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Domestic Services: The Hidden Key to Growth

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Domestic Services:
The Hidden Key to Growth

Forward

“Domestic Services: The Hidden Key to Growth” draws on the McKinsey Global Institute’s in-depth research on the drivers of productivity in more than 15 countries across nearly 30 industry sectors and offers new insights on the role of local services in middle-income economies.

This perspective is part of the fulfillment of MGI's mission to help global leaders understand the forces transforming the global economy, improve company performance, and work for better national and international policies.

MGI combines McKinsey's business experience with the rigor of academic discipline. This document reflects active dialogue with policy makers, industry experts, and researchers from leading institutions.

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Diana Farrell, Martin Baily and Jaana Remes

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Domestic Services: The Hidden Key to Growth

Having focused for many years on manufacturing-led growth, policymakers across the developing world now recognize the contribution that service exports can make: India leads the world in offshore IT services; Dubai has tourism as well as a growing financial services hub; Singapore is building hospitals to serve patients from across Asia; the Philippines is developing call centers. Yet these offshore service strategies overlook a far larger, if less well-understood, opportunity to boost wealth creation: stimulating domestic service sectors.

Higher productivity in services is the key to growth in any economy. Local services account for more than 60 percent of all jobs in middle income and developed economies, and virtually all of new job creation (Exhibit 1). Manufacturing is not going to be a sustainable long-term source of new jobs anywhere—even in China—given the rapid advances in technology and productivity that are reducing industry's labor needs.

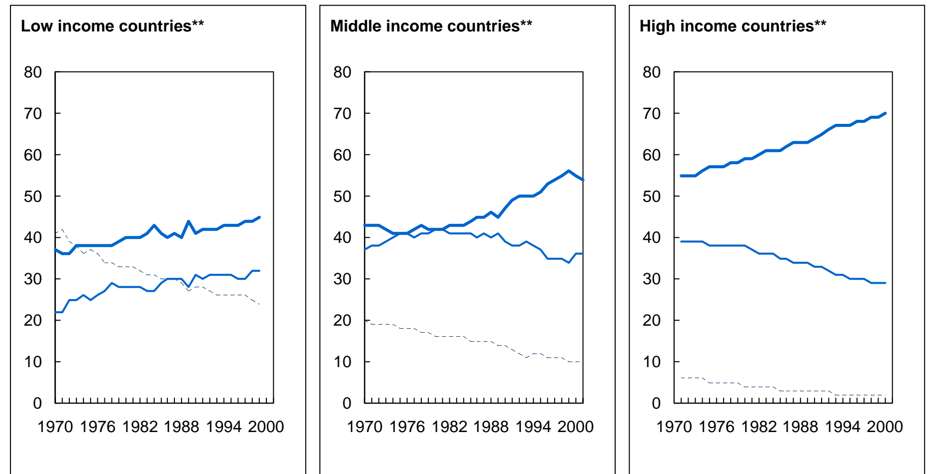
Why, then, do so many policymakers omit local services from their development plans? Part of the reason is that service work has a poor reputation. Low-skill, low-wage, ephemeral jobs in fast food joints and beauty parlors hardly seem the building blocks of a modern economy. But such jobs form the minority of service employment: even in the United States, widely thought to have too many of them, they represent only 22 percent of the huge range of total service employment. In fact, services comprise many activities critical to economic growth, like power supply, transport, and telecommunications, as well as numerous high-skill, high-wage occupations, such as accountants, researchers, and professionals in health and financial services (see "What are services?" on page 6).

Exhibit 1

SERVICE SECTOR GROWTH DURING ECONOMIC EVOLUTION

Percent of GDP, 1970-2001

Services*
Industry*
Agriculture



* Industry includes manufacturing, mining, and construction; services include personal, professional, and public sector services and utilities.

** The World Bank defines middle-income economies as those with per capita GNI in 2003 between $766 and $9,385 USD measured with average exchange rate over past 2 years.

Source: World Bank; World development indicators

WHAT ARE SERVICES?

Market service activities in today's economies are tremendously diverse. The EU Services Directive divides them into three categories: services provided to consumers, services provided to other businesses, and services provided to both consumers and businesses.

In the United States, which is typical of a developed service economy, some 29 percent of the roughly 100 million service jobs are in consumer services, which include retail, food and accommodation services, and personal services like car repair shops, dry cleaners, and beauticians. About 77 percent of US consumer service jobs are in relatively low-skilled sales and service occupations. These jobs tend also to have a higher share of very small businesses, higher business turn-over rates, and a disproportional share of female employees.[1]

1 Foster, Haltiwanger, and Krizan (2002): The Link Between Aggregate and Micro Productivity Growth: Evidence from Retail Trade. NBER Working Paper #9120

As economies grow richer, business to business services represent an increasing share of total economic activity. Today, they represent 27 percent of all US service sector employment, almost as much as consumer services. These activities include: professional services, such as law, accountancy, and consulting; technical services, such as IT and software support; wholesale trade services; and employment services like headhunters and temp agencies. The recent rapid growth in business services in developed economies is an outcome of specialization. As companies focus increasingly on their core competencies, they buy more non-core services from third parties.

Services provided to both consumers and businesses include real estate and banking, as well as services based on extensive physical networks, like telecommunications and electricity supply. These types of services account for another 7 percent of service sector jobs. The remaining 36 percent of service jobs are in non-market activities like healthcare, education, and public sector services.[2]

After years of neglect and undue regulatory constraints, local service productivity in most emerging economies lags far behind productivity in sectors developed for export. This is a pity. Research by the McKinsey Global Institute (MGI) suggests that, given the right competitive environment, local services across the range can be a powerful source of wealth creation and jobs for middle-income economies, more powerful than offshore services could ever be.

FASTER GROWTH AND MORE GOOD JOBS

Once an economy reaches the middle income level of development, service industries become a more important source of job growth than manufacturing. And, contrary to popular belief, a substantial percentage of these jobs are high-skill and high-wage. The more dynamic and competitive an economy's service sector, the more jobs and GDP growth it will create.

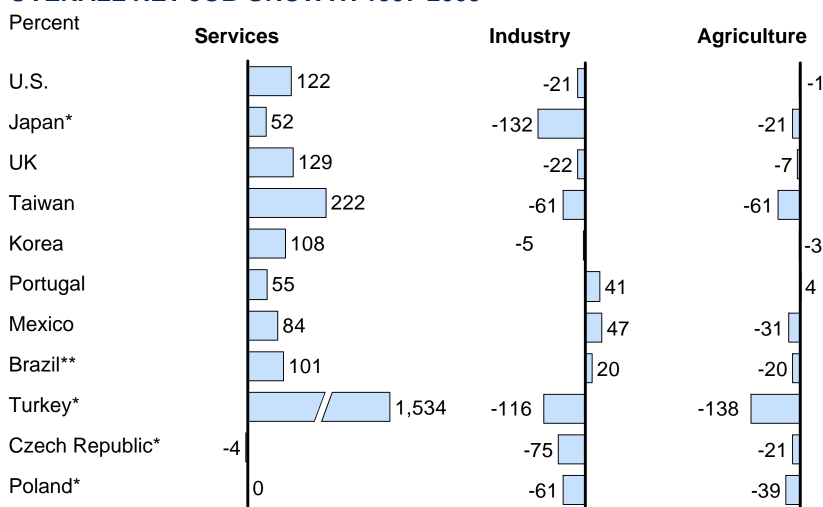
2 We do not cover non-market services in this article. For a perspective on performance improvement potential in the public sector, see Dohrman and Mendonca: Boosting Government Productivity. *McKinsey Quarterly* 2004 (4).

More good jobs

Since 1997, employment has declined in the goods producing sectors of most developed and many developing economies, leaving service industries responsible for all net job creation (Exhibit 2). Among middle-and high income economies today, services generate 62 percent of all employment on average, and the higher a country's GDP per capita, the higher the share of service employment (Exhibit 3).[3]

Exhibit 2

SERVICES AND NET JOB GROWTH SECTOR CONTRIBUTION TO OVERALL NET JOB GROWTH 1997-2003



* Negative overall net job creation means that sector contributions sum upto -100%
** 1997-2001
Source: OECD

Manufacturing employment is shrinking as a result of more efficient use of labor, automation, and new IT. Roughly 22 million manufacturing jobs disappeared worldwide between 1995 and 2002, despite policy efforts to preserve them. Even China, the world's "factory floor", lost 15 million manufacturing jobs, equivalent to 15 percent of total Chinese manufacturing and a higher proportion than the global average loss of 11 percent.[4] New jobs created by the boom in foreign manufacturing investment were not enough to offset these losses, caused largely by restructuring in China's state-owned manufacturing plants.

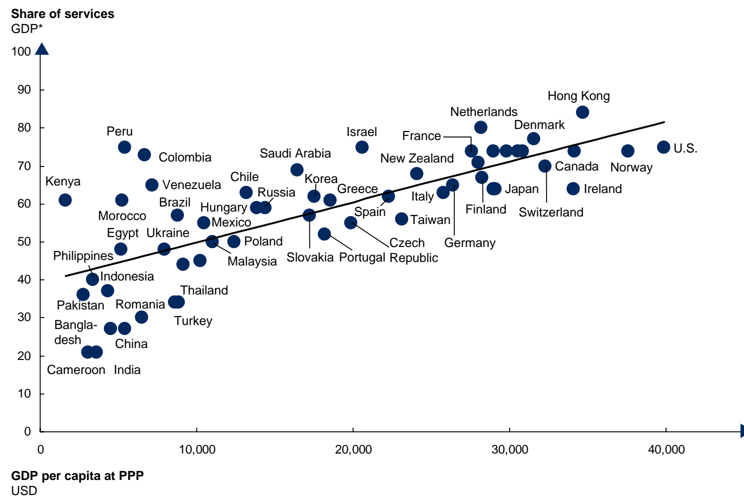
3 The differences in service employment we observe among lower middle-income countries with similar levels of GDP per capita are due largely to differences in their remaining levels of agricultural employment: for example, Turkey's low share of services is explained by the fact that 46 percent of all workers are still in agriculture, while in Venezuela, only 11 percent of workers are still farming.

4 "Manufacturing Payrolls Declining Globally: The Untold Story," by Joseph Carson, Alliance Capital Management, 2003

Exhibit 3

SHARE OF SERVICES IS HIGH AND INCREASES WITH GDP PER CAPITA

2004



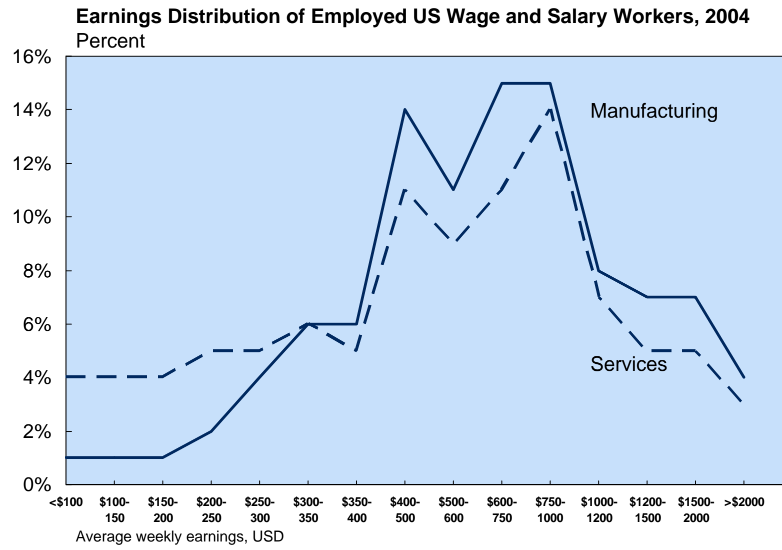
* Includes all other sectors except agriculture, manufacturing, and mining
Source: World Development indications, Global insight

Somewhat surprisingly, service industries actually create more high-skilled occupations than manufacturing. In the US, more than 30 percent of service jobs are in the highest skill category of professional, technical, managerial, and administrative occupations. In contrast, only 12 percent of all manufacturing jobs are in this category, and the same pattern holds in other developed nations.[5] There are also many well-paid "blue-collar" jobs in services, such as electricians, plumbers and auto mechanics. In fact, the distribution of wages in the US looks broadly similar in services and manufacturing (Exhibit 4). There are more low-wage jobs in services, but also many high-wage jobs, and the variance within each sector is actually greater than the variance between them. Moreover, the experience of some countries in Europe shows that trying to contain growth in low-skill service jobs by imposing high minimum wages and other labor market restrictions results in higher overall unemployment, not more high-skill jobs.

5 OECD, "Enhancing the Performance of Service Sectors", 2005; Figure 2.14 on page 50

Exhibit 4

DISTRIBUTION OF MANUFACTURING AND SERVICE EARNINGS IS VERY SIMILAR



Source: US Census Bureau, Current Population Survey

Low-skill consumer service jobs, just like low-skill manufacturing jobs, may not be the most attractive. But they are crucial to all economies in providing formal employment for new entrants to the workforce and also unskilled workers—a group whose only alternatives are informal (and therefore illegal) work or welfare. Even if consumer service workers learn few value-adding skills "on the job", having a formal position can help them or their dependents to study elsewhere, and so move up the occupational ladder.

Faster growth

Because of their sheer size, local service sectors like retail and construction are important drivers of overall GDP growth. And access to high quality local services affects rates of growth in all other sectors because every enterprise uses them. Good local services can also make a difference in attracting foreign direct investment (FDI). Electricity, communications, and transport quality and cost all influence the overall attractiveness of an offshore location to multinational companies choosing where to invest. In the early 1990s, for instance, India's nascent offshore sector was hobbled by unreliable phone and Internet connections. It was only after local telecom services improved that

offshoring in India took off. Indeed, MGI interviews with executives at multinationals show that they value a stronger infrastructure and reliable network services more than direct incentives from governments. Managers at Brazilian auto OEMs and Indian offshore service companies that received direct government incentives told us they would rather the money had gone on improving ports and roads in Brazil and telecommunications in India.[6]

THE MYTHS ABOUT SERVICES

Given the employment and growth benefits of a dynamic service sector, why have so few economies adopted service sector reforms? Three myths explain this anomaly.

MYTH 1: There is little scope for innovation in local services, so reforming them won't do much for overall growth

History shows otherwise. Productivity improvements in service industries like electricity supply and telecommunications were important drivers of overall productivity growth in the developed economies after World War II. In the US, the late 1990s boom in productivity was in large part due to services industries like retail, wholesale, and financial services.

Indeed, MGI's studies of countries around the world show that gaps between productivity levels in their large, employment-intensive local service sectors, such as retail and construction, explain a substantial amount of the gaps between their respective GDP per head figures. In Turkey, we found that labor productivity in manufacturing averaged 64 percent of the US level, while it was only 33 percent in services.

Retail sector reforms are particularly important in triggering productivity growth, partly because these sectors employ so many people, partly because improvements here stimulate productivity advances among upstream suppliers. For example, the liberalized retail sector in the United States has been one of the top three contributors to aggregate productivity increases since 1995.

6 One interviewee from the US headquarters of a leading electronics manufacturer said that of course the company accepts tax incentives, and of course its local leaders will say these are important when asked by local government representatives, but in the grand scheme of things, taxes are nevertheless very low in their priorities. The same is indicated by our survey of IT/BPO companies conducted as part of our New Horizons research. See MGI report, "New Horizons: Multinational Company Investment in Developing Economies: Policy Implications", Exhibit 4, at http://www.mckinsey.com/mgi/publications/newhorizons/index.asp

Research has shown that removing restrictions on outlet size, opening hours, or product selection from retailers in other OECD countries would allow their retailers likewise to streamline distribution systems, and grow both sales volumes and employment. Their consumers, too, would benefit from lower prices and a broader array of services.[7]

Research elsewhere has demonstrated that liberalizing trade policies governing services generally has far higher welfare benefits for developing economies than equivalent reforms to manufacturing or agricultural policies. Even though trade barriers in services are usually lower, the economic benefits from removing them are larger because of the huge improvements in service productivity they unleash.[8]

MYTH 2: Increasing service sector productivity will rapidly increase unemployment

This anxiety centers on the retail sector, a huge employer in all economies. Policymakers rightly believe that more productive supermarket and large discount formats will drive out traditional, less productive, small stores. But this is the normal process of economic development that will result in a bigger national income and higher overall employment.

MGI emerging country case studies show that in most cases net employment in retailing *increases* when the sector adopts more productive formats. Supermarkets and large-scale retailers, because of their higher productivity, can cut prices, attract more customers, and so increase their incomes. As they grow, they employ more people. Their growth also stimulates new jobs in retail supply industries, such as food processing and consumer manufacturing. In Mexico, for example, rapidly expanding formal convenience stores were the main source of employment growth in the retail sector after it was opened to foreign investment.[9] Likewise, we found that in Thailand and Poland, the net impact on employment of opening the retail sector to investment by modern format retailers was likely to be neutral or positive.[10]

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7 Nicoletti, G and Scarpetta, S. "Regulation, Productivity and Growth", OECD economics department working paper No 347, 2003

8 Philippa Dee (2005): The Economy-Wide Effects of Services Trade Barriers in Selected Developing Countries. In Enhancing the Performance of the Services Sector; OECD 2005

9 See MGI report, "New Horizons: Multinational Company Investment in Developing Economies - Food Retail Case", 2003, at http://www.mckinsey.com/mgi/publications/newhorizons/index.asp

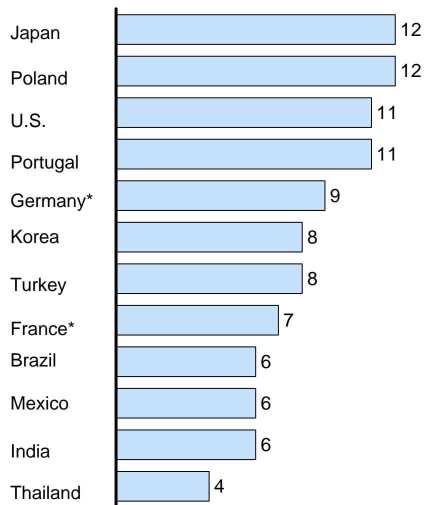
10 See the retail sector cases of MGI's productivity reports on Thailand and Poland
http://www.mckinsey.com/mgi/publications/thailand.asp
http://www.mckinsey.com/mgi/publications/poland.asp

This phenomenon helps explain why the share of retail in total employment is still higher in the United States, with its very small percentage of traditional retailers, than in most low and middle-income economies, with a large proportion of retail workers employed in traditional formats (Exhibit 5).

Exhibit 5

SHARE OF EMPLOYMENT IN RETAIL

Percent



* Excludes automotive retail/gas stations

Note: 1) Employment data refers to formal market employees except Brazil food retail, which includes large informal market

2) Year of retail employment data varies from 1995-2001, depending on the year in which the MGI study was conducted

Source: Local government sources; McKinsey Global Institute

MYTH 3: Services are an unreliable source of jobs

Many policymakers still believe that manufacturing jobs are not only higher skill and higher wage than service jobs but also more reliable, because the fixed costs of capital intensive plants means they are unlikely to move elsewhere. Are they?

There certainly is higher turnover in service jobs than in manufacturing jobs. But service jobs provide a much more reliable source of overall employment than manufacturing. In any given year, on average roughly 10 percent of all jobs in an economy come to an end, because workers quit or become redundant. More jobs end in services than manufacturing, particularly in service segments dominated by small scale operations, with their relatively high failure rates.

However, service industries as a whole create more jobs than they lose, often through the activity of new entrants.[11] Creating a dynamic service sector therefore reliably guarantees lifetime employment opportunities for everyone, if not the same job for life.

For example, from 1977–1987, the US auto repair industry lost 49 percent of its jobs, but at the same time took on new employees in jobs equivalent to 56 percent of total employment in the industry. So although almost half of all auto repair jobs ended over the period, net employment in the sector grew by 7 percent.[12] Data from middle-income economies, albeit limited, suggest their dynamics of service job destruction and creation are similar.[13]

These myths about services have led many policymakers to penalize or neglect their local service sector, usually in favor of industrial expansion. But MGI's country research has shown such choices bear considerable costs. Take Japan. By the end of the last century, Japan's world-class manufacturers of autos, steel, machine tools and consumer electronics were legendary for their performance. But their output comprised only 10 per cent of GDP. Productivity in the rest of the economy—about 68 percent of it in local services—was a dismal 63 percent of US levels.[14] Low productivity in local services goes a long way towards explaining why Japanese gdp growth tailed off in the 1990s, just as subsequent incremental reforms of service sectors help to explain the recent improvement in Japan's economic performance. Japan's Cabinet Office calculates that deregulation in telecoms, transport, energy, finance and retailing were responsible for 4.6 percent of the country's GDP in 2002.[15]

Neglecting and over-regulating service industries also has the perverse consequence of encouraging growth in the informal service sector. In many developing and middle-income economies, the majority of output in services

11 Davis, J.S., and Haltiwanger, J.: Gross Job Flows. In Ashenfelter and Card (1991): Handbook of Labor Economics, Vol. 3, p 2711-2805. Our turn-over rates reported here reflect the share of jobs being destroyed and replaced by others - or half of the excess reallocation rate used in the economic literature (sum of creation and destruction rates minus the absolute value of net employment change)

12 Foster, Haltiwanger, and Krizan (1998): Aggregate Productivity Growth: Lessons from Microeconomic Evidence. NBER Working Paper #6803

13 Davis and Haltiwanger op. cit. cite research results from Chile and Morocco

14 "Reviving Japan's economy" by M. James Kondo, William W. Lewis, Vincent Palmade, and Yoshinori Yokoyama (Photos by Paul Van Riel), *The McKinsey Quarterly 2000 Special Edition: Asia Revalued*

15 "Capitalism with Japanese characteristics", *The Economist*, 6th October 2005

such as retail and construction comes from informal firms that neither pay full taxes, nor abide by worker safety and other regulations, nor even register. Their unearned cost advantage allows low-productivity players to survive and prevents more productive formal companies from taking market share. In Brazil's food retail sector, for example, MGI found that tax-paying, productive, modern format retailers are at a large cost disadvantage to small, unproductive, informal players that evade tax. Acquiring the informal players is no remedy as the scale gains would be too small to offset the extra tax burden. As a result, growth in more productive, higher wage jobs in services is capped, and average productivity in Brazil's retail sector is only 16 percent of the US level.[16]

HOW TO DEVELOP A DYNAMIC LOCAL SERVICE SECTOR

Government policymakers keen to unlock local services' power to generate growth and jobs must remove barriers to competition. This requires leveling the playing field so that services can compete freely for capital, labor and technology; removing inappropriate restrictions on service businesses; and tackling informality.

Level the playing field

Governments first need to remove any remaining biases against services and give them equal treatment in fiscal, financial, and development policies. Then service companies can compete for capital and workers on the same terms as manufacturing firms.

- *Open up capital markets to local services.* Investments in services should be assessed against the same criteria as manufacturing investments. In many countries, this is not the case. Directed lending policies in banking remain prevalent. In South Korea, for instance, during its push for manufacturing-led growth, banks were prohibited outright from lending to consumer service sectors like leisure and real estate. In China today, state-owned manufacturing enterprises account for 65 percent of all loans, even though they produce just 35% of industrial output. Meanwhile, IPO rules in

16 For more detail on the Brazilian food retail case, see the MGI case study at http://www.mckinsey.com/mgi/publications/newhorizons/food_retail.asp
For a more general discussion of the costs arising from informality, see http://www.mckinsey.com/mgi/publications/informaleconomy.asp

most developing countries' stock markets allow only large companies to list, thereby discriminating against service sectors that have smaller players. Policymakers need to liberalize financial systems, so they will allocate capital to the projects with highest returns, regardless of sector.

- *End industrial subsidies*. Governments often explicitly subsidize investments in manufacturing activities they consider in the national interest. For instance, Malaysia has supported the creation of the Proton in order to have a national car company. The Brazilian government offered subsidies worth $100,000 per job created to foreign carmakers to invest in local factories, prompting so much investment, the result was overcapacity and generally low productivity throughout the industry. Such subsidies not only often waste taxpayers' money, but put service industries at a disadvantage.

- *Expand favorable business conditions to cover services*. Many middle income economies have created special economic zones (SEZs) for foreign and/or export manufacturers, with more favorable tax and tariff rates and lighter regulation than domestic companies face. It makes sense to provide conditions that allow businesses to flourish, but why not extend them to all businesses? Governments should equalize regulations between sectors and set corporate taxes at affordable levels across the economy.

- *Physically integrate manufacturing and service activities*. Today's SEZs are often geographically as well as fiscally separate from local service providers, making them harder to serve. This is one challenge facing service providers in Mexico's business centers, far away from the maquiladoras on the US border. Extending SEZ-type conditions to all businesses has the added advantage of allowing them physically to reunite. This will be increasingly important as manufacturers continue to outsource more of their previously in-house functions to third party service providers.

Remove the product market barriers limiting competition in services

MGI productivity studies have shown that inappropriate product market regulations governing service sectors are the biggest barrier to increased competition, which drives the diffusion of more productive processes. Product market regulations govern company ownership, trade, foreign direct investment, land use, prices, and products. Misconceived regulations make competition less

intense by limiting the entry of new players (particularly global ones), discouraging innovation among existing competitors, and restricting enterprise scale.[17]

- *Reduce public sector ownership*. Utilities, telecommunications, and banking remain in government hands in many emerging economies. Lack of investment and low productivity in these sectors stunt not only their own but also their customers' growth. According to some estimates, Mexico has forgone $50 billion of potential investment in the electricity grid because this has been entirely state-controlled since 1933.

- *Remove barriers to FDI in services*. This can open the door to substantial inflows of capital.[18] Moreover, it allows countries to benefit from the best practices and increased competition provided by global companies, which will impel service productivity upwards. For example, when FDI restrictions in retail banking were removed in many In Latin American countries during the 1990s, foreign companies invested over $50 billion in their banking sectors alone over the next 10 years.

- *Revise unnecessary barriers to scale*. Scale can yield substantial productivity gains to enterprises. Yet many companies face limits to scale, like restrictions on store size and land use, which keep them less productive than they could be without always yielding a commensurate social gain. Productivity in housing construction, for example, depends critically on scale. Yet in Germany and France, construction companies cannot acquire lots of land big enough to support large-scale housing developments. This explains why productivity in the German and French construction industries lags far behind its equivalent in both the Netherlands and the US.[19] Land purchase is similarly difficult in many emerging economy cities because these are large and crowded, and land titles are unclear. The solution here is to clarify titles, so land can be traded more easily and put to its most productive use.[20] Many

17 See Bill Lewis: The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability. University of Chicago Press, 2004

18 For example, the FDI inflow has been a critical source for capital in the Brazil retail sector. See New Horizons food retail case op. cit.

19 See MGI Report "Removing Barriers to Growth and Employment in France and Germany" at http://www.mckinsey.com/mgi/publications/growth_barrier.asp

20 There is, of course, a place for zoning laws. No one wants dirty factories next door to residential housing. But zoning laws are often excessively complex and restrictive. The reasonable goals of zoning can be combined with a flexible land use policy that encourages a competitive and expanding service sector

governments also restrict store sizes to protect mom-and-pop stores from large-scale retail outlets, but at the cost of higher retail productivity. For instance, French zoning laws have required retailers to get local authorization before opening new stores bigger than 300 square meters, or expanding existing stores.[21]

Enforcement of fiscal and administrative rules to reduce informality

The high proportion of small firms in service industries makes them particularly likely to operate informally, ignoring tax requirements, employee benefits, and other regulations. This is a much larger barrier to growth than most policymakers in emerging—and developed—economies acknowledge.[22] Steps to reduce informality in local service sectors will be rewarded by rapid increases in their productivity, growth and employment.

- *Strengthen enforcement*. Most informal businesses evade taxes and bend rules because they can get away with it. Strengthening inspection and audit services as well as increasing penalties for rule-breaking will help push enterprises into the formal sector.

- *Eliminate red tape*. So will streamlining what businesses must do to comply. For example, lots of companies never register because the process is so long and complicated. The noted economist and author Hernando de Soto found that in Egypt it takes an average of 549 days to register a new bakery.[23] Levying taxes on unregistered businesses is almost impossible, hence the importance of making registration simpler. Simplifying tax practices will compound the benefit.

- *Reduce taxes*. Many emerging economies have generous governments. But they fund their generosity by imposing high taxes on companies in the formal sector. This increases the unfair advantage enjoyed by informal players, and puts them off crossing into the formal sector. Lowering tax rates would tackle both problems. Indeed, combining lower corporate tax rates with stronger enforcement may well increase the overall tax take.

21 See MGI Report Reaching Higher Productivity Growth in France and Germany, op cit.
22 Diana Farrell: The Hidden Dangers of the Informal Economy. *McKinsey Quarterly* 2004(3)
23 Hernando de Soto, unpublished working paper, 2003, cited in ibid

Facilitate "creative destruction" in services

Services are dynamic by nature. To maximize overall service employment, companies must be free to start up, grow and create more jobs or—if they can't compete—to shrink, lay off workers and close. To lubricate this process of creative destruction, governments need to make detailed policy changes.

- Make it simpler to create and grow new firms, and close failing ones. That means cutting the red tape surrounding both business start-ups and bankruptcies. In addition, governments should make it easier for small businesses to prove ownership of their firms. Having security of title means business owners can offer the business itself as collateral for the loans it needs to grow, and also sell it and move, when the right time comes.

- *Enhance labor mobility*. Labor laws intended to promote job security and large severance costs deter firms from taking on more people when business is brisk. Firms even try to get round such legislation by employing people as "temps" and then firing them just before the law recognizes them as permanent employees. On the other hand, restricting temporary or seasonal, or part-time employment also makes it hard for businesses to adjust staffing to fluctuations in demand. Governments should examine their labor laws for such unfortunate unintended effects, and revise them so that employers can create jobs and workers can take them more easily.

* * *

Local services have been left out of developing economy growth strategies for half a century. Import substitution, export manufacturing and, more recently, services for export have captured policymakers' imaginations instead. But dynamic, competitive local services can unlock a huge contribution to overall GDP growth and employment. In fact, achieving higher productivity in local services is the only way for middle income—and developed—economies to ensure lifetime employment for all.

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