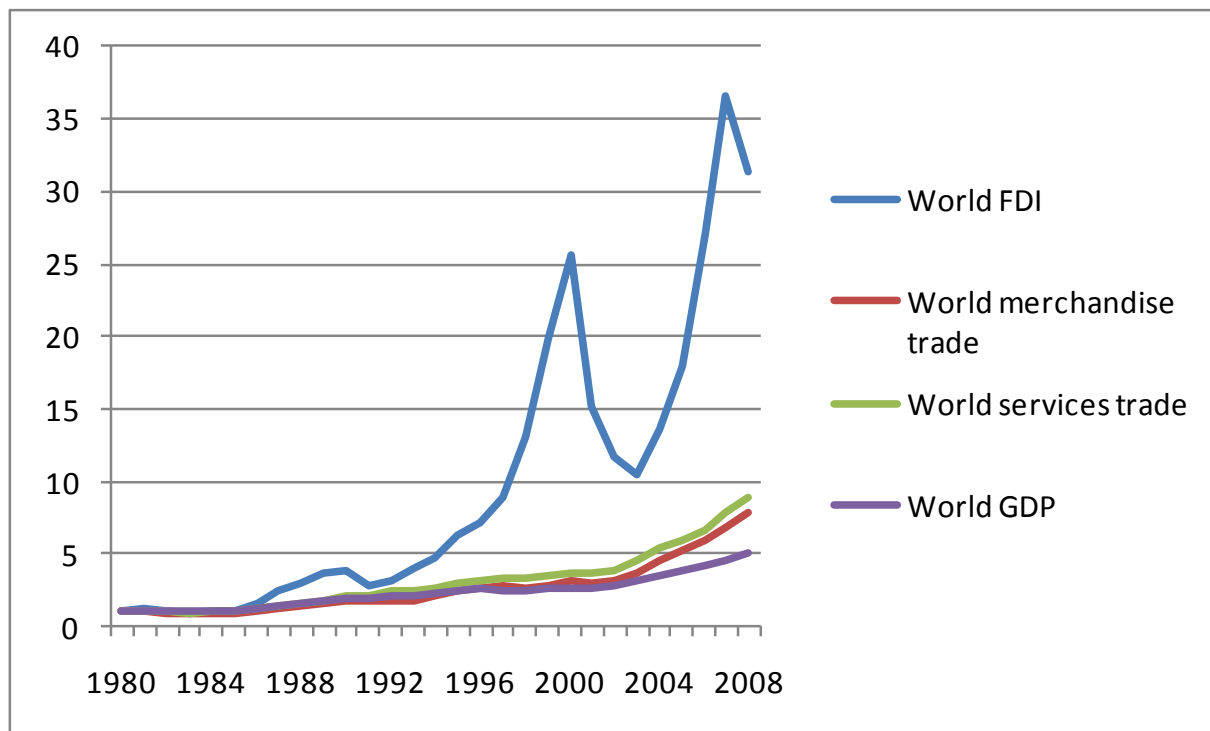
It is commonly held that services accounts for only 20% of Australia's exports. While this may be true, if the measure is narrowed to conventional exports, it ignores any contribution to international business from the sales of foreign affiliates. Typically, manufacturing companies choose to export their goods because there are economies of scale in concentrating production in one place. However, for services companies, the need to localise services (for example, accounting firms require local regulatory and industry knowledge to provide a comparable service) mean it is often more cost effective to service an overseas market through foreign affiliates.

Thus, for services businesses, the value of their international sales via foreign affiliates is around three times that delivered through conventional exports credits. In fact, the ACIL Tasman report suggests the contribution of services businesses is around 46% of Australian international business sales, if foreign affiliate sales are taken into account.

More importantly, there is every reason to take these into account and no reason for excluding sales via foreign Australian affiliates. The sales of affiliates make just as significant a contribution to a business's scale as conventional exports – and notably corporate financial accounts do not distinguish between these types of sale. Indeed, the activities of foreign affiliates of Australian-based businesses deliver significant economic benefits to Australia through repatriating profits, and supporting headquarter functions such as marketing, innovation, accounts and management.

Looking ahead, foreign affiliate trade is likely to increase in line with the dramatic growth in foreign direct investment (FDI), see Figure 3. This has already been enabled by significant liberalisation of ‘behind the border’ barriers to services trade and investment, including working visas, business establishment, tax/profit repatriation and professional recognition. However, services trade liberalisation remains very much a work in progress, with substantial potential to further encourage activity by foreign affiliates of services businesses. As awareness of the link between services trade liberalisation and services productivity growth spreads, we expect the pressure for further trade liberalisation to grow.

Figure 3 **Globalisation indices 1980-2008: FDI, world trade and world GDP (1980 = 1)**



Data source: WTO for trade data; UNCTAD for FDI and GDP data

Clearly, the trajectory of growth in trade and investment has been impacted by the global financial crisis, with Foreign Direct Investment dropping in 2008 and again in 2009 and world trade in preliminary data from the WTO for 2009 showing a 23 per cent decline over 2008. However, importantly the trends driving FDI and trade growth before the global financial crisis – globalisation and liberalisation – remain in place. For this reason, as the global economy recovers, we can expect foreign affiliate sales to continue to grow, increasing the services sector’s contribution to international business sales.

Services role in innovation and productivity growth

Growing services productivity is the key to revitalising Australian productivity growth, given the size of services sectors in Australia’s economy.

In services, we know – through a wide range of economic studies – that ICT adoption, trade liberalisation, privatisation, deregulation and competition policy can greatly increase innovation and productivity outputs. Similarly, a range of regulatory reforms can have a substantial impact on

services innovation; for example, introducing e-health systems and processes, and opening up Australia's health and wellness system to international trade.

It is also well known that R&D is a less important driver of services innovation than it is for the goods sector. An ABS Innovation Survey found that for services businesses non R&D innovation forms 77 per cent of their total expenditure on innovation, and that services businesses in Australia undertake 84% of all non-R&D innovation expenditure.⁴

This finding is valuable in terms of understanding the nature of business expenditure on services innovation, but measures of innovation inputs may not be the best way to understand or improve services innovation.

Better understanding of the value-adding processes within services businesses, how to measure them and how to identify barriers to their improvement could better help realise the potential for productivity growth in sectors such as finance, business services, transport, health, education, built environment, environmental and energy services.

There has also been important recent work on understanding the innovation process itself within services businesses, and the development of the new discipline of services science. This work enables better management and measurement of innovation and creativity within organisations and how to improve organisational capabilities in these dimensions.

Innovation in services is not just about process or product innovation, or even performance and productivity improvements, but in fact is a much wider concept. Increasingly, researchers have amassed significant evidence of the influence on innovation made by strong relationships and collaboration between partners along the services supply chain. It is also to be noted that knowledge is socially constructed and is highly intangible, and service organisations in their pursuit for distinct knowledge and hard to imitate innovation need to understand, inculcate and foster higher-order dynamic capabilities within organisations

Australia's position as a relatively remote, middle-sized economy, means that demand side issues such as access to global markets, the supply chains of multinational companies and government procurement markets are critical to achieving the scale economies for significant innovation investments.

ASR has set out a typology of services innovation, noting that it tends to:

- take place specifically at the point of interaction between services provider and the client.
- be driven by client relations more than is the case for innovation in manufacturing. Service companies must maintain a flexible approach to innovation, constantly changing to solve client problems and meet new needs.
- be people-driven as well as laboratory-driven, i.e. to break the bounds of traditional hierarchy by requiring integrated input from all kinds of operational, organisational, technical and managerial staff as well as researchers.
- not offer necessary economies of scale, as in manufacturing.

⁴ ABS regards this result as indicative and no longer requests expenditure information on innovation from businesses as it was found that this information is not generally separately accounted for in companies.

- involve a high level of interaction and interdependence between knowledge providers (such as research organisations) and knowledge users (such as service firms) – to the extent that the term co-innovation has relevance.
- be focused not only on new suites of services but also on new modal delivery methods for those services and on new business models to reach new markets.
- not take place as a specialised and separately accounted activity located in a separately identified part of a firm but to be inextricably tangled up with everyday creativity and design.
- show evidence of a strong responsiveness to both technological and non-technological inputs, including when provided jointly.
- involve the social as well as the natural sciences.
- involve the creative arts and humanities.
- suffer from inadequate formal or informal access to collaboration opportunities between services providers and the education and R&D community.

Scoping future work

These headline results are produced for the ASR Annual Services Summit on 17 March 2010, with further research being conducted for the final report. While it is too early in the report writing to provide a definitive outline of the priorities that will be recommended for future work, the following list is indicative:

- Priorities for services sector regulatory reform need to be developed
- Sector based roadmaps – several sectors are expected to be ready to embark on this work
 - Such roadmaps would help to identify the regulatory reforms that need to be addressed
- Foreign affiliates trade has not been measured since 2002-03 and a repeat survey is long overdue as without it, current statistics are misleading as to the impact of services trade
- There should be an extension of the International Legal Services Advisory Council survey for services trade measurement to other services sectors, including possibly financial services, architectural services, engineering services, probably in conjunction with the sector roadmaps⁵
- Demand-side and output measures for services innovation, including financial impact are also needed.

⁵ ILSAC is a joint business-government body supported by the Attorney General's Department. The survey of international legal services trade is jointly supported by government and business. As part of this study, ABS has offered to provide advice to other sectors who wish to develop the methodology for use in carrying out similar surveys in their sector.