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# Analysing the Contribution of Business Services to European Economic Growth

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## **Abstract**

The sector business services contributes directly and indirectly to aggregate economic growth in Europe. The direct contribution comes from the sector's own dynamism. Though the business-services industry appears to be characterised by strong cyclical volatility, there was also a strong structural growth. Business services actually generated more than half of total net employment growth in the European Union since the second half of the 1990s.

Apart from this direct growth contribution, the sector also contributed in an indirect way to economic growth by generating knowledge and productivity spill-overs for other industries. The knowledge role of business services is reflected in its employment characteristics. The business-services industry created spill-overs in three ways: original innovations, knowledge diffusion, and the reduction of human capital indivisibilities at firm level. The share of knowledge-intensive business services in the intermediate inputs of the total economy has risen sharply in the last decade. Firm-level scale diseconomies with regard to knowledge and skill inputs are reduced by external deliveries of such inputs, thereby exploiting positive external scale economies. The process goes along with an increasingly complex social division of labour between economic sectors.

The European business-services industry itself is characterised by a relatively weak productivity growth. Does this contribute to growth stagnation tendencies à la the so-called "Baumol disease"? The paper argues that there is no reason to expect this as long as the productivity and growth spill-overs from business services to other sectors are large enough.

Finally, the paper concludes by suggesting several policy elements that could boost the role of business services in European economic growth. This might to achieve some of the ambitious Lisbon goals with respect to employment, productivity and innovation.

**JEL Classification:** E32, L2, L8, L16, O3, O4, O52

**Keywords:** business services, structural change, growth, Europe, services.

# **Analysing the Contribution of Business Services to European Economic Growth**

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## **Introduction**

The European economy is in a process of structural change. Two major trends characterised the period of the past two decades. One is that the share of manufacturing in the economy is shrinking. The other trend is that services, and particularly business services, account for a monotonically increasing share of the European economy. Both structural shifts are linked to each other in several ways. The fabric of inter-industry relations is being weaved in a new way due to the growing specialisation in knowledge services, the exploitation of scale economies for human capital, lowered costs of outsourcing in-house services, and the growing tertiarisation of all production processes, including that of manufacturing industry. The business services industry plays a key role in many of these processes. Many links between the development of the business-services industry, and its role in economic growth remain under-explored in the literature. In the present paper we argue that business services contributed heavily to European economic growth, in terms of employment, productivity and innovation.

The paper analyses two aspects of the position of business services in the European economy: (a) what has caused the fast growth of the European business-services industry, and (b) how has the business-services industry contributed to the growth of the European economy?<sup>1</sup>

This paper is divided in four parts. The first one deals with conceptual issues, presenting a nutshell history of the concept of business services. The second section covers the explanations for the very strong growth of business-services industry in recent decades. We first focus on explanation for the structural element in the growth of business-services industry. Is it merely caused by the fact that other economic sectors outsource existing (in-house) activities to the business-services industry, as some authors contend. We will argue that such a growth element can only provide a small part of the explanation. The growth of business services represents a qualitatively new stage in the social structure of production. A major characteristic of this structural change is that firm-level scale economies with regard to knowledge and skill inputs are reduced by external deliveries of such inputs, thereby exploiting external scale economies. It goes along with an increasingly complex social division of labour between economic sectors.

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<sup>1</sup> The present paper is written in the preparation of a forthcoming book on this subject (Rubalcaba and Kox 2007).

At the end of the second we will also deal with the relation between structural and cyclical element in the growth of business-services industry.

The third section covers the contribution by the business-services industry to overall economic growth through spillovers in the form of knowledge dissemination, innovation and productivity in other parts of the economy. The business-services industry includes, inter alia, the software and computer-services industry. What are the interactions between business services and other economic sectors? Can we identify the impacts of business services inputs on the growth or productivity of other economic sectors? What role do the business-services sectors have in knowledge dissemination and innovation across European industries?

In the fourth and final section we address some policy issues that pertain to the role of business services in future European economic growth. In this regard we pay particular attention to the role market failures that are associated with the present structure of competition in business services.

## 1. What are business services?

The container concept *business services* covers a broad spectrum of services that are mainly traded in business-to-business transactions. These intermediary services range from software development to temporary-labour agencies, from equipment rental to legal consultancy, and from translation services to the management of complex engineering projects. Business services form a most dynamic group of activities that over the last two decades accounted for more than half of the European employment growth. In some EU countries, this sector is by now in terms of employment equal-sized or larger than the total manufacturing industry.

Interest in the business-services industry is relatively new within economic theory. The surge in attention is to a large extent a by-product of structural change in the economy. Classical economists such as Smith and Ricardo used to regard services as an unproductive activity having more to do with the distribution and consumption of wealth than with its production. An exception was sometimes made for transport and distributive trades. The implicit association of production with material goods production disappeared with the ascent of neo-classical economic theory from the early 1870s onwards. But in the century to follow, theoretical interest in the service sector's contributions to growth was little more than half-hearted. A gap remained between acknowledging theoretically that value could be created through both material and non-material production, and empirical research in which the emphasis remained on material production.

Service activities were initially part of more vertically integrated production activities. Agriculture and manufacturing already included service functions like planning, management, administration, assessment of quantity and quality of products and inputs, product improvement, labour recruitment, learning and education, marketing, transport, storage and distribution. Service professions gradually took over part of these business functions, running them as specialised and commercially independent activities. This

went along with process and product innovations that further developed these service functions. It took some time before this specialisation was recognised as a new phase in the social division of labour. Colin Clark pointed out in 1938 that no less than 50 per cent of the British and US labour populations worked in professions other than mining, agriculture, manufacturing and crafts. He framed the catchword “tertiary production” for this no longer negligible category. However, it still was treated as a heterogeneous residual of goods production.<sup>2</sup>

In the 1960s the American economist Baumol pointed out that growth of the service sector could function as a drag on macroeconomic growth owing to a limited potential for productivity increase (Baumol 1967). Ensuing discussion soon led to the conclusion that at least an analytical distinction had to be made between government services, consumer-oriented market services and producer-oriented market services. Theoretical interest in producer services as a specific economic sector thus dates back to the 1970s.<sup>3</sup>

It was not before another decade had passed that business services — a subset of producer services — received any real theoretical and empirical appreciation. The interest was triggered by the industry’s high growth rates and the complexity of its relationship with outsourcing, innovation and productivity tendencies elsewhere in the economy. Moreover, the high rate of human capital input in business services made the industry an interesting case from the perspective of modern growth theory and the economics of technical change. The general shift of economic activities away from the primary and secondary sectors and towards the tertiary sector has recently seen a specific focus on knowledge-based services.

From Adam Smith’s times onwards, services were defined by what they are *not* – no goods, no material, no agriculture, no manufacturing. Hill, in a seminal article (1977), did away with the negative approach towards services. In ‘*On goods and services*’ he emphasised that a difference exists between goods and services. Goods are physical objects that are appropriated and therefore transferable between economic units. However, a service provided by an economic unit, represents “*a change to the condition of*” a person or goods belonging to another economic unit. The service is defined as a positive result.<sup>4</sup>

Business services are predominantly delivered to companies, other production organisations and government agencies. Hence, viewed from the angle of their destination, business services are primarily intermediate inputs, even though some business services – such as notary or architectural services – supply part of their production to individual consumers. Often the business service is co-produced interactively with the client. Building on Hill’s definition of services we define BS by their role for clients:

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<sup>2</sup> Clark (1938). Later on, Clark dropped “tertiary” and instead referred to the “service” sector. Cf. Fisher (1939) and Maddison (2004).

<sup>3</sup> Browning and Singelmann (1978) came up with a useful disaggregation of tertiary services, distinguishing four categories: distributive services (trade, transport and communication), producer services (banking, insurance, business services), social services (government, health, education, non-profit organisations) and personal services.

<sup>4</sup> See also Martini (1990), Rubalcaba (1999) and Gadrey et al. (1998) for positive definitions of services.

*Business services is a set service activities that - through their use as intermediary inputs - affect the quality and efficiency of the production activities, by complementing or substituting the in-house service functions.*

The definition implies that business-services firms supply activities that in many cases could also have been produced in-house by the client. Service elements are pervasive in any production process, indeed functional services lie at the very heart of any production process. Such functional services can be provided by employees on a firm's own payroll, or they can be bought from outside providers. In the latter case, we speak of business services as an independent industry. In Figure 1.1 we present an operational taxonomy of business services based on the aforementioned definition.

**Figure 1.1 Defining business services as part of producer services**

<i>Producer Services</i>	<i>Business services</i>	<i>Knowledge intensive-business services (K.I.B.S.)</i>	<ul style="list-style-type: none"> <li>• Software and computer services</li> <li>• Strategy and management consultancy</li> <li>• Auditing, tax and legal advise</li> <li>• Marketing services, Opinion polling</li> <li>• Technical services, engineering</li> <li>• Personnel training, headhunting</li> <li>• Strategy and management consultancy</li> </ul>
		<i>Operational business services</i>	<ul style="list-style-type: none"> <li>• Security services,</li> <li>• Facility management, cleaning</li> <li>• Administration, bookkeeping</li> <li>• Temporary labour recruitment</li> <li>• Other operational services (e.g. catering, translating, call centres)</li> </ul>
	<i>Business-related services</i>	<ul style="list-style-type: none"> <li>• Distribution and trade services</li> <li>• Transport and logistics</li> <li>• Banking, insurance, stock exchange</li> <li>• Telecommunication, couriers</li> <li>• Energy services</li> <li>•</li> </ul>	
		Consumer services partly used by enterprises (business travel, company health services, social insurance services)	

Statistical classification problems for business services are much greater than for services as a whole, or for some traditional services like banking, trade, transport or tourism. The newness of the sector, the continuous development of new activities, the proximity of one activity to another and also the lack of interest shown by statisticians have made for a multiplicity of classifications and a lack, even today, of criteria for the study of business services. The fact that most business services nowadays can be found in the residual category *Other Business Services* (NACE 74) exemplifies the relatively short history of business services as an independent economic sector.<sup>5</sup> The functional

<sup>5</sup> The NACE category *Other Business Services* is subdivided in sectors. The last 3-digit sector (NACE 748) again uses a negative residual criterion: 'Other business services, not elsewhere classified'. Hence, this is a residual category within a residual taxonomic category. Nonetheless, it employs millions of employees in the European Union.

industry classifications (NACE, ISIC) do not start from a positive definition of business services. They use a negative statistical approach based on classification as residual: *what is not in ..., not elsewhere classified*.

## 2. The growth of European business services

The most direct contribution of the business-services sector to economic growth comes from its own dynamism and expansion. The present chapter discusses the stylised facts about business-services growth in the European Union, differentiating between cyclical and structural elements in the sector's growth. We also offer explanations for both the cyclical and the structural elements in business-services growth.

For brevity reasons and to avoid endless repetition in the rest of this paper, we will henceforth use the abbreviation 'BS' for business services and 'BS industry' or 'BS sector' for the business-services industry.

### 2.1 The magnitude of BS growth

The BS sector has experienced a remarkably strong growth process in the past two decades, in terms of both employment and value added. Business services nowadays count as one of the largest economic sectors in the European economy, larger than such sectors as transport, communication, hotels and restaurants taken together. As shown in Table 2.1, more than 19 million workers in business services generate more than 1000 billion euro, and the sector's employment and value added account for some 11 per cent of the total EU15 economy.

Between 1979 and 2003, value-added growth in business services (4.2 per cent) was higher than in any other sector except telecommunications. In terms of employment, the growth of business services (4.4 per cent) far outstripped the growth of all other sectors.

Table 2.2 provides further insight into the differences between EU countries.<sup>6</sup> The BS value-added share in EU member states ranges from 3 per cent in Greece to 13-14 per cent in Ireland, France and the UK. In terms of the BS employment shares, the intra-EU differences are somewhat smaller. The annual growth of both value added and employment in the EU15 has been more than four per cent. Countries with consistent high growth rates are Austria, Ireland, Luxemburg and Spain, while France, Belgium and Denmark are witnessed relatively low growth rates for value added and employment.

Interestingly, the EU15 countries and the USA had similar employment growth rates in business services over this long period, but the average value-added growth in the USA was higher. This differences implies that productivity growth in the EU business-services sector was weaker than in the USA.

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<sup>6</sup> Apart from possible statistical biases, the country results may also reflect different market situations and sectoral specialisations.

**Table 2.1**  
**Key data on the growth of business services, European Union (EU15), 2003**

Sector	Value added			Employment		
	Billion euro <sup>a)</sup>	% relative shares	Growth rates <sup>b)</sup> 1979/03	Thous-ands	% relative shares	Growth rates <sup>b)</sup> 1979/03
<b>Business services</b>	<b>1,067</b>	<b>11.2%</b>	<b>4.2</b>	<b>19,460</b>	<b>11.4</b>	<b>4.4</b>
- Renting of equipment	90	0.9	5.0	563	0.3	3.4
- Computer and related activities	183	1.9	6.6	2,450	1.4	6.1
- Research and development	37	0.4	2.4	632	0.4	1.8
- Legal, technical, advertising	472	4.9	3.8	7,037	4.1	3.8
- Other business activities, nec	286	3.0	3.9	8,778	5.1	4.8
<b>For comparison</b>						
All sectors	9,540	100.0%	2.2%	171,167	100%	0.6%
- Manufacturing	2,516	26.4%	2.2%	42,055	24.6%	-1.0%
- Distributive trades	937	9.8%	2.3%	25,943	15.2%	0.9%
- Transport	455	4.8%	2.4%	7,191	4.2%	0.5%
- Financial services	576	6.0%	2.5%	5,392	3.2%	1.3%

Notes: <sup>a)</sup> Current prices. <sup>b)</sup> Annual exponential growth rates. Value added at constant prices 1995.

Sources: Based on OECD National Accounts data (STAN), and data compiled by Groningen Growth and Development Centre GGDC (cf. O'Mahony and Van Ark, 2003).

**Table 2.2**  
**The growth rate and the share of business services value added and employment. Selected countries, 1979-2003**

Country	Relative shares in total economy, 2003 <sup>a)</sup>		Annual growth rates, 1979-2003 <sup>b)</sup>	
	Value added	Employment	Value added	Employment
EU15	11.2	11.4	4.2	4.4
Austria	9.2	9.4	5.7	5.3
Belgium	-	14.2	3.8	3.5
Denmark	7.8	9.7	4.1	3.1
Finland	7.2	8.5	4.8	5.2
France	13.3	13.7	2.9	3.5
Germany	12.3	11.4	4.4	5.1
Greece	3.4	6.4	3.5	4.5
Ireland	14.3	7.8	5.2	6.0
Italy	11.7	10.5	4.4	6.3
Luxembourg	7.6	15.6	8.6	7.5
Netherlands	11.2	14.2	4.5	4.3
Portugal	6.5	6.6	3.6	6.6
Spain	7.1	7.4	5.3	5.4
Sweden	10.3	9.8	4.3	4.2
UK	13.5	13.7	4.6	3.2
<b>PM: USA</b>	<b>11.0</b>	<b>11.8</b>	<b>4.6</b>	<b>4.3</b>

Notes: <sup>a)</sup> Current prices. <sup>b)</sup> Annual exponential growth rates. Value added at constant prices 1995.

Sources: Based on OECD National Accounts data (STAN), extended and compiled by GGDC, see Table 2.1.

Summarising the empirical evidence, over the past decades employment in business services grew faster than in the total European economy and also faster than in the rest of the European services sector. The countries of northern and central Europe display stronger employment growth in business services than those in southern Europe. In absolute terms, job creation in the BS sector in all countries represented a major shift in market-sector employment. The growth difference between business services and the rest of the economy was smaller for value added than for employment.

## 2.2 Decomposition of cycle and trend in BS growth <sup>7</sup>

The growth data presented in section 2.1 concerned the period 1979-2003. The length of this period is sufficient to speak of a structural growth pattern. But how stable was the growth of the BS sector over time? Traditionally, services have been considered as relatively stable sectors, less sensitive to cyclical fluctuations than agriculture and manufacturing. They served as refuge sectors in case of economic crisis. The reasons for the tempering, or even anti-cyclical behaviour of some of the tertiary activities have been analysed by several authors.<sup>8</sup> Does cyclical growth stability also hold for the BS sector? We find indications that this is not the case. First we investigate how volatile BS growth is in the EU. Subsequently, we address the question of how sensitive the growth of the BS sector is to business-cycle fluctuations.

### 2.2.1 How volatile is the growth of BS sector?

As a sector whose output mostly serves as intermediary inputs for other industries, the BS industry is intimately tied-up with the economic performance of other industries. This would suggest that the sector is much more sensitive to cyclical aspects than, for instance, consumer services. On the other hand, the BS sector has some characteristics that could support its stability. We first identify the major factors involved.

The following characteristics of the BS industry tend to make it susceptible to cyclical fluctuations:

- Some parts of business service demand (e.g. software) are used as investment inputs in other industries. Since investment demand displays high cyclical fluctuations, this exposes some parts of business services to cyclical patterns.
- The sector's high degree of integration with the manufacturing industry may increase volatility.
- Compared to other service sectors, business services have a higher exposure to international competition, which could expose the sector to more cyclical effects.
- The BS sector employs more part-time, temporary and self-employed workers than the average of the main economic sectors. This segment of the labour market tends to be most affected by cyclical effects.

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<sup>7</sup> The authors thank Pilar Bengoechea of DG ECFIN (European Commission) for her contribution on this section.

<sup>8</sup> E.g. Elfring (1988); Cuadrado and del Rio (1993); Lee (1996); Filardo (1997); Petersen and Strongin (1996).

- The BS industry has high birth (entry) and death (exit) rates for firms. In the down-turn of the cycle, a relatively large group of firms that entered during the upswing, are "shaken out". In the upswing, many start-ups enter this sector as self-employed firms.
- Flexibility arises from the fact that the labour market for business services is, in many cases, more liberalised than that of its products, so that employment may be more volatile than value added.
- The BS industry is a strong client of itself; this means that a cyclical downturn in other client industries will be multiplied.

Apart from these factors, the BS sector also has some characteristics that could contribute to growth stability over time:

- Job market characteristics: the on average high qualification of workers in business services may produce a high degree of labour hoarding during the downswing of the business cycle.
- Sharp cyclical fluctuations are often found in sectors whose products can easily be stocked. As with other service sectors, this does not apply, thus contributing to limited business cycle sensitivity.
- Some 25% of the intermediate outputs of the BS industry go to sectors (public sector, trade, utilities) that are relatively stable over the business cycle.<sup>9</sup>
- The fact that some professions and activities are still relatively heavily regulated (e.g. EU 2002) could dampen the effect of business fluctuations.

As far as business services are concerned, we can expect them to behave differently from the services sector as a whole. The aforementioned factors suggest that the BS sector has a higher exposure to cyclical effects than most service sectors, but there are also some compensatory characteristics. Moreover, the business-cycle volatility may be different in various parts of the BS industry. The behaviour, for instance, of advanced and personalised services, where labour hoarding can be important, may be very different from that of operational and standardised services, where labour can be hired and fired more easily. It is a matter for empirical analysis to determine whether pro-cyclical or anti-cyclical effects dominate in the behaviour of BS growth in the EU Member States.

### 2.2.2 Trend estimation and cyclical components in BS growth

The present section breaks down the growth of the BS industry into cyclical and trend effects. This is done by applying the most widespread practice of decomposing, i.e. the procedure adopted by Hodrick and Prescott (1980). They propose a filter (henceforth: HP filter) for decomposing cyclical and trend effects. Advantages of the filter are its flexibility, simplicity and reproducibility.<sup>10</sup> In this section we use the HP trend and

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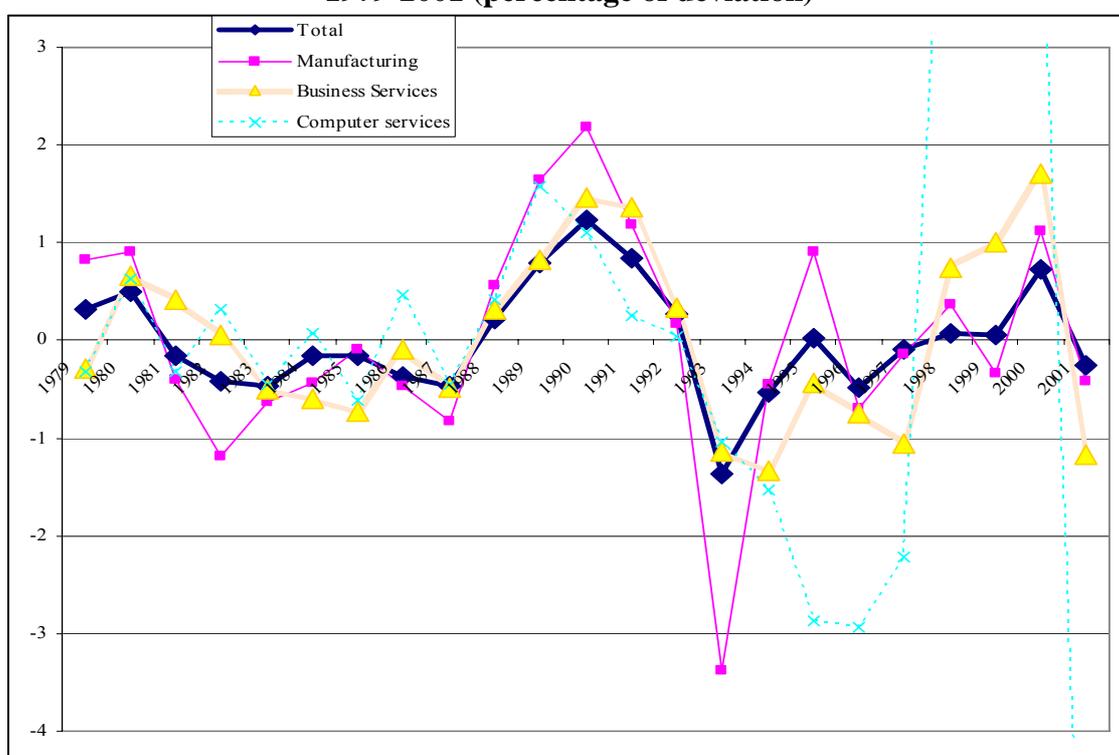
<sup>9</sup> However, the anti-cyclical part played by the public sector may have declined over the past decade, as the result of the control over the public deficit and less use of open-ended contracts by the national administrations.

<sup>10</sup> Recent dynamic CGE theory advises against making a distinction between trend and cyclical effects, based upon the argument that both growth and business cycles are determined by fundamentally the same factors.

cycle decomposition for the identification of structural trends in a very volatile sector rather than for separate explanations of trend and cycle developments.<sup>11</sup>

Figure 2.2 shows the development over the business cycle of value added for BS (and separately computer services), manufacturing and the total economy. The BS sector consistently displayed a strong cyclical volatility between 1979 and 2001, quite similar to manufacturing. BS has grown faster than other sectors in expansion phases (1978-1980, 1988-91 and 1997-2000) and suffered more negative effects during the downturns in the business cycle (1981-84, 1991-94, 1996-97 and 2000-2002). The link between BS

**Figure 2.2**  
**Cyclical growth as annual deviation from long-term value-added growth, EU15, 1979-2001 (percentage of deviation)**



Note: the Y-axis is derived from total value added minus structural trend related to value added after the use of a HP filter. Data: based on National Accounts data (STAN) and data by GGDC (cf. O'Mahony and Van Ark 2003).

growth and the business cycle in manufacturing may reflect the strong links through intermediate demand and the growing globalisation of some services markets. While manufacturing from 1995 onwards appeared to become less cyclically volatile, we see the opposite happening in BS industry. This may to some extent be caused by a

<sup>11</sup> This filter defines a tendency (obtained from the original time series to obtain the cyclical component)

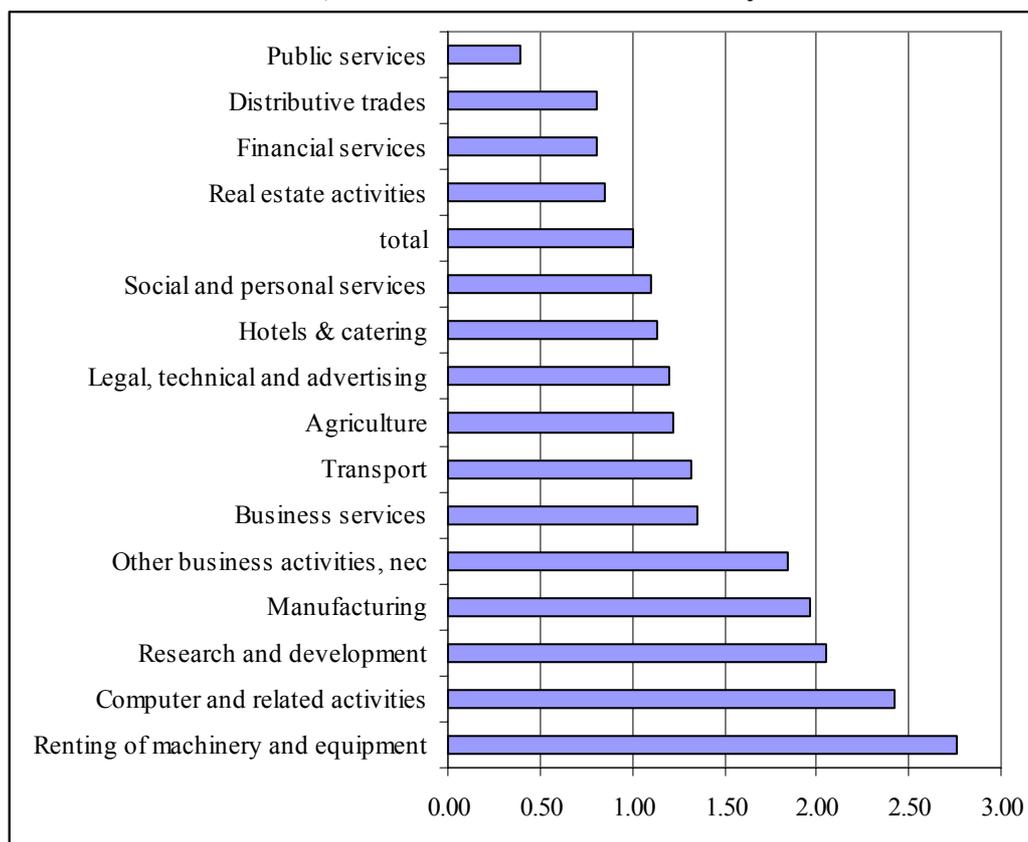
as the value of  $\tau$  that minimises the expression: 
$$\sum_{t=1}^T (y_t - \tau_t)^{2+\lambda} \sum_{t=2}^T [(\tau_{t+1} - \tau_t) - (\tau_t - \tau_{t-1})]^2$$

where  $y$  is the time series and  $\lambda$  is an arbitrary parameter. If  $\lambda$  is relatively small, the adjustment is assimilated to the original series, while a  $\lambda$  towards infinity makes time series closer to a straight line. For annual series often the value of 100 is used. With regard to the present type of data we follow O'Mahony and Van Ark (2003) who - after assessing different alternatives- opt for a value of 6.

composition effect. The booming ICT-related services (e.g. software, hardware consultancy) form part of business services, and as Figure 2.2 shows, growth of ICT-related services was quite volatile since 1995.

Figure 2.3 shows that the high cyclical volatility of BS employment growth contrasts with that of most service sectors. Some sectors (public services, distributive trade and financial services) display less volatility than the economy average. Employment fluctuations in business services are particularly strong. This indicator is marked by labour flexibility and by the growing integration of services in manufacturing industry. Advanced services such as computer services and R&D services are more volatile than those operational services included under the category “other business services”.

**Figure 2.3**  
**Relative volatility of employment growth, selected sectors,**  
**EU 15, 1979-2001 (All-sector volatility =1)**



Note: HP filter based on National Accounts data (STAN) and data compiled by GGDC.

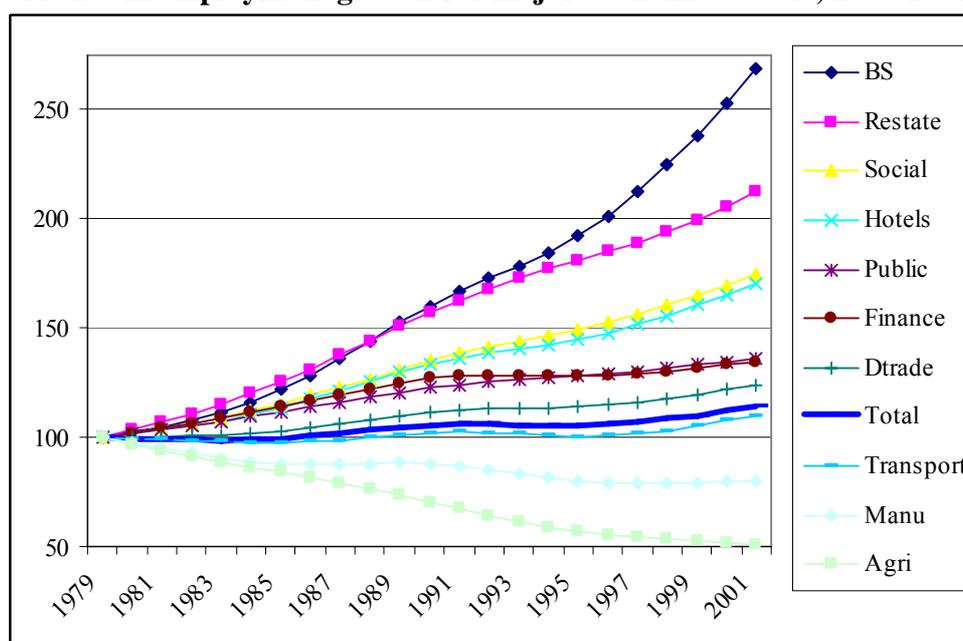
These empirical results demonstrate that the sector has a strong pro-cyclical influence on employment, with much more volatility than the economy average. High integration with industry and labour flexibility may be two explanatory factors.<sup>12</sup> However, the

<sup>12</sup> Thus, it is not surprising that the volatility of business services is consistently higher from the beginning of the eighties onwards. Since then, processes of market flexibilisation and inter-industrial integration have taken place, which have had a very powerful influence on business services.

strong sensitivity of business services to economic cycle could also be understood as a weakness due to the “temporary” character of business services: when things go wrong, enterprises reduce their costs and cancel many BS contracts, but when they go right, enterprises decide to expand, and more business services are contracted. The cyclical behaviour of business services cannot explain the continuous growth of the sector in both absolute and relative terms during the last quarter century. The growth of business services is explained mainly from structural factors, absorbing most of the recession effects. That explains why only in few countries and few sub-sectors recessions have absolute negative influences in business services.

Figure 2.4 depicts development trends in employment for major economic sectors. The difference between the structural growth of business services and the rest of the sectors is marked, even though the BS sector starts from a relatively small absolute size.

**Figure 2.4**  
**Trends in employment growth for major economic sectors, 1979-2001**



Note: HP filter based on National Accounts data (STAN) and data compiled by GGDC.

We conclude that the structural growth trend for the BS industry has until now dominated its relatively high cyclical volatility. The flip side of the coin is that once the structural growth of the BS sector falters, the by then even larger weight of business services in the total economy and its cyclical characteristics could increase cyclical volatility for the entire economy. In several European countries, the cyclical prospects of the BS sector are already being used as an early-warning indicator for the cyclical development in the entire economy. It must be stressed, however, that the structural growth of business services in many EU Member States does not yet seem to be exhausted.

### 2.3 Causes for structural growth of the BS sector

The rather spectacular growth of the BS industry may have several reasons. A literature survey may yield a panoply of explanatory factors, related to different aspects (technology, institutions, social preferences, organisational developments). The explanations operate at different levels of analysis (micro, meso, macro). Several factors can operate at the same time, though at different levels of analysis. Other factors may hold for particular periods, for particular branches, or for countries in a particular stage of development. Rubalcaba (1999), Aiginger (2001), Kox (2001) and Miles (2007) present comprehensive literature surveys on the growth factors.

Here we focus exclusively on two dominant explanations for structural growth of business services. The first theory, defended *inter alia* by Rajan (1987) and Lewis (1988), states that the growth is an optical illusion, because existing activities and jobs in other industries are simply replaced by similar activities in BS industry.<sup>13</sup> The second theory defends that structural growth of business services is a new development phase in the social division of labour. It builds on Adam Smith's classic view that specialisation and scale effects form the very heart of economic progress.<sup>14</sup> We subsequently deal with both explanations.

If the entire growth of BS industry would be based on a simple shift of existing in-house services jobs from other sectors to BS firms then we could indeed speak of a purely administrative shift: a "changing of nameplates". It is inherent in our definition of business services (section 1) that many services supplied by BS firms *could* also have been produced *internally* by firms in other industries. On average about 40 per cent of all persons employed in manufacturing work in occupations that are more or less (business)service-related.<sup>15</sup> Table 2.3 sketches a range of intra-company service functions that may or may not be up for outsourcing to BS firms.

The proposition that the growth of business services merely represents only an administrative change can be analysed in the same way as an analogue problem in international trade theory. Viner (1950) investigated whether economic integration between countries leads to additional trade (trade creation) or whether it represents a re channelling of trade patterns (trade diversion).<sup>16</sup>

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<sup>13</sup> Rajan (1987) and Lewis (1988) find empirically that business-services growth is due to employment substitution inside the companies as a result of subcontracting the required services outside the company. The characteristics and significance of their statistical results have, however, been called into question by Perry (1992).

<sup>14</sup> The theory has been developed further by *inter alia* Stigler (1951), Edwards and Starr (1987) and Francois (1990).

<sup>15</sup> The following count as services-related occupations are: legislators, senior officials and managers, professionals and associate professionals, clerks, service workers and shop and market sales workers, as well as drivers, sales and services elementary occupations and transport workers (Wölfl 2004).

<sup>16</sup> Cf. also Meade (1955).

**Table 2.3**  
**Internal service functions and externally delivered producer services**

<i>Major functions in enterprises</i>	<i>Corresponding external producer services</i>
<b>1. Strategy and new markets</b>	Management consultancy, Market research, Organising Fairs and exhibitions
<b>2. Information management (IT services and infrastructure)</b>	Computer services, Consultancy on information technologies, Telecommunication services
<b>3. Personnel</b>	Selection and provision of personnel, Professional training
<b>4. Production and technical function</b>	Engineering and technical services. Tests and quality control. Maintenance service and repair of equipment
<b>5. Design functions</b>	Research and development, Industrial Design
<b>6. Marketing</b>	Advertising, Direct marketing, Public relations
<b>7. Purchases and sales</b>	Distributive trades ( incl. after sales services)
<b>8. Financial resources</b>	Banking, Insurance, Renting and leasing
<b>9. Administration and accounting</b>	Accounting and auditing, Legal services, Tax advise
<b>10. Transport and logistics</b>	Logistics, Transport services (persons), Transport services (merchandises), Express couriers, Real Estate
<b>11. Facility management services</b>	Security services, Building maintenance, Cleaning services, Catering, Environmental services / waste disposal, Energy and water services

Following Viner's distinction, we can distinguish two types of BS growth:

- *Displacement growth* (trade diversion) occurs when services hitherto produced in-house by other industries are outsourced to BS firms, without a change in the nature of the services.
- *Trade creation* occurs when BS firms provide products to client firms that are different (higher quality, more specialised) from the in-house services that the client firms produced in-house beforehand, or that are even completely new.

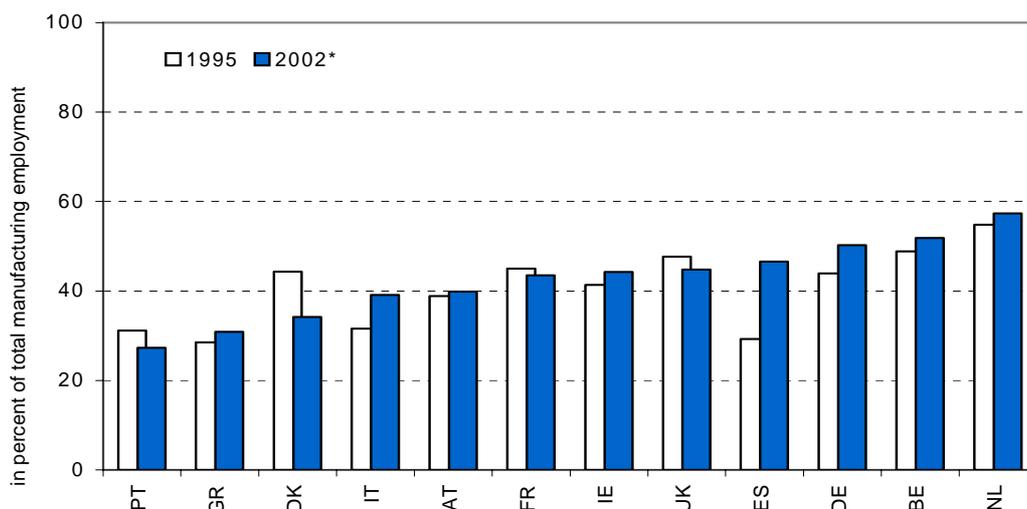
It is an empirical question which of both growth-types accounts for most of the recent growth of business services. Given the heterogeneity of firms and their in-house services this in fact requires a broad survey-based research method using firm-level microdata. To our knowledge such a study does not yet exist. We therefore turn to second-best research methods based on sector-level data.

### **2.3.1 Is replacement growth the best explanation?**

A first test is whether the share of services jobs in manufacturing has diminished over time. Figure 2.5 shows that since 1995 it has indeed declined in the UK, Denmark and France. However, it has increased in all the other EU countries, especially in Spain, Italy and Germany. These data therefore do not confirm the existence of an overall trend towards a lower share of service-related jobs in manufacturing. The test is not conclusive because the data on employment structure in manufacturing may be subject

to other tendencies that affect the number of services jobs. An increasing number of manufacturing products are nowadays sold "encapsulated in a service jacket" (Howells 2002).<sup>17</sup> This in itself could cause a persistent increase in the number of service jobs in manufacturing.

**Figure 2.5**  
**Share of employment in service-related occupations in the manufacturing sector**  
 (as % of total employment of manufacturing, 1995 and 2002)



Note: Services related occupations cover ISCO classes 100-500, 830, 910, 933. Data for Germany are from 2001. Data source: EU Labour Force Survey 1995, 2002 (figure reproduced from Pilat and Wölfl, 2005).

Since the late 1980s many empirical studies applied some form of input-output analysis to analyse growth factors for services sectors, often at a rather high aggregation level and mostly for one specific country.<sup>18</sup> Most of the intermediate deliveries from business services appear to go to manufacturing, the BS industry itself, and the public sector (e.g. ECORYS-NEI 2004). A test to establish the growth sources of the BS sector can be based on input-output analysis. A rough approximation method is the following. Suppose we divide the total economy into three parts: *Business Services*; *Other Industries* (all other market sectors); and *Government* (non-markets sectors). Using decomposition methods we may break down the sources of structural growth for *Business Services*, and thus answer the question why it has got a larger share of total production and employment over time. Specifically, it may give the relative importance of the following structural growth sources:

- a) final demand in *Business Services* grows faster than in both other sectors ;
- b) *Business Services* benefits most of both markets sectors from privatisation (public services procurement) in the *Government* sector;

<sup>17</sup> For instance, producers of photocopying machines now sell  $x$  months of problem-free photocopying instead of only the hardware, just as producers of airplane engines sell  $y$  hours of problem-free flying. This means an increase of manufacturing jobs into downstream production stages (sales, consulting, maintenance, insurance, leasing).

<sup>18</sup> Cf. the empirical growth studies on producer and business services by Beyers and Lindahl (1996), Kutscher (1988), Tschetter (1987), Fontaine (1988), Oosterhaven and Hoen (1998), Klodt et al. (1997), Peneder et al. (2000), Wölfl (2004), Perry (1990), De Bandt (1995, 1999), Kox (2001), Pilat and Wölfl (2005), Coe (2000), Savona and Lorentz (2006).

- c) the *Business Services* sector gets a larger share in total intermediary deliveries of *Other Industries*;
- d) comparing the change in value added of *Other Industries* with the change in *Business Services'* intermediary deliveries to *Other Industries*. In case of replacement growth both must be about equal.

If replacement growth would indeed be the dominant reason for the growth of business services then we should find that the last two conditions (*c,d*) are satisfied. Moreover, the importance of growth source *c* for *Business Services* must be larger than that of the growth sources *a* and *b* together. A more technical description of the growth decomposition method is added as Annex 1 at the end of the paper.

The aforementioned growth decomposition analysis has not yet been applied to the structural growth of European business services for the period starting in 1990, partly due to data comparability problems.<sup>19</sup> Savona and Lorentz (2006) apply growth decomposition for 13 sectors in four countries. On the basis of their results, Figure 2.6 shows that in each of the countries the BS sector registered a higher growth rate of intermediate demand than two benchmark sectors. The graph shows that intermediate demand was relatively strong for business services in the 1980s and early 1990. This indicates – in terms of the aforementioned growth factors – that factor *c* indeed has been relatively important for BS. In the last time period, the role of intermediate demand is getting more in line with the two benchmark sectors (smaller growth-rate difference). Savona and Lorentz find that most of the growth in business services came from intermediate demand (factor *c*), but we do not know to whether this arose from new services products or from replaced services. Savona and Lorentz also find that a substantial part of BS growth came from final demand (factor *a*). The latter finding is clearly at odds with the replacement hypothesis. The same holds for the empirical result that BS industry itself has become the most intensive user of BS inputs (e.g. ECORYS-NEI 2004). This can hardly be reconciled with the proposition that the growth of business services is mostly due to displacement growth. The available evidence suggests that displacement growth can at best explain a limited part of BS growth.

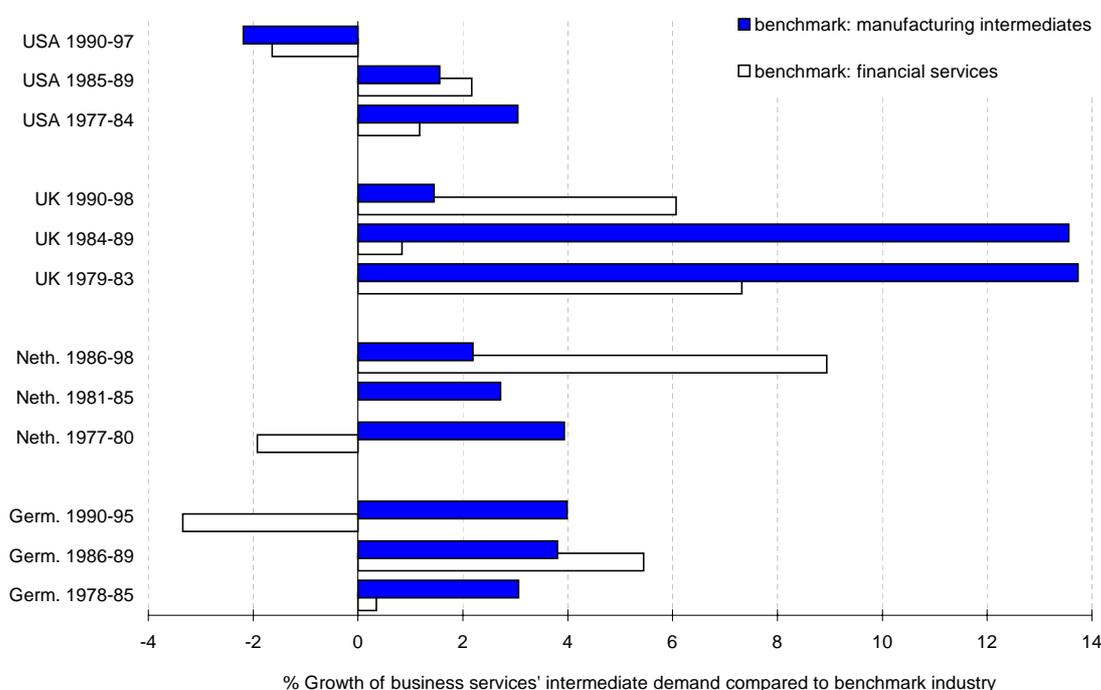
Ruyssen (1990) in a study for the European Commission found that the role of BS subcontracting is seldom just a transfer of employment between sectors. It often involves a new division of work between the client company and the service-providing company. Several studies indicate that a shift has taken place from pure replacement outsourcing to service-upgrading, particularly with regard to the human-capital content of the services product.<sup>20</sup>

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<sup>19</sup> Amounts must be expressed in constant prices and correction is necessary for that part of growth that is due to growth in final output of *Other Industries*. The test can be done for most EU countries as soon as comparable input-output tables in constant prices for the 1990s are available. A large ongoing EU project, EUKLEMS (<http://www.euklems.net/>), in which many national statistical and research institutes co-operate, may yield these results in some years.

<sup>20</sup> E.g. Peneder et al. (2000), Beyers and Lindahl (1996), De Bandt (1995; 1999); Coe (2000); Kox (2002; 2001).

**Figure 2.6**  
**Growth rate difference of the share of intermediate demand in total output: business services compared to manufacturing industries<sup>a)</sup> and financial services. (Germany, UK, Netherlands and USA, data for three sub-periods)**



Note: a) For manufacturing we used two sub-sectors (machinery industry and electrical-equipment industry) that both have substantial intermediate deliveries. Source: calculated from data in Savona and Lorentz (2006).

### 2.3.2 BS growth and structural change

The development of business services as an industry forms a step in the process of labour division. Many studies conclude that the output increase in (business) services has to more to do with overall changes in the productive system than with just a redistribution of activities between manufacturing sector and the services sector. Specialised knowledge-intensive business functions that in the past were regarded as core competences of firms –and therefore not subject to outsourcing– are increasingly outsourced to specialised outside firms, or are continued in close co-operation with the latter.<sup>21</sup> In the past 15 years, knowledge-intensive business functions have increasingly become eligible to outsourcing. A facilitating factor in this process was the substantial fall in information and communication costs due to the ICT revolution, making it easier to co-ordinate specialised and spatially separated business processes. The BS sector has benefited from this process of structural change in a double way. Firstly, the ICT revolution partly came from within the BS industry (software development and IT services). And secondly because the surge in outsourcing created new business

<sup>21</sup> Examples are customer relations, marketing, management information systems, quality control, logistic management, R&D functions, recruitment of top management, project management, invoicing, administrative organisation, human resource management, professional training, engineering, computer services and legal affairs.

opportunities for other branches in business services. The complexity of inter-sectoral and intra-sectoral division of labour also has an international dimension through the rise of 'offshoring', particularly since the turn of the century (Grossman and Rossi-Hansberg 2006; Baldwin 2006; Van Welsum and Vickery 2006). The specialisation by some knowledge-based firms is such that even the size of most national markets is not even large enough for them. Sometimes, routinised elements within knowledge services are further split up so that parts of the process can be one in less-developed countries, benefiting from the wage-rate differences. It gives rise to new international trade flows in knowledge-intensive business services, or shortly: *KIBS* (Leshner and Nordås 2006).

The increasingly complex social division of labour with regard to knowledge services allows several types of product and process innovations, more knowledge specialisation, and better use of specialised inputs. Scale bottlenecks with regarding knowledge-intensive specialisations at the firm level become less relevant, as outsourcing makes it possible to benefit from external scale advantages in these areas. A popular way of obtaining the most from advanced business-related services is the combination of both in-house and external services. The expertise and specialist knowledge of external *KIBS* firms can better be absorbed and optimised if the outsourcing firm also employs highly skilled people.<sup>22</sup>

These structural changes give an impetus to aggregate economic growth with repercussions that go beyond the BS sector. This can be illustrated on the basis of macro-economic production functions. A macro-economic production function is a specific national production constellation, i.e. a particular relation between sectors that together form the national economy. Alternatively, we may also view this as a particular way in which the social division of labour in the economy is organised. Figure 2.7 plots two macro-economic production functions with on the vertical axis the total value added of all industries, and on the horizontal axis the aggregated production inputs (like labour) used to produce this value added.<sup>23</sup>

Initially, the relation between industries and sectors is reflected in macro-economic production function 1. It represents all the production possibilities that are within reach by a certain state of technology and by a given social division of labour between sectors. By using production inputs  $F_0$  it yields value-added level  $Y_0$ . By increasing the amount of production inputs to  $F_1$  value added grows to  $Y_1$  as output shifts upwards from A to B along production function 1.

Now suppose that a technological breakthrough such as the ICT revolution, makes a new arrangement of the relations between economic sectors possible, allowing for further division of labour, more outsourcing possibilities and more use of specialised service inputs. In Figure 2.7, the new social division of labour is represented by macro-economic production function 2. Note that at input size  $F_0$ , it is not yet profitable to switch to production function 2; it takes more scale-size (amount of inputs) to bring the efficiency benefits into reach.<sup>24</sup> Structural change occurs when the production system switches from production function 1 to production function 2, with a 'jump' from

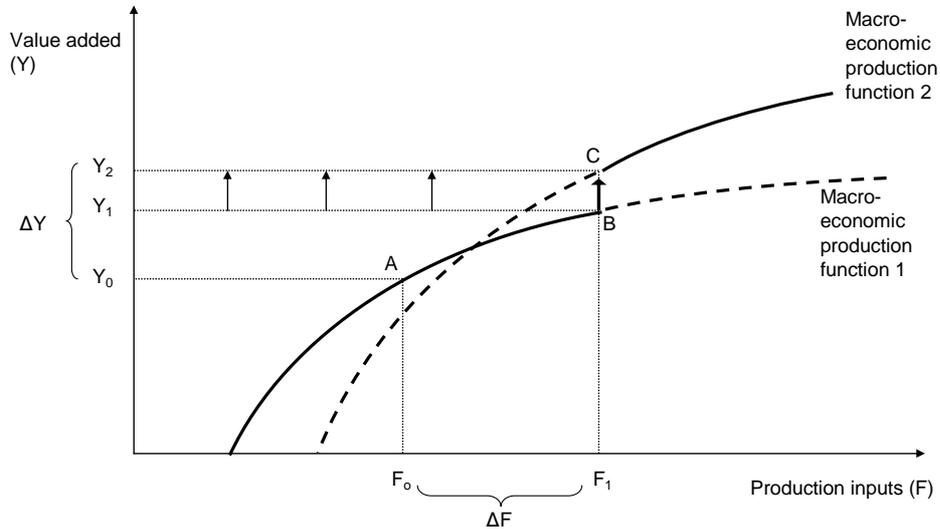
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<sup>22</sup> For further evidence, see Baker (2007), Camacho and Rodriguez (2007) and Crespi (2007).

<sup>23</sup> Figure 2.7 assumes that diminishing returns to scale are dominant in the production function.

<sup>24</sup> E.g. Edwards and Starr (1987).

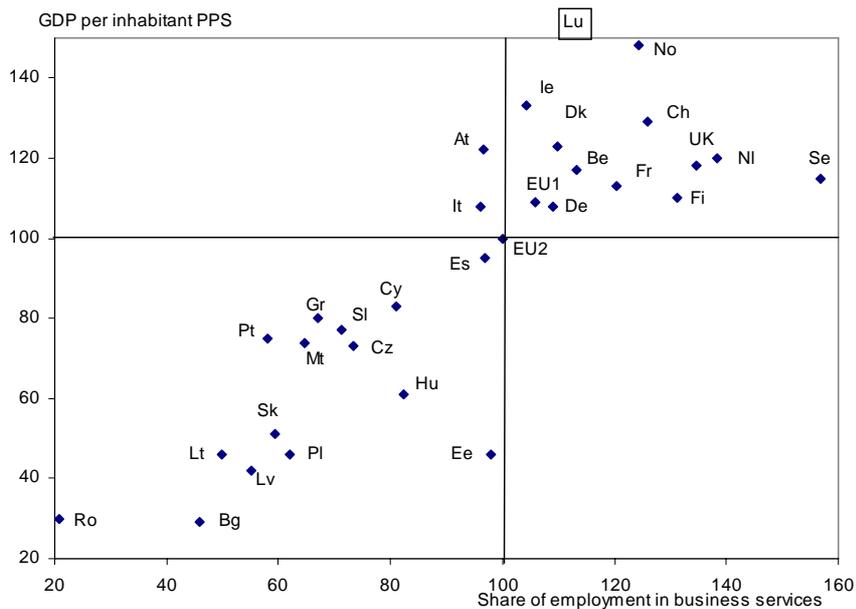
**Figure 2.7**  
**Structural change and macro-economic growth potential**



point B to point C. With a given increase in factor inputs ( $\Delta F$ ), a higher level of economic growth (namely  $\Delta Y$ ) becomes possible, thus attaining production level  $Y_2$ .

If there is indeed a positive relation between economic size and the role of the BS sector in the inter-industry division of labour, we would expect to find a relatively larger BS sector in the larger and more developed countries. In Figure 2.8 we plot a correlation between GDP per capita and the employment share of the BS sector. The average values

**Figure 2.8**  
**Correlation between GDP per capita and the share of business services in total employment in Europe, 2000**



Data: Eurostat national account data for GDP, PPS (standardised PPP-purchasing power parity)

for the EU25 are used as the basis for comparison (index = 100). We indeed find the expected pattern, even within the Europe. EU member states with a low income per capita all have a less developed BS sector, while in none of the richer countries we find a low share of BS jobs. Countries like Portugal, Lithuania, Latvia or Slovakia are below 60 per cent of the EU25 average. Luxemburg is an outlier. The correlation coefficient is 0.75 for the whole set of 30 countries presented here. It increases to 0.85 if Luxemburg is excluded from the sample. The results imply no direction of causation, but we may infer that the development of the BS sector is associated with a process of structural change in the economy as average income goes up.

There is a second interesting finding on the basis of this empirical analysis. The four quadrants of the graph are derived from the EU25 average for both variables. If we confine us to the country sample in the upper right quadrant of Figure 2.8, it appears that there is no longer a significant correlation between GDP per capita and the employment share of the BS sector. This suggests the existence of some threshold level in the relation between both variables. The correlation does not say anything about the direction of causality with regard to this threshold level.<sup>25</sup>

Input-output analysis provides further indications that the growth of the BS sector indeed reflects an increasingly complex social division of labour between industries, and even within industries. Total intermediate demand for business services is for an important share absorbed within the BS sector itself (cf. Table 2.4). This pattern would be difficult to explain if the growth of the BS sector was purely replacement growth. If the size differences between the sectors are taken into account,

**Table 2.4**  
**Intermediate demand for BS inputs: ranking of the main destination sectors, selected countries, period 1994-1998**

	Rank of business services as destination sector	Five most important destination sectors of intermediate BS inputs, ranked by importance <sup>a)</sup>	Share (%) of Business Services in intermediate demand
UK	1	BS - MFG - PUB - FIN - THC	<b>26.1</b>
Netherlands	1	BS - MFG - THC - PUB - FIN	<b>24.9</b>
France	2	MFG - BS - PUB - FIN - CON	<b>24.2</b>
Germany	2	MFG - BS - PUB - REA - THC	<b>17.1</b>
Italy	3	MFG - THC - BS - PUB - FIN	<b>14.2</b>
Spain	3	MFG - PUB - BS - THC - CON	<b>13.6</b>
Denmark	5	CON - THC - PUB - MFG - BS	<b>12.9</b>
Finland	4	MFG - PUB - THC - BS - REA	<b>8.1</b>
Greece	8	MFG - THC - PUB - CON - TRA	<b>3.1</b>
<b>PM: USA</b>	2	THC - BS - PUB - MFG - FIN	<b>17.7</b>

Note: a) The sector codes are: MFG: manufacturing; BS: business services; FIN: financial services; PUB: public sector; THC: trade, hotels and catering; TRA: transport and storage; CON: construction; REA: real estate. Source: The country data are based on the most recent IO table available in the OECD database over the period 1994-1998. OECD input-output tables; ECORYS-NEI (2004).

<sup>25</sup> Either there is a level of BS employment beyond which income growth per capita depends on other factors, or there is a level of income per capita beyond which economic wealth may be derived as well from BS as from other economic sectors.

the BS sector is the most intensive user of BS inputs.<sup>26</sup> The vertical fragmentation and specialisation process in the production chain translates itself into growing 'roundaboutedness' of production, i.e. a higher transaction density in the trajectory between primary inputs and the final good. The term 'roundaboutedness' is derived from the neo-Austrian capital theory where it is regarded as a measure of capital intensity (Hicks 1973).<sup>27</sup> In our case it points more particularly to increasing human-capital intensity with KIBS firms providing the intangible assets (know-how, software, organisational skills, R&D capabilities etc.) that drive additional value creation in client firms.<sup>28</sup> The growth of business services since the 1990s reflects a different way of organising social production, allowing a better spread of the advantages of knowledge specialisation, more external scale economies, and a higher-level growth path. The key position of the business services industry in this process must go along with high forward-linkage intensity: a one-unit increase in final demand in the economy will necessitate BS industry to supply a more-than-average increase of intermediates to accommodate the economy-wide demand. Leshner and Nordås (2006) indeed find evidence for this in OECD countries.

From the mid-1990s onwards the process of domestic outsourcing has gradually changed. Even specialist and close-to-management service activities - that thus far were considered to be the core company domains - became eligible for outsourcing. Typically, these were non-routine jobs. Knowledge-intensive services with high skill inputs gained strongly in this most recent outsourcing wave (cf. Miles 2007). Outsourcing of knowledge-intensive services went along with product innovation and product differentiation, generating demand for specialised services products. Sub-sectors that mostly produce client-specific business services have gained most since the mid-1990s. The professional specialisation and the quality of knowledge inputs of knowledge-intensive business services firms became a dominant reason for outsourcing in this stage (Kox 2002).

We may summarise the evidence so far. Leaving international outsourcing (offshoring) apart, the available evidence suggests that *trade creation* is probably more important than *displacement growth* (trade diversion) for explaining the domestic structural growth of business services. Business services play a key role in the growing complexity and "knowledge roundaboutedness" of the social division of labour.

## 2.4 Human-capital characteristics of BS employment growth

Earlier in the paper we found that BS employment in Europe has grown at a striking annual rate of 4.4% between 1979 and 2003 (Table 2.1). We reported findings that the knowledge role of BS industry in the inter-sectoral division of labour has increased over time. This begs the question whether the increasing knowledge intensity can be traced

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<sup>26</sup> This is calculated by dividing a sector's share in total intermediate demand for business services by the sector's share in total industrial output.

<sup>27</sup> For this interpretation, see *inter alia* Grubel and Walker (1991); Grubel (1995) and Burda and Dluhosch (2000).

<sup>28</sup> From an accounting point of view, expenditures on software and R&D are increasingly registered as investments rather than as current expenditures, due to their contribution to future benefits (cf. Zambon 2003).

back in the (changed) human capital characteristics of the BS industry in Europe. We discuss the characteristics of employment in business services, based on data from the European Labour Force Surveys. We first analyse whether BS jobs are different from jobs in other industries, and subsequently we zoom in on the human-capital characteristics of BS industry.

**Anything special in business service jobs?** Business services are sometimes considered a source of flexible employment, providing new opportunities for women, young people, part-time workers, tele-workers and so on. In some sub-sectors such as consultancy services or ICT services, all these assumptions hold to a large extent. However, when one considers business services as a whole – including operational services and professional services – the sector is not very special compared to other economic sectors. Table 2.5 provides a comparison between business services and other economic sectors in terms of job profiles.

**Table 2.5**  
**Characteristics of labour markets by economic sector, EU25, 2003**

	% women in total	% 15-39 people	% self-employment	% part-time jobs	% temporary work	Average hours first job	Average hours second job
Business services	44,6	54,3	<b>21,4</b>	18,5	12,5	37,2	11,8
<b>PM</b>							
Total all sectors	43,7	50,1	14,7	17,0	12,7	37,4	12,4
Manufacturing	30,1	52,2	7,4	6,7	9,9	38,8	12,8
Services	53,0	50,1	13,1	19,8	12,5	36,5	11,5
Dist trades	48,4	56,0	20,6	19,8	11,5	38,0	12,8
Hotels & rest	54,5	<b>60,6</b>	20,1	24,4	<b>19,2</b>	39,4	13,5
Transport & com	25,8	47,9	11,1	9,1	7,7	<b>40,2</b>	<b>14,0</b>
Finance	50,7	53,4	7,4	12,5	5,7	37,3	10,4
Public admin	44,4	44,1	0,0	11,7	10,6	36,7	11,8
Other services	<b>70,3</b>	44,8	9,2	<b>26,5</b>	15,1	33,5	10,6

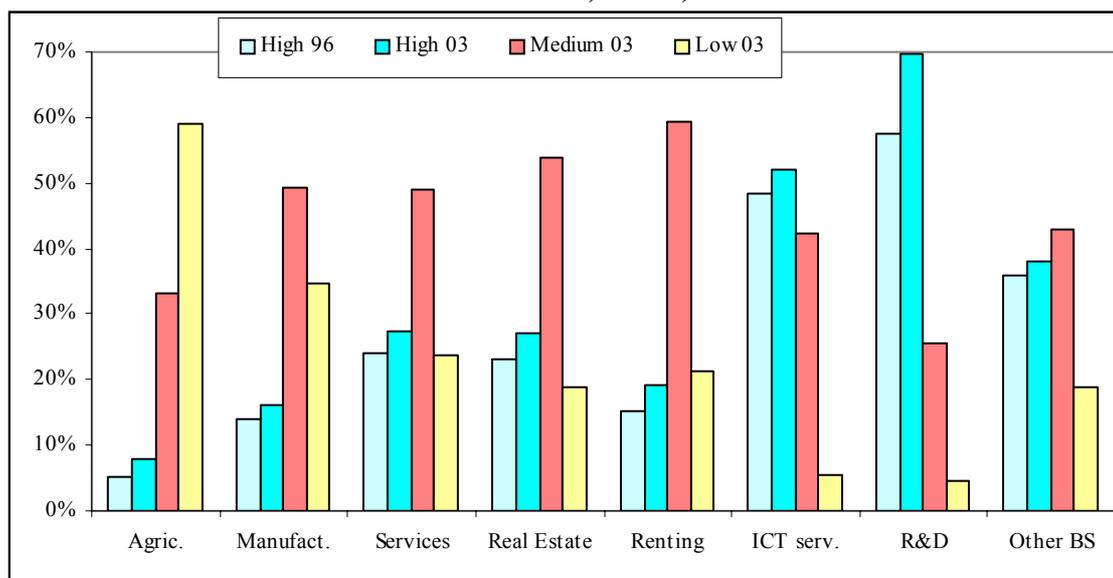
Source: Eurostat, Labour Force Survey, 2004

Apart from the very high rates of self-employment, business services do not lead in any of the relevant employment characteristics. Its employment profile is very similar to those of the economy-wide total. Business services offer slightly more opportunities for women, young people and part-time jobs than other economic sectors, but not so much as hotels, restaurants and personal and social services. Compared with manufacturing industries, business services employ many more women, young workers and part-time workers, but these results are similar to other service activities. In temporary work or number of hours worked, the sector also presents a situation similar to the total economy, but slightly “better” in the sense of less temporary work and fewer hours worked. The only clear characteristic specific to BS jobs is the rate of self-employment, which is significantly higher than for other major economic sectors. This is due to the presence of professional services and ICT professionals working independently.

**Education and training profile of business services.** The sector, in general, has a very strong orientation towards higher education, much more than most other industrial or

service sectors. This can be seen in Figure 2.9. In manufacturing and total services, the education profile is dominated by the intermediate educational level, while there are more workers with low education levels, particularly in manufacturing.

**Figure 2.9**  
**Education attainment levels in business services compared to other economic activities, EU15, 2003**



Source: Based on Eurostat data, Labour force Survey, 2004

The business services sector consists of equipment renting, ICT services, contract R&D and *Other Business Services*. In computer services and R&D services, the share of highly educated people is impressive, especially in R&D services. It is also high in *Other Business Services* despite the fact that this aggregate also includes sub-sectors like cleaning or security services, which employ many low-skilled workers. *Other Business Services* represents most of the business services employment. In equipment renting and real estate the educational profiles are similar to the total services average.

In order to add a time dimension, Figure 2.9 also pictures the employment share of highly educated workers in 1996. In all economic sectors, the share of highly educated increased between 1996 and 2003. This also holds for the BS sectors, even if they were already very much geared towards this high profile in 1996.

A further indication of the high educational profile in business services can be derived from the percentage of BS enterprises that provides their workers with any type of training. It may reflect the extent to which workers are prepared to adapt to new requirements and manage to deal with increasing organisational and work complexity. Data for 2000 from the European Labour Force Survey indicate that in all EU15 countries, business services invests more in providing Continuous Vocational Training (CVT) to their workers than the average for the total economy. Moreover, it also appears that the average costs of CVT courses are much higher in business services than in the rest of the economy. This may reflect a higher level of specialisation and knowledge input in these courses. There are strong differences among European

countries in terms of the percentage of business services firms that use CVT training for their employees. For example, the percentage of Spanish and Portuguese enterprises spending resources on training is less than 50% of their Dutch or Danish counterparts. In the countries where the percentage of enterprises providing courses is highest (Denmark, Ireland and Netherlands), also the training costs per course are highest.

Summing up, BS jobs on average appear not have many special characteristics compared with other economic sectors. There are two major characteristics of BS which can –to a certain extent– be considered “special”. The first is the high incidence of self-employment, especially in professional and knowledge-intensive business services. The second is the high profile of educational attainment levels and the relatively strong importance of professional training in the sector. The importance of know-how in business services is epitomised by the large number of enterprises providing their staff with continuous vocational training courses, as well as the greater amount of resources used on those courses. This finding supports the earlier evidence on the role of BS industry in the inter-sectoral division of labour, especially in view of its knowledge role.

## 2.5 "Offshoring" tendencies and BS replacement growth

Most outsourced services in the early 1980s were either low- or medium-skilled (cleaning, catering, internal and external transport, building maintenance). From the mid-1980s until the late 1990s, many standardised in-house services became subject to outsourcing, including security services, training of personnel, administration, storage, technical testing, computer services and recruitment. Especially wage costs and scale effects derived from standardisation played a dominant role in this stage of outsourcing. If replacement growth took place, it was probably most relevant in this period. Before the turn of the century, almost all authors took for granted that outsourcing of in-house services from manufacturing and other industries came to the benefit of *domestic* BS industry.<sup>29</sup>

ICT developments have since then lowered communication and co-ordination costs to such an extent that international outsourcing of in-house services tasks has become more than an exotic exception. Due to this development a new range of standardised in-house services can be sourced from low-wage countries, including knowledge-intensive jobs of a standardised nature (cf. Van Welsum *et al.* 2005, 2006). Offshoring of standardised services tasks to low-wage countries could weaken the market position of domestic firms that produce standardised business services.<sup>30</sup> If anything, the offshoring tendency will therefore make the displacement-growth hypothesis less relevant for explaining the structural growth of *domestic* business services in Europe.

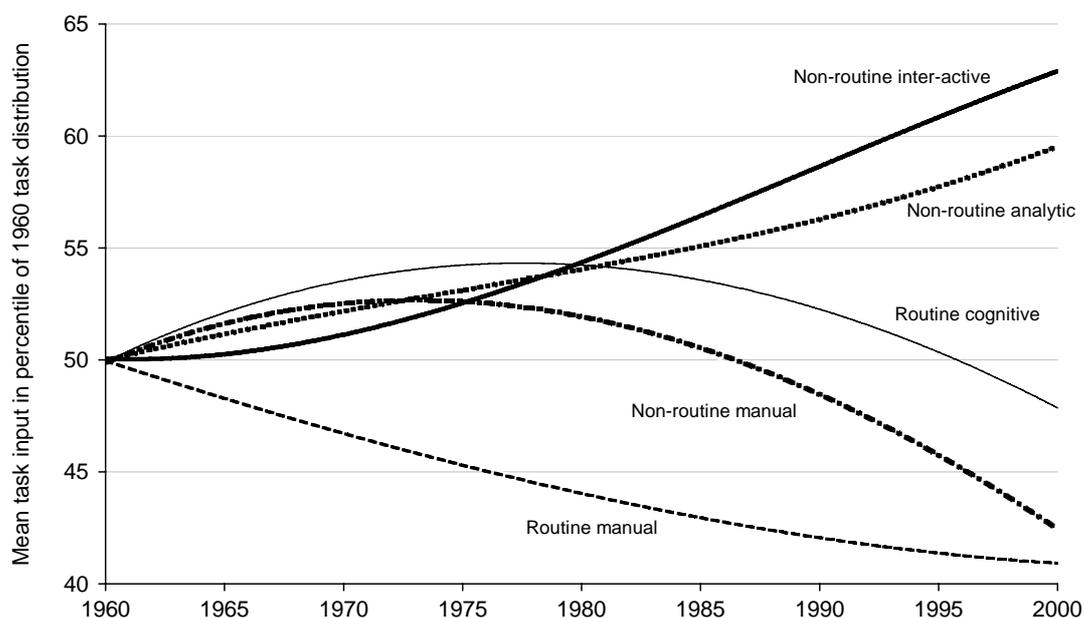
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<sup>29</sup> An exception was Feenstra and Hanson (1999) who also looked into the international dimensions of outsourcing.

<sup>30</sup> Recent trends towards the offshoring of some business services such as call centres and ICT services have led to fears in the US and Europe about the migration of jobs to low-wages countries like India. Some estimates say that more than two million jobs in the US and one million in Europe will move to developing countries (e.g. McCarthy 2002).

At a national scale this process goes along with a change in the composition of the total labour force. Figure 2.10 illustrates the shift away from routinised jobs that is taking place in the total labour force of the USA. As more routinised manual jobs and standardised knowledge-intensive jobs are sourced from low-wage countries this reduces the scope for future replacement growth by the domestic BS industry smaller. An increasing part of the remaining jobs will be characterised by non-routinised services tasks.<sup>31</sup>

**Figure 2.10**  
Trends in routine and non-routine task inputs in US labour force



Note: The picture is based on an analysis of the occupational structure, using census data and Current Population Survey data, using the mean 1960 task input structure as point of reference. Plotted variables depict the employment-weighted mean of each assigned percentile in the indicated year. Source: Autor, Levy and Murnane (2003).

Offshoring of routinised manual and cognitive BS jobs could in a way be regarded as a form of prolonged replacement growth, although now in an international context. To the extent that offshoring is done intra-company by BS firms, it may give rise to something new, namely vertical (i.e. input-sourcing related) foreign direct investment in BS industry. Vertical direct investment till now used to be something that is important in mining and manufacturing, but unimportant in services.

However, the offshoring process is getting increasingly differentiated. In the software sector, for example, India's computer-services exports are no longer restricted to routinised offshored software jobs. Indian BS firms are actively involved in the management of complex automatization processes of European and US clients (e.g. Marsh 2007). Even in this area we can no longer speak of pure replacement growth.

<sup>31</sup> The issue has many interesting aspects from an international trade perspective (cf. Grossman and Rossi-Hansberg 2006; Baldwin 2006), but these go beyond the scope of the present paper.

## 2.6 Growth of European BS industry: conclusions

The BS sector has experienced a remarkably strong growth process in the past two decades, in terms of both employment and value added. Business services nowadays count as one of the largest economic sectors in the European economy, larger than such sectors as transport, communication, hotels and restaurants taken together. The sector's employment and value added account for, respectively, 11 per cent and 12 per cent of the total EU15 economy. Value-added growth during last two decades was higher than in any other sector except telecommunications. Regarding employment, the growth of business services far outstripped the growth of any other sector. For European countries we find a significant and strong positive correlation between the average income per capita and the share of business services in total employment. This correlation holds up to some threshold level of BS employment.

Traditionally, services were considered as relatively stable sectors, less sensitive to cyclical fluctuations than agriculture and manufacturing. They served as refuge sectors in case of economic crisis. Our analysis learns that the BS sector has a higher exposure to cyclical effects than most services sectors, but there are also some compensatory characteristics. Moreover, the business-cycle volatility may be different in various parts of the BS industry. The empirical analysis concludes that the structural growth trend for the BS industry has until now dominated its relatively high cyclical volatility.

Two main explanations stand out for the structural growth in the business services industry. Partly, the growth may have been caused by outsourcing of existing in-house services jobs from other sectors to BS industry, especially in the 1980s and in the early 1990s. Sub-sectors that produce standardised business services contributed most to the growth process in this period. Since the mid-1990s, a shift has occurred. The growth of business services especially reflects a growing complexity and specialisation in the social division of labour between industries. In this stage, many knowledge-intensive and non-routine services tasks became eligible for outsourcing to independent services firms. However, this was seldom a simple substitution of pre-existing in-house services jobs. Professional specialisation and product innovation often also caused the nature of the service product to change. Since the mid-1990s, those sub-sectors that predominantly produce client-specific services products contributed most to the structural growth of business services industry.

The recent tendency to 'offshore' some standardised services tasks from suppliers in low-wage countries may weaken the market position of domestic firms that produce mainly standardised business services. As a consequence, the displacement-growth hypothesis will become even less relevant for explaining the present structural growth of business services in Europe. To the extent that intra-company offshoring by BS firms grows, it may improve overall cost competitiveness and labour productivity in European BS industry.

Business services jobs on average appear not have many special characteristics compared with other economic sectors. There are two major characteristics of BS which can -to a certain extent- be considered "special". The first is the high incidence of self-employment, especially in professional and knowledge-intensive business services. The

second is the high profile of educational attainment levels and the relatively strong importance of professional training in the sector. The importance of know-how in business services is epitomised by the large number of enterprises providing their staff with continuous vocational training courses, as well as the greater amount of resources used on such courses.

### 3. The contribution of business services to European economic growth

This section analyses the contributions of business services to aggregate economic growth in Europe. The growth of business services represents a qualitatively new stage in the social structure of production. A major characteristic of this structural change is that firm-level scale economies with regard to knowledge and skill inputs are reduced by external deliveries of such inputs, thereby exploiting external scale economies. It goes along with an increasingly complex social division of labour between economic sectors. The share of knowledge-intensive services in the intermediate inputs of the total economy has risen sharply in the last decade.

The business-services and communication sectors are in the focal point of the structural change. The *direct* growth contribution of business-services industry arises from its own employment and value-added growth. The *indirect* growth contribution stems from the positive spillovers that business services create for other industries. The spillovers relate to the sector's role in knowledge and technology dissemination to client industries, and to its role in removing scale indivisibilities with regard to knowledge inputs.

The structure of the section is the following. The first two sub-sections analyse, respectively, the direct and indirect growth contributions of business services. The relatively poor labour-productivity growth of business-services industry in combination with its expanded share in the total European economy has evoked discussion whether this sector contributes to a growth stagnation tendency. The third sub-section briefly deals with this so-called 'Baumol disease'. The fourth sub-section gives a brief survey of the empirical literature on the indirect growth contributions, and a final sub-section summarises the conclusions.

#### 3.1 The direct growth contribution of business services

The strong expansion of the BS sector over the past decade contributes in itself to aggregate economic growth. We subsequently deal with the sector's contribution to growth in terms of employment, value added and labour productivity.

**Employment growth.** Table 3.1 brings out that the sector has had a most prominent role in inter-sectoral employment shifts during the last two decades. The BS industry on its own accounted for more than half the EU's net employment growth between 1979 and 2003. This was more than the joint employment contribution of all other

commercial services taken together.<sup>32</sup> It was even larger than employment growth in public services. Business services more than compensated the shrinking employment in manufacturing.

**Table 3.1**  
**The contribution of business services to EU15 employment growth, 1979-2003**

	Employment in 1000 persons, 1979	Employment in 1000 persons, 2003	Average annualised sectoral growth rate (%)	Contribution to aggregate growth (% point)	Contribution (%) to EU15 absolute employment change <sup>a)</sup>
<b>Business services</b>	<b>6 837</b>	<b>19 460</b>	<b>4.5</b>	<b>0.33</b>	<b>54.4</b>
- Equipment renting	250	563	3.4	0.01	1.4
- Computer services	571	2 450	6.3	0.05	8.1
- Contract R&D	411	632	1.8	0.01	1.0
- Professional services	2 846	7 037	3.8	0.11	18.1
- Other, n.e.c.	2 759	8 778	4.9	0.16	26.0
<b>Total all sectors</b>	<b>147 984</b>	<b>171 167</b>	<b>0.6</b>	<b>0.6</b>	<b>100.0</b>
- Manufacturing	53 381	42 055	-1.0	-0.30	-48.9
- Distributive trades	20 993	25 943	0.9	0.13	21.4
- Financial services	3 976	5 392	1.3	0.04	6.1
<b>PM</b>					
KIBS business services <sup>b)</sup>	3 828	10 119	4.1	0.17	27.1
Non-KIBS business services <sup>c)</sup>	3 009	9 341	4.8	0.17	27.3

Notes: a) Each industry's absolute change in employment as percentage of the total employment change in the entire economy. b) The group of knowledge-intensive business services (KIBS) is here taken to consist of 'Computer services', 'Contract R&D', and 'Legal, technical, accountancy, advertising'. c) Non-KIBS business services is here taken to consist of 'Equipment renting' and 'Other, n.e.c.' Sources: data are from OECD National Accounts data (STAN), extended with data from GGDC.

The largest annualised growth rate within the business services was registered by the sub-sector computer services. The latter started from a very small initial size in 1979, but nonetheless its employment growth accelerated to 6.6 per cent in the second half of the 1990s (OECD 2003b).<sup>33</sup> Over the entire period, knowledge-intensive business services (KIBS) and the rest of business services (non-KIBS) have grown at about the same pace, with the employment-growth contribution of 'non-KIBS' only being a little bit higher than the contribution of KIBS.<sup>34</sup>

<sup>32</sup> The absolute change in employment for financial services, transport, distributive trades, hotels and catering, communication together represented 46 per cent of the absolute change in European employment over the period 1979-2003. Agriculture and manufacturing made a negative contribution. Source: own calculations based on OECD STAN data and data from GGDC.

<sup>33</sup> Over the period 1995-2000, OECD-area employment in computer services grew by more than 3 million, equalling an annual growth rate of over 4.3%, more than three times that of overall market-sector employment (OECD 2003).

<sup>34</sup> The distinction between knowledge-intensive business services and other business services is not a sharp one. All sub-sectors in business services have elements of both. The demarcation line in Table 3.1 is based on average human-capital inputs and the average incidence of knowledge-intensive tasks.

**Value-added growth.** Measured in constant prices, the value-added growth between 1979 and 2003 was stronger in business services than in any other economic sector of the European economy, except for communication services (cf. Table 3.2). Within business services, *computer services* registered the strongest growth performance, while the weakest growth occurred in *contract R&D*. The ‘non-KIBS’ part of business services grew slightly faster than the KIBS part.

**Table 3.2**  
**The contribution of business services to value-added growth, 1979-2003**

	Value-added level in billion euros, <sup>d)</sup> 1979	Value -added level in billion euros, <sup>d)</sup> 2003	Average annualised sectoral growth rate (%) <sup>e)</sup>	Sector contribution to aggregate growth (%) point)	Contribution (%) to EU15 absolute value-added change <sup>a)</sup>
<b>Business services</b>	<b>122.9</b>	<b>1067.4</b>	<b>4.2</b>	<b>0.28</b>	<b>12.7</b>
- Equipment renting	10.8	90.3	5.0	0.02	1.1
- Computer services	12.4	182.7	6.6	0.05	2.3
- Contract R&D	7.0	36.7	2.4	0.01	0.4
- Professional services	59.7	472.0	3.8	0.12	5.6
- Other, n.e.c.	33.0	285.7	3.9	0.08	3.4
<b>Total all sectors</b>	<b>2124.0</b>	<b>9540.1</b>	<b>2.2</b>	<b>2.2</b>	<b>100</b>
- Manufacturing	804.1	2515.9	2.2	0.51	23.1
- Distributive trades	218.5	936.6	2.3	0.22	9.7
- Financial services	103.7	576.4	2.5	0.14	6.4
<b>PM</b>					
KIBS business services <sup>b)</sup>	79.1	691.4	4.1	0.53	8.3
Non-KIBS business services <sup>c)</sup>	43.8	376.0	4.4	0.29	4.5

Notes: a) Each industry’s absolute change in value added as percentage of the total value-added change in the entire economy. b) The group of knowledge-intensive business services (KIBS) is here taken to consist of ‘Computer services’, ‘Contract R&D’, and ‘Legal, technical, accountancy, advertising’. c) Non-KIBS business services is here taken to consist of ‘Equipment renting’ and ‘Other, n.e.c.’ d) Current prices, for 1979 conversion to euro from ECU and other national currencies. e) Based on constant 1995 prices. Sources: data are from OECD National Accounts data (STAN), extended with data from GGDC.

The contribution of BS to the absolute change in total value added was much smaller than its contribution than in terms of employment growth. About one-eighth of the overall EU15 change in value added was accounted for by business services. Two-thirds of this direct growth contribution stemmed from the KIBS, which is mainly explained from the fact that its 1979 share in value added was already larger than the ‘non-KIBS’ part.

**Direct contribution to EU productivity growth.** The direct contribution of BS to the growth of aggregate productivity is implied by the two preceding tables.<sup>35</sup> Productivity growth is defined as the growth of real value added per employed person, expressed in

<sup>35</sup> If  $H_{1979}$  is initial labour productivity in 1979, then  $H_{2003}$  is defined as:  $H_{1979} \cdot (1+g_{VA})^n \cdot (1+g_{EMP})^{-n}$  where  $g_{VA}$  and  $g_{EMP}$  are, respectively, the growth perunages for value added and employment, and  $n$  is the number of years (24 in this case). Note that  $g_{VA}$  must be measured in constant prices, so that the resulting  $H_{2003}$  does not match the current-prices value added in Table 3.2.

constant prices of 1995. This definition counts persons, not hours worked; it could therefore underestimate the productivity growth if the share of part workers grows over time.

**Table 3.3**  
**The contribution of business services to EU15 labour productivity growth, 1979-2003**

	Productivity level in euros, curr. prices 1979*	Productivity level in euros, curr. prices 2003*	Labour productivity level 2003 based on constant 1995 prices <sup>a)</sup>	Average annualised growth rate in constant prices (%)	Sector share (%) in EU15 growth of aggregate in productivity <sup>d)</sup>
<b>Business services</b>	17 976	54 851	16777	-0.3	-0.023
of which:					
- Equipment renting	43 200	160 391	62450	1.6	0.012
- Computer services	21 716	74 571	23236	0.3	0.003
- Contract R&D	17 032	58 070	19611	0.6	0.002
- Professional services	20 977	67 074	20977	0.0	0.000
- Other, n.e.c.	11 961	32 547	9504	-1.0	-0.021
<b>Average Total EU15 economy</b>	14 353	55 736	20961	1.6	1.600
<b>PM: KIBS <sup>b)</sup></b>	20 664	68 327	20664	0.0	0.000
Non-KIBS business services <sup>c)</sup>	14 556	40 253	13280	-0.4	-0.012

Notes: a) Using 1979 productivity levels as starting values and calculating on the base of the value-added growth rate in constant 1995 prices. b) The group of knowledge-intensive business services (KIBS) is here taken to consist of 'Computer services', 'Contract R&D', and 'Legal, technical, accountancy, advertising'. c) Non-KIBS business services is here taken to consist of 'Equipment renting' and 'Other, n.e.c.' d) Employment weighted. Sources: calculated on the basis of data in Tables 3.1 and 3.2.

In Table 3.3 we see that the direct contribution of business services to EU15 productivity change has been negative over the 1979-2003 period. The reason is that the employment in business services has grown faster than its value added did. The negative productivity contribution is entirely caused by the non-KIBS part of business services, and more particularly by the sub-sector '*Other, not elsewhere classified*'. This residual category includes *inter alia*, industrial cleaning, security services, call centres, packaging firms, and agencies for temporary labour. Branches like call centres and industrial cleaning tend to employ many part-time workers, and especially call centres form a relatively young activity. So, a growing share of part-timers could in this case lead to underestimation of real productivity growth (per hour worked).

The KIBS —though representing more than half the BS employment— also failed to make a positive direct contribution to EU15 productivity growth over the period 1979-2003. The positive exceptions in this category are *computer services* and *contract R&D*. The sub-sector aggregate that includes most professional services (*Legal, technical, accountancy, advertising*), and that accounts for about one-third of total BS employment, had on average a zero growth of real productivity.

Summing up, the own productivity performance by business services can at best be called very poor. The same holds for this sector's direct contribution to European productivity growth, a result that was also found by the European Central Bank (ECB Task Force 2006). It gives some reason for worry. Economic growth is mainly driven by two sources, namely productivity growth and increased labour inputs (participation). In the coming decades, population ageing effects will become palpable, and increased labour participation can no longer be relied upon as a major source of economic growth in the European Union (cf. EC 2002a). So, productivity growth will be left as the only major source of economic growth. The weak productivity performance by the BS industry - if carried on into the future - could become a drag on economic growth, this sector now forms a major sector in the European economy. Some have even raised the question whether the 'Baumol disease' (growth stagnation due to an increasing weight of low-productivity services sectors) is lurking behind the horizon.<sup>36</sup> We return to this discussion in section 3.4.

First, we want to qualify some of the aforementioned conclusions on productivity growth in business services. Productivity performance in business services differs by country and by sub-sector, so one must be careful with generalisations (cf. Pilat 2007; O'Mahony and Van Ark 2003; Wölfl 2003). Moreover, there is international agreement nowadays that measurement issues might affect the productivity record of business services more than in many other economic sectors.<sup>37</sup> The high degree of product differentiation makes it difficult to distinguish between price and volume components of value added growth (cf. Triplett and Bosworth 2004; Wölfl 2003; Rubalcaba 2006). This especially regards the KIBS, where the products are in many cases client-specific.

The theory on industry dynamics provides us with a reason for being careful about extrapolating the past productivity-growth performance of business services into the future. BS industry is relatively new, and some of its branches did not even exist 20 years ago. Many of its products, particularly knowledge-intensive products, are even newer. The theory on product life-cycles (Vernon 1966) states that products in an early stage of their development tend to be quite little standardised and highly differentiated, but many of these products become more standardised over time. In the beginning, price elasticity for the output of individual firms may be quite low. Production methods still have a learning-by-doing character, and producers have a large degree of freedom in changing their inputs. Once demand for a product expands, a certain degree of standardisation (commonly accepted product standards) takes place.<sup>38</sup> Efforts at product differentiation do not come to an end, since competitors try to avoid the full brunt of price competition. Moreover, more product variety may arise due to specialisation. Over time, concern about production costs gets more important and uncertainties diminish about how the product should best and cheapest be produced. Once standardisation

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<sup>36</sup> Baumol (1967) inferred that the growth of labour-intensive service industries with few opportunities for labour saving might cause an overall stagnation of economic growth.

<sup>37</sup> In the BS sector, the measurement of productivity can be even more important than for other services sectors due, among other reasons, to the fact that prices are much less standardised and "registerable" in statistical terms. Wölfl point out three different problem areas with regard to the measurement of services productivity: in the selection of inputs (labour mostly), in the selection and definition of outputs (at constant prices and quality), and finally, in the method of aggregation over sectors.

<sup>38</sup> It is worth noting in this context that the European Commission (DG Enterprise) is actively promoting the development of more standardised product formats for some business services.

occurs in the product market, the price elasticity of demand for the output of individual firms increases. Firms that wish to survive, must give full attention to cost efficiency. When this happens, the productivity record in business services can be expected to improve.

### 3.2 The indirect growth contribution of business services

Thus far we focussed on the growth of BS industry itself and how that contributes to economic growth in Europe. Two important characteristics of the sector are that its products are used as intermediate inputs, and that these inputs are often knowledge-intensive. Both affect the further role of business services in overall economic growth.

There is reason to assume that individual firms in business services are not always able (or willing) to charge the full value of their inputs to clients. An important economic explanation for this is that knowledge products are non-rival in their use. It means, that once the knowledge product has been created it is difficult for BS firms to prevent it from being used subsequently by the client in new applications, or from being copied by other firms. It is difficult to fully appropriate the rents of new knowledge products.<sup>39</sup> In BS markets dominated by few large companies price-umbrella effects may occur, necessitating SME companies to charge limited fees due their reputation lag with respect to large firms. Both factors may imply that the value added of the BS sector underestimates the sector's contribution to overall economic growth.<sup>40</sup> A comprehensive picture of the growth contribution by BS industry therefore also requires that such knowledge 'externalities' or spillovers are somehow taken into account. Griliches (1979) made a distinction between knowledge spillovers and rent spillovers. Real knowledge spillovers do not necessarily imply economic transactions between industries. Rent spillovers relate to quality improvements in intermediate inputs that are not matched by price increases. Under-pricing of products in the case of rent spillovers is the result of the market structure for the knowledge products, and not necessarily a matter of flawed statistical measuring.<sup>41</sup> Spillovers generated by business services firms are generally rent spillovers.

Knowledge-intensive BS firms have an important role in national innovation systems. They contribute in three ways to modern knowledge infrastructure, through *original innovations*, through *knowledge diffusion*, and through their role in *surpassing human capital indivisibilities*. We subsequently discuss these three forms of indirect growth impacts.

**Original innovations.** The BS industry has a key role in the development of original innovations. Firms in the software, engineering and contract research sub-sectors

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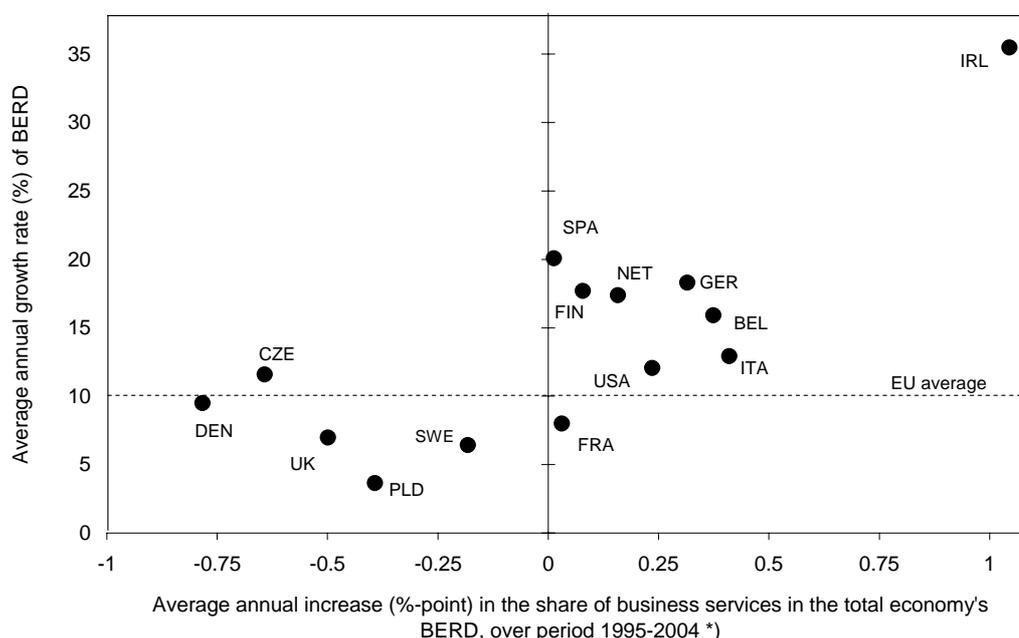
<sup>39</sup> From the results of the European *Community Innovation Survey* over 1999-2001 it appears that innovating BS firms —compared to manufacturing firms— make relatively more intense use of 'secrecy', 'design complexity' and 'lead-time advantage on competitors' to prevent copying of their innovations, and relatively less use of copyrights and trademarks (EC 2004).

<sup>40</sup> And, for that matter, it also means that the economic-growth contributions from other sectors are over-estimated on the basis of the latter's value-added figures.

<sup>41</sup> Spillovers would still exist if we knew all prices charged by individual business-services firms.

actively contribute to technological innovations. Other sub-sectors like accountancy, consultancy and marketing are more active in the development of non-technological innovations. This sector's role in original innovations can be shown using the business expenditures on R&D (shortly: BERD) as an indicator. Figure 3.1 shows on the vertical axis that the annual growth of these expenditures over the period 1995-2004 has been very strong in most EU countries, and in several cases also higher than in the USA.

**Figure 3.1**  
**Growth of R&D expenditure by BS industry, and its changing share in the national R&D expenditures, period 1995-2004 \*)**



Note: \*) The share of business services is corrected for its increased share in the total economy. Business expenditures on R&D (BERD) are measured in PPP dollars. Source: own calculations, using data from OECD ANBERD (2006) and STAN databases.

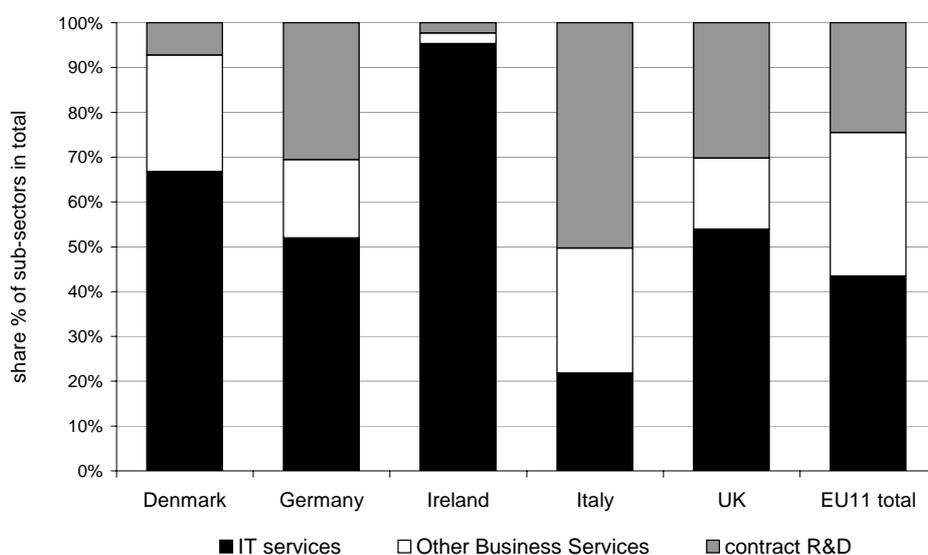
The horizontal axis of Figure 3.1 gives the annual change in the share of BS in the total economy's BERD during the period 1995-2004. We corrected for the fact that the business- services sector itself has become a bigger part of the total economy. The figure therefore also allows the conclusion that the BS sector in most of the EU15 countries became more R&D-intensive than the rest of the economy did.<sup>42</sup> The Europe-wide *Community Innovation Survey* show that the share of innovating firms in business services – or more precisely: in computer services, engineering, architecture Computer activities, contract R&D, consultancy and technical testing – is higher than in manufacturing industry (EC 2004; Pain and Jaumotte 2005).

Figure 3.2 shows that there are substantial intra-EU differences in the R&D share of different sub-sectors. *Computer services* and *Contract research* account for a major part of the R&D expenditures in business services. Most European patent registrations in

<sup>42</sup> This did not hold for the United Kingdom, Sweden and Denmark, where the R&D expenditures of the business-services sector increased less than the share of the sector in the total economy. The same also holds for the Czech Republic and Poland who joined the Union in 2004.

services also originate from these sub-sectors (European Commission 2003a; Blind *et al.* 2003). In 2000, some 16 per cent of all innovating BS firms in the EU applied at least for one patent, only slightly less than the equivalent figure for manufacturing. In five countries (Sweden, Denmark, Germany, Spain and Portugal), the percentage of innovating firms with patents was higher in business services than in manufacturing (EC 2004).

**Figure 3.2**  
**Share of sub-sectors in R&D expenditure in BS industry, 2004**



Data source: OECD ANBERD (2006).

Firms in *Other Business Services* are active innovators in non-technological areas such as organisational development, firm strategy, human resources management, public relations or marketing. (Boden and Miles 2000; Rubalcaba 1999). The innovations in these sub-sectors are often of a non-technological kind, and they do not go along with formal R&D expenditure. Many of their original innovations are developed and adapted for client firms on a case-by-case basis.

**Knowledge diffusion.** With regard to many business competences, BS providers lead their client firms towards the relevant efficiency frontier by spreading ‘best practice’ information. This is in itself an important indirect contribution to economic growth. A consistent finding from the EU *Community Innovation Survey* is that BS firms tend to rank before universities as a source of external information for innovating companies. This pattern was found *inter alia* in Finland (Leiponen 2001), Netherlands (Kox 2004) and the United Kingdom (Hughes and Wood 1999). Many BS providers are in the unique position of being able to look into the ‘knowledge kitchen’ of client firms. They observe localised, tacit knowledge solutions in client firms. But since their horizon is wider, they can more easily conceptualise such solutions and select ‘best practice’ solutions to more common business problems. Such ‘best practice’ information is subsequently introduced as input when BS firms serve new clients. It has been demonstrated empirically that BS firms also play a role in international knowledge

dissemination. Drejer (1999) established that knowledge intensive services have played a central role as a knowledge source for Danish firms in manufacturing as well as services. Guerrieri *et al.* (2005) have shown that international trade in BS between countries could explain bilateral knowledge spillovers as measured by patent citations. Apart from the overall contribution of BS industry to knowledge spillovers, we should in particular point to the role of computer-related services (part of BS sector). Many BS firms actively contribute to ICT-related innovations and introduce innovations that make the use of ICT more effective.

***Surpassing human capital indivisibilities.*** A further indirect growth contribution of business services relates to the production potential of small and medium-sized enterprises (SME). It is well-documented in the literature that firm-specific economies of scale play a role with regard to human capital inputs like knowledge specialisations and skills development (e.g. Edwards and Starr 1987; Francois 1990; Grubel 1995). Before the rise of the BS sector, say before 1980, a certain firm size was required to have access to particular specialist knowledge and skill. The expertise of some professionals in branches like law, science, engineering, public relations, logistics, marketing or security is sometimes so specialised that even the largest manufacturing companies do not need these specialisms on a full-time basis, let alone the small firms. The setup costs for departments that sustain such specialists are simply too high. These scale indivisibilities prevented SME firms from access to such production inputs. The growth of the BS availability since the 1980s has drastically widened the potential input-mix choices of SME firms, thereby reducing the importance of firm-specific scale economies in the area of human capital resources. Even small firms nowadays have access to specialist knowledge and specialist skills that once were the exclusive domain of universities and large firms. Professionals of specialised BS firms now cater to clients throughout a region, country or worldwide. Their services are now accessible to small firms in more localised markets or local governments, thus widening their production and efficiency potential.

Summing up, we have good reasons to assume that the poor productivity performance of BS industry will at least to some extent be compensated by the indirect growth contributions originating from this industry. Of particular importance are three forms of spill-over effects –in the form of original innovations, knowledge diffusion, and the reduction of human capital indivisibilities at firm level– that have a positive impact on productivity in other industries.

### **3.3 Is the 'Baumol disease' looming?**

Since the BS sector did grow so fast in the preceding two decades, its own poor productivity performance may – at first sight – have had a downward impact on aggregate productivity growth. This has led some observers to conclude that the growth of this sector contributes to growth stagnation, the so-called Baumol disease. The unbalanced-growth model developed by Baumol (1967) and Baumol *et al.* (1989). The latter analysed how an expanding low-productivity services sector may bring down the growth rate of the entire economy, a pattern that is nowadays known as “Baumol disease”. The services sector in his growth model has only a limited potential for

labour-saving and productivity growth. Moreover, it is characterised by a relatively price-inelastic demand, while its wages follow those of the most productive sector. In this economy, an increasing share of labour will be employed by the services sector. The imminent ‘disease’ is that the growth rate of the economy falls, while the relative price of services rises.

Some of these ‘unbalanced-growth’ characteristics also seem present in the growth of the BS sector, in particular its vigorous employment growth and its poor productivity record, while also the Baumol assumptions on wage growth and the relative price inelasticity might at least partially apply.<sup>43</sup>

Even apart from the likelihood that productivity growth of the BS sector may be downward-biased because of measurement problems, there are several further reasons why growth of the BS industry does not necessarily contribute to stagnation of macro-economic growth. Firstly, the Baumol model focuses on consumer services, whereas business services are intermediate inputs for other industries. Several studies have demonstrated that even low-productive intermediate industries may increase macro-economic productivity growth if the intermediate inputs replace primary labour inputs in the client industries and if the BS industry itself has a positive productivity growth rate (Fixler and Siegel 1999; Oulton 2001).<sup>44</sup> An important but implicit assumption in Oulton’s model is that competition in the markets for BS products is such that all labour productivity gains (no matter how small) are passed on to its clients. This precondition may not be fulfilled. The ECB has found for the euro area that gross profit margins and mark-ups in the BS sector exceeded the mark-up in total economy and manufacturing. They infer that this might indicate lower competitive pressures in business services relative to the rest of the economy (ECB Task Force 2006). Weak competition and market opacity in business services may thus hamper the positive effects of the BS sector on aggregate productivity. Secondly, in contrast to the service sector in the Baumol model, the BS industry might have an unexhausted potential for labour-saving and productivity improvements (Kox 2002; 2004). Thirdly, as shown in the preceding section, the BS industry indirectly raises the productivity of other industries by the knowledge spillovers that we dealt with in the preceding section.

In Figure 2.8 we found a strong and positive correlation between the employment share of business services and GDP per capita. Francois and Reinert (1995) using a cross-country sample also find that countries with a higher share of producer services in intermediate inputs of manufacturing had a significantly higher income (GDP) per capita. Also in the future, the weak productivity growth of the BS sector does not necessarily have a negative effect on European economic growth provided that the

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<sup>43</sup> Some evidence for this is presented in Kox (2004), where it is also shown that measurement errors with regard to business-services output are unlikely to not affect the measured productivity growth for the economy as a whole. If real value added created by the business sector is systematically underestimated, this implies that the value added of other sectors that use business services as intermediate inputs must be over-estimated. Measurement errors with regard to business-services output do only affect the macro-economic productivity for the small part of business-services output that is destined for final demand (consumption, export, investment).

<sup>44</sup> This is exactly what has happened, for cost-saving reasons, in the outsourcing movement that swept across all market industries throughout the 1980s and 1990s. Privatisation of government services had the same effect.

positive productivity and innovation spillovers to other industries are strong enough, and provided also that competition and market transparency in business services are such that productivity gains are passed on to client industries.

### 3.4 Measuring the contribution of business services to economic growth

If the BS sector is indeed the source of positive spill-over effects for other sectors, this must show up empirically. We surveyed a number of empirical studies that – though they use different methods and investigate different countries and periods – have in common that they try to assess the quantitative impacts of BS use on aggregate productivity and economic growth. Table 3.4 gives a nutshell survey of empirical findings on spillovers from an important sub-sector of business services, namely computer-related services. The table does not claim to be comprehensive, but it is illustrative for standard findings in this area.<sup>45</sup> Most spill-over studies focus specifically on the contributions of R&D and information technology. Crespi (2007) finds highly significant effects from the use of IT in labour productivity.

**Table 3.4**  
**Survey of empirical studies with regard to the impact of computer-related services inputs on aggregate productivity change and growth**

Study and main approach	Country, coverage	Productivity or spillover indicator	Main findings
<u>Pilat &amp; Lee (2001)</u> Decomposition aggregate labour productivity growth by industry contributions	5 EU countries (DK, NL, FINL, IT, GERM), 1989-99	Aggregate labour productivity growth	Computer services contributed positively in Denmark, Germany and Italy, but negatively in Netherlands and Finland.
<u>Nordhaus (2002)</u> Decomposition of productivity growth (measured from income side value-added data)	USA, 1975-2000	Aggregate productivity growth	Software industry contributed 0.1% to the 1.6% productivity growth acceleration after 1995.
<u>Crespi (2007)</u> : Cobb-Douglas-like production function, measures of IT use and proxies indicators of innovation and labour.	EU, 9 countries (GERM, F, UK, IT, SP, FL, DK), 1995-2000	Aggregate labour productivity	Highly significant fixed effects from IT use, R&D intensity and labour costs.
<u>Van Leeuwen &amp; Van der Wiel (2003)</u> Growth accounting and production function model, including ICT spillovers and innovation indicators	Netherlands, market services, 1994-1998	TFP growth, labour prod. growth	Contribution of ICT spillovers to productivity growth was very strong, and even more so in innovating firms

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<sup>45</sup> Not included are studies by Hempel (2002), Collecchia (2001), Müller and Zenker (2000), which all deal with similar research questions, though sometimes on a regional rather than national level.

The studies in Table 3.4 focus in particular on the effects of computer-related or ICT services. With the exception of the Nordhaus study, all the surveyed studies investigate EU countries. Though the empirical evidence is incomplete and fragmentary, we may conclude that positive spill-over effects from the computer (IT) services sub-sector have been quite strong. Other studies show positive spill-over effects from BS inputs without differentiating their sub-sector origin. A number of important results are shown in Table 3.4.

**Table 3.5**  
**Survey of empirical studies with regard to the impact of Total Business Services (TBS) inputs on aggregate productivity change and growth**

Study and main approach	Country, coverage	Productivity or spillover indicator	Main findings
<u>Ecorys-NEI (2004)</u> Cross-section production function, compares estimated coefficient for the TBS contribution to aggregate output with the actual BS cost share in intermediate inputs	7 EU countries + Australia, Canada, Japan, Norway, 1994-1998	Difference between actual cost share and estimated production contribution	(a) For France, Germany, Canada, for the EU total, and for the pooled regression: estimated contribution is 1.5 to 2.5 the actual cost share. (b) coefficient for TBS is not significant in regressions for other individual countries.
<u>Antonelli (1999)</u> Calculate production elasticities for TBS use in production functions for a large range of industries (cross- section and time series)	4 EU countries (IT, FRA, GERM, UK), 1988-1990	Value added impact of TBS use	Effect of TBS use on value added of client industries: a 1% increase in BS inputs caused value added to increase by on average 2.6 to 4.2%
<u>Greenhalgh &amp; Gregory (2000)</u> Growth decomposition in input-output framework: tracing key sectors that generate cost savings and product improvements	UK, 1979-1990	Labour productivity growth, R&D spillovers	TBS industry key sector for productivity growth during 1980s, causing large labour saving in other industries. TBS also important player in the forward transmission of rising product quality
<u>Katsoulacos &amp; Tsounis (2000)</u> Correlation between TFP residuals of industry production functions and BS use, 75 industries	Greece, 1980-1988	TFP, TFP growth	Strong correlation between TBS use and TFP levels and TFP growth of industries
<u>Camacho and Rodriguez (2007)</u> Production function with KIS and KIBS as inputs. Separately: innovation diffusion by KIS/ KIBS through product-embodied R&D.	DK, GERM, SP, NL, UK, 1995-1998	Production, productivity and product embodied R&D diffused by KIS	Positive and significant impacts of KIS on production and productivity. In this second case, no clear results for the UK and Spain. Concerning diffusion on innovation, uneven results by country and sector were identified, but positive impacts dominate.
<u>Pilat &amp; Lee (2001)</u> Decomposition aggregate labour productivity growth by industry contributions	5 EU countries (DK, NL, FIN, IT, GERM), 1989-99	Aggregate labour productivity growth	Inputs of non-IT Business Services inputs contributed negatively except in Denmark (period 1995-1999) <sup>a)</sup>

Note: a) Contributions by other BS sub-sectors were positive in Finland and Germany during 1989-1994.

The studies for the BS sector (Table 3.5) as a whole have met with more mixed results than those for IT services.<sup>46</sup> The Ecorys-NEI (2004) study, commissioned by the EU, finds statistically significant indications for the existence of positive spillovers in the EU as a whole, in France and in Germany. For the other five individual EU countries, no significantly positive effects could be established. Pilat and Lee (2001) found indications for negative impacts of non-IT business services on aggregate productivity. That effect may be caused by the poor productivity performance of the BS sector itself. The studies by Antonelli, by Greenhalgh and Gregory, by Katsoulacos and Tsounis mostly cover the period 1980-1990, and they all found indications of the existence of positive spillover effects. Camacho and Rodriguez (2007) find positive and significant impacts of the use of knowledge-intensive services on production and productivity of client sectors. In the second part of their study they find no significant impacts for the UK and Spain, compared to some other EU countries. Besides, they estimate impacts on innovation diffusion through product embodied R&D: positive impacts of KIBS use prevail, but impacts differ by country and sector.

Taking these results together, we might tentatively conclude that the growth of business services during the 1980s caused overall positive productivity spillovers. The available positive evidence for the existence of technology and knowledge spillovers seems to imply that BS firms during the 1980s were unable or unwilling to charge prices that reflect the full contribution of their services to value creation in client industries. The empirical results for the mid-1990s onwards are more mixed. This can be partly explained by the different methodologies used, country selection and uneven shares of operative low-productive services with respect to KIS within the total BS aggregate. IT and computer services have had an overall positive impact on aggregate productivity and growth, but for other business services, the empirical results do not allow this conclusion for all EU countries. Taken as a whole, the available empirical evidence indicates that the contribution of the BS sector to aggregate economic growth may be positive, and that — at least during important parts of the preceding two decades — the BS sector has created positive spillover effects for other industries.

### **3.5 The contribution by BS industry to European growth: conclusions**

The growth of business services represents a qualitatively new stage in the social structure of production. A major characteristic of this structural change is that firm-level scale economies with regard to knowledge and skill inputs are reduced by external deliveries of such inputs.

The sector has had a most prominent role in inter-sectoral employment shifts during the last two decades. The BS industry on its own accounted for more than half the EU's net employment growth over the entire period. The direct contribution of BS to the absolute

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<sup>46</sup> We have only presented by studies that focus on spillover effects. Other studies like those by Windrum and Tomlinson (1999) focus on explaining production or productivity levels, using industry production functions with industry-level inputs of knowledge-intensive services (for Germany, Japan, the Netherlands, and the UK, 1970-1990). They find that input of knowledge-intensive services has a significant positive impact on gross output and productivity level of industries in all four countries.

change in total value added was much smaller than its contribution than in terms of employment growth. A consequence was that the productivity growth in BS industry during last decades can at best be called poor. The poor productivity performance of BS industry is at least to some extent compensated by the indirect growth contributions originating from this industry. Of particular importance are three forms of spillover effects –in the form of original innovations, knowledge diffusion, and the reduction of human capital indivisibilities at firm level– that have a positive impact on productivity in other industries.

The empirical studies surveyed in this paper indicate that positive spillover effects from the computer (IT) services sub-sector have been quite strong. The studies for the BS sector as a whole have met with more mixed results. The growth of business services during the 1980s caused overall positive productivity spillovers. The available positive evidence on technology and knowledge spillovers seems to imply that BS firms during the 1980s were unable or unwilling to charge prices that reflect the full contribution of their services to value creation in client industries. The empirical results for the mid-1990s onwards are more mixed. IT and computer services persistently have an overall positive impact on aggregate productivity and growth, but for other business services, the empirical results do not allow this conclusion for all EU countries.

The weak productivity performance by the BS industry - if carried on into the future - could be potentially become a drag on economic growth. Since the BS sector has become a major sector in the European economy, this is some reason for concern. Some have even raised the question whether the 'Baumol disease' (growth stagnation due to an increasing weight of low-productivity services sectors) is lurking behind the horizon. We argue that this is not yet a big economic threat because of the sector's positive productivity and innovation spillovers to other industries. However, improvement of market transparency and competition in business services may be needed, on the one hand, to ensure that productivity gains are passed as much as possible, on to clients industries, and, on the other hand, to provide more room for the BS sector's own efficiency.

#### **4. Policy issues related to the future role of business services in the European economy**

The growth of business services since 1990 absorbed about half of European employment growth. Apart from that, the BS industry has had impacts on aggregate productivity and innovation. In the movement towards a more competitive Europe the role of business services in economic growth needs particular attention. The evidence from the USA about its use of business services suggests that there is additional room for growth. The contributions of the BS industry to innovation, to scale economies in respect of human capital and knowledge, to efficiency spillovers and their impacts on productivity growth have all served to strengthen a more productive and competitive EU economy. Most of the quantitative empirical evidence on these contributions points to very positive results.

Since these facts all touch upon the EU's Lisbon goals, the BS sector is an interesting enough domain for policy makers. But is there a real need for policy intervention at EU level? Most of the recent developments in the BS sector have been driven by markets and private initiatives. The free development of an industry does not automatically generate the best possible welfare outcomes. There may be 'banknotes left on the sidewalk', which the BS sector itself is unable to pick up. Targeted, stimulating action can in some cases seize welfare opportunities that otherwise would have remained underdeveloped. Welfare theory suggests that policy intervention is only called for if markets do not work properly. Moreover, if policy intervention is called for, at what level should it take place? The subsidiarity principle indicates that EU policies are required when national market problems have a European dimension. These elements will be used to discuss whether EU policy intervention is required in the development of the BS sector. For a proper discussion, this chapter splits the issue into two questions, each of them calling for an answer:

- Are there market failures in connection with the expanding BS sector, and if so, are they such that the welfare outcomes could be improved upon by policy intervention?
- If indeed market failures exist, is there a need for EU-wide policies beyond what national governments do (or can do) to improve the market outcomes of national BS sectors? Put another way, do market failures in the BS sector have a European dimension?

#### 4.1 Potential market failures in the BS sector

Welfare theory distinguishes several reasons why market failure may occur. Market failure exists when the private-market prices for business services would systematically differ from the marginal costs and benefits of these services for society as a whole. The achievement of socially optimal outcomes by the free development of BS markets can be disturbed by the three types of market failures, or combinations thereof:

- *Markets do not account for social externalities*, either positive or negative. Intervention may be required to suppress negative social externalities, or to sustain a sufficient provision of positive social externalities.
- Existence and abuse of *market power* results in socially undesirable outcomes. In markets with entry barriers, monopolist or strategic oligopolist behaviour by market parties results in sub-optimal allocation of resources or too high prices for consumers. This means that the private market prices for a substantial group of firms are systematically higher than marginal costs.
- *Information asymmetry* causes undesirable outcomes in markets for information-sensitive goods. Less-informed parties may systematically find themselves in a disadvantaged position, and — being aware of this risk — may also deliberately reduce their exposure to being deceived. This reduces total transaction volume below the level that would prevail without the information asymmetry problem.

The three groups of market failures will be dealt with one by one, although there are clear overlaps between some aspects.

*Social externalities.* External effects arise when transactions between suppliers and buyers of business services have welfare effects for other producers or consumers that are not taken into account by the transaction partners. External effects are not reflected

in the costs and prices of the BS products. As a consequence, the market price for the delivered service is – from the social perspective – either too high or too low. We first mention some branch-specific externalities, and afterwards turn to more general externalities, positive and negative.

Intervention in markets for a number of knowledge-intensive BS products has long been based on the social externalities that go along with these services. Specific examples of such services and the social externalities involved are:

- accountancy: important for safeguarding of reliable financial information, which is essential for trust in capital markets and the financial system as a whole;
- legal services (lawyers, notaries): important for upholding the legitimacy of the constitutional state and the legal system;
- engineering: safeguarding the liability of technical systems;
- architects: special role in upholding the amenity value of the urban environment, and the quality and aesthetic value of housing and other buildings.

Prevention of charlatanism and concern for the independence, reliability and accountability of providers of these professional services, many of them under traditional self-regulation umbrellas, partly explain why policymakers hesitate to remove regulation barriers and ‘red tape’ with regard to multi-professional cooperation. This concern, real or exaggerated, also played a role in the recent debate on the EU services directive.

The growth of the BS industry has had several positive external effects outside the industry itself, particularly in the areas of innovation and productivity development. This is especially true if innovation is understood in the broad sense of the word and not only in the traditional sense of R&D carried out for certain products. Innovation of both processes and organisation proves to be very important in providing those innovative services that can lead to productivity gains.

The sector makes its own, direct contribution to technological innovation, particularly in software and engineering. It also contributes directly, through non-technological innovations, to labour productivity development in client industries. The availability of external business services makes it possible for small and medium-sized enterprises to surmount scale problems (and associated setup costs) for knowledge inputs. Finally, the BS sector contributes to the diffusion of production-frontier knowledge among client firms, with regard to many competence areas of business development. Through the latter contribution, business services contribute to the general speed of technological and non-technological innovation in the European economy.

Many of these effects can be regarded as externalities, because the BS industry itself cannot appropriate all associated benefits for client industries. Intellectual property rights in the BS industry are underdeveloped. Clients, competitors and employees that leave the business services firm, often have few problems in applying the same idea for their own account and benefit. The positive external effects are increasingly acknowledged by national governments and international organisations. Recent policy documents mention business services as a crucial factor for enhancing the productivity

and competitiveness of client industries.<sup>47</sup> Given these positive externalities, it can be taken for granted that economic welfare in the European economy is served by having a strong and innovative BS industry.

Under-provision of innovation-related positive externalities can occur for several reasons. Consider first the yield in terms of original innovations. Several BS branches in EU countries, mostly SME, spend only a small share of their turnover on innovation expenditure. Such expenditure is essential for the creation of original innovation by the BS industry. The incentive structure, institutional structures, bureaucratic procedures and fiscal climate for original innovations with an immaterial character deserve to be screened for this reason. Intellectual property rights for services products, such as brand names and copyrights, are underdeveloped in the EU. Many business services products, even though innovative, are difficult to patent. Under-provision of positive externalities in the area of knowledge diffusion may occur when the knowledge assets upon which diffusion must rest become obsolete. Constant maintenance and renewal of such human capital assets is necessary. The problem in this respect lies with the large majority of small BS firms. Many of them entered the markets in the second half of the 1990s. Entrepreneurs and their employees (if there are any) are often so engaged in daily business services that they do not have the opportunity to keep their knowledge up-to-date, and certainly not to acquire new knowledge and skills that go beyond their current activities. Projected into the future, this could lead to exhaustion of the knowledge base in important parts of the BS industry.

A major negative externality of business services development on general economic welfare derives from this industry's own sluggish productivity development. A stagnating productivity development in a large sector like the BS industry could become a drag on economic growth. Efficiency stagnation in intermediary industries has economy-wide effects, because most transactions in the final goods market are preceded by several intermediary transactions. Low efficiency in business services markets causes too high prices, passed on downstream throughout the entire economy. Exactly this argument is mentioned in a report to the EU Industry Council. The EU Commission stresses that "*a great number of the cost pressures on the industry are generated not only within manufacturing, but in the service sectors. These input services to manufacturing are in many cases not competitive in Europe. The resulting negative downstream externalities effectively reduce the competitiveness of Europe's manufacturing industry*". The report adds that "*the most important obstacle to enhanced competitiveness of business services is represented by national market access restrictions*" (EU Commission Services, 1997). Business services have become a

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<sup>47</sup> According to the OECD: "*The provision of strategic business services is considered key to enhancing performance across the economy, in manufacturing and services alike. Increased efficiency in the provision of services will have positive spillover effects on both large and small firms*" (OECD, 1999a, p.8). A similar judgement stems from the European Commission: "*The key importance of business services lies in their dynamic links and their contribution to the competitiveness of EU industry. An important element in EU competitiveness policy is to promote intangible investments (knowledge creation, quality, innovation, management, etc.). Business services are often required to supply key elements of such investments*" (European Commission 1998).

strategic sector in advanced economies.<sup>48</sup> Since BS industry has become a major source of intermediary inputs for all sectors in the EU economy, a lack of competition and cost efficiency in BS industry has economy-wide repercussions. Improving overall competitiveness and efficiency of BS industry may therefore strengthen this industry's contribution to overall European economic growth. Policy actions towards BS industry are still at an embryonic step so far as for many of other service activities as well (Rubalcaba, 2007).

How do positive and negative externalities of BS growth add up? Present data do not allow a cost-benefit quantification. If we look only at the overall effect of BS growth on macro-economic labour productivity, there are two diverging effects. The positive effect runs through the impact on client industries. The negative effect comes from productivity stagnation in the BS industry itself. A double-edged policy would therefore seek to improve the productivity-growth of the BS industry itself, while at the same time grasping opportunities to foster the productive impact of this sector for its client industries.

*Market failure resulting from market power and monopolistic competition.* Product markets in the BS sector differ in their competitiveness. Table 4.1 provides some EU-wide data on market structures. Markets for standardised products are relatively transparent, characterised by limited product differentiation, and product prices are important competitive tools. Table 4.1 shows the market position of the leading firms (at EU level) in relation to the position of all other companies. The market hybridity factor measures the gap between the average leading firm and the average 'other' firm. A salient difference emerges between the branches with client-specific and standardised BS products. When judged by the relatively small combined market share of the leading firms, markets for client-specific products are far more fragmented. It would seem that firms in the standardised business services branches are better able to exploit some scale economies. In most branches for standardised services products, a small number of large and often international firms together account for a sizable market share, often in the range of 20 to 50 per cent of the market. This opens up the possibility for strategic and collusive behaviour by leading oligopolists. Since the markets for standardised products are reasonably transparent, competition-surveillance authorities will probably be able to deal relatively easily with collusive behaviour.

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<sup>48</sup> This has been recognised by the European Commission (1998, 2003). Studies by Arnold et al. (2005) and Rutherford et al. (2005) confirm that improved productivity in intermediary services may be a crucial factor for productivity growth in other sectors of the economy.

**Table 4.1**  
**Hybrid market structure in European business services industries, 1992**

Business services branch	Number of firms (x1000)	Number of leading firms	Combined market share (%)		Market hybridity factor <sup>a)</sup>
			leading firms <sup>b)</sup>	all other firms	
<b>Standardised services</b>					
Inspection and control	5.0	20	18	82	69
Temporary work agencies	7.6	6	35	65	682
Security services	5.0	7	62	38	1165
Cleaning services	40.0	200	35	65	108
Car hire	12.0	5	50	50	2400
Other equipment rental	72.0	47	20	80	383
<b>Client-specific services</b>					
Management consulting	8.0	20	8	92	35
Legal services	200.0	15	2	98	272
Accounting/auditing serv. <sup>c)</sup>	150.0	6	10	90	2778
Industrial engineering	15.0	10	7	93	113
Computer services	16.0	10	9	91	158
Market research	1.5	10	..	..	..
Advertising	20.0	13	55	45	1880

Notes: a) The market hybridity factor is calculated as the average market share of large, leading firms divided by the average market share of the small firms. b) Market share is based on turnover value. c) Data did not allow differentiation between simple administration shops and more knowledge-intensive services like certified accountants. Sources: data compiled by Rubalcaba (1999: 46, 430) from EU, Panorama of the EU Industry and industry sources; Kox (2002: 39).

A different story holds for BS branches characterised by client-specific business services. The existence of concentrated market shares is not a widely present market failure problem here.<sup>49</sup> The leading firms often have smaller combined market shares than in the markets for standardised business services products. Rather, market failure stems from the fact that these product markets are non-transparent and segmented, with prices playing a smaller role in competition. Distinctive knowledge-based inputs have come to be the key element in the reputations and competitiveness of firms in these markets for client-specific services.<sup>50</sup> Market segmentation occurs by region and by reputation of the provider. A proliferation of different product varieties is offered in different regional markets. Monopolistic competition, sometimes approaching localised monopolies, makes up the dominant form of competition.<sup>51</sup> A widespread complaint among users of these client-specific services is that the buyers find the tariff structure of the providers not very transparent. Buyers of knowledge-intensive services often have

<sup>49</sup> An exception may be the market for certified accountancy services, in which the international market is characterised by a small number of very large firms. However, due to lack of data, Table 4.1 is unable to distinguish this sub-market from that of the much more standardised administration services.

<sup>50</sup> Distinctive assets are often intangible in nature (cf. Eustace 2000), and as such it is difficult to separate them from the organisational fabric of the company and its workers.

<sup>51</sup> Balkanisation is the label used in industrial organisation theory for the proliferation of product varieties. In a survey article, Eaton and Lipsey (1989, p. 760) note: “Market failure is ubiquitous in [...] models with balkanisation and localised competition since in free-entry equilibrium the position of each product is very much like [...] a natural monopoly”.

little insight into the real quality of the service providers, certainly not before buying the service. The standard market-failure problem that prices diverge from marginal costs, must necessarily occur whenever demand is not perfectly price-elastic (Eaton and Lipsey 1989). Since demand for client-intensive BS products is not perfectly price-elastic, market failures must be omnipresent here. Switching-costs on the clients' side lower the price-elasticity of demand and contribute to the opacity of these markets.<sup>52</sup>

Policy attention seems required for the lack of market transparency, and the prevalence of imperfect competition in knowledge-intensive business services branches. Some years ago already, the European Commission called on Member States to take steps to promote transparency in the supply and demand sides of the BS market (European Commission, 1998, pp. 15-17) but these actions remained largely ineffective till the effects of the Lisbon strategy led to a new Communication on the competitiveness of business-related services and their contribution to economic growth (2003); at that time some actions related to services started to be promoted within the Commission actions<sup>53</sup>.

*Market failure due to information asymmetry.* Many knowledge-intensive business services products can be considered as credence goods, i.e. before and perhaps even shortly after purchasing the service, the client firm may not be able to judge its quality adequately. This creates information asymmetry. The market-based correction mechanism for this problem is the reputation premium. A client firm has to rely on information on the business services firm's past performance. Basically, a reputation is nothing other than the expectation that an economic agent will act in the same way as he did in the past. BS firms with a proven reputation for being able to supply a high-quality service product can earn a price premium. The premium is a reward for time-consistent behaviour by the business services provider. Building up a broad reputation for being able to supply high-quality services products is a lengthy and precarious process. Reputations in the BS industry form implicit market-entry barriers, causing market segmentation. The established reputations of incumbents form a barrier to entering the premium segments of their market, with the reputation-barrier sheltering them from competition by newcomers. Hence, the reputation mechanism forms a barrier in the competition process, preventing direct competition between established, large incumbents on the one hand and new entrants or SME firms with local reputations on the other. In a market with reputation-based segmentation, increased entry of new firms in the market does not necessarily mean that the total BS market becomes more competitive, nor that incumbents have a stronger incentive to reduce X-inefficiencies, and exploit any possible scale economies in order to gain cost-price advantages.

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<sup>52</sup> Client firms necessarily invest labour time and other resources in identifying, communicating and sometimes jointly solving specific business problems with the external business services provider.

<sup>53</sup> E.g. the promotion of self-related standards on BS quality, the integration of service innovation in the EU innovation and R&D policies or the actions related to regional promotion of competitive business services (within the Structural Funds); these policy actions begun at the same time the COM747(2003) on business-related services was drafted.

For client firms, the reputation mechanism means that they often pay too high a price.<sup>54</sup>

The general conclusion from this section is that the development of the European BS industry goes along with several market failures — social externalities, market power, information asymmetry and market non-transparencies — that may result in socially undesirable outcomes. This means that there may be a case for policy intervention in BS markets. The next question is for which market failures policy-intervention should perhaps be left in the hand of national authorities, and which elements deserve to be taken up at EU level.

## 4.2 Scope for EU-wide policies in business services markets

A few simple rules may help in deciding which policy interventions in BS developments are most appropriately made at the national level, and which issues might more auspiciously be tackled at the European level. The following criteria may help in delineating the most efficient policy level for dealing with issues related to market failures in business services:

- Does the issue at hand form a clear issue provided for in the *acquis communautaire* of the European Union?<sup>55</sup>
- Do the market failures in BS development have a common European dimension?
- For all other aspects: is there a positive reason to deviate from the subsidiarity rule that leaves policy intervention in principle at the level of Member States?

Table 4.2 indicatively presents some market-failure issues that most likely pertain to particular elements in the *acquis communautaire*. Indicatively, because in the new 25-member Union there is likely to be debate between EU Member States on any specific policy interference.

Creating a common ground for national BS firms in the Internal Market is a policy area where market failures may have a clear European dimension. A particular European challenge relates to the role of market integration and the elimination of obstacles in the Internal market for services. This is a political challenge that would allow European business services to compete in better positions and take advantage of wider and less fragmented markets.

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<sup>54</sup> The clients may also have higher switching costs than necessary. In the case of proven reliability by a familiar business services supplier, client firms may 'put all their eggs in one basket' by purchasing other services from the same supplier without the latter being the best or the cheapest supplier. The problem of market failure as a result of asymmetric information creates additional market-information costs, and hence stands in the way of the most cost-effective business solutions.

<sup>55</sup> During the process of the enlargement of the European Union, the *acquis* was divided into 31 chapters for the purpose of negotiation between the EU and the candidate countries. Some of the relevant "Chapters" are: Free movement of persons, Freedom to provide services, Free movement of capital, Company law, Competition policy, Taxation, Statistics, Social policy and employment, Industrial policy, Small and medium-sized enterprises, Science and research, Telecom and information technologies, Culture and audio-visual policy, Regional policy and coordination of structural instruments, Consumers and health protection, Cooperation in the field of Justice and Home Affairs.

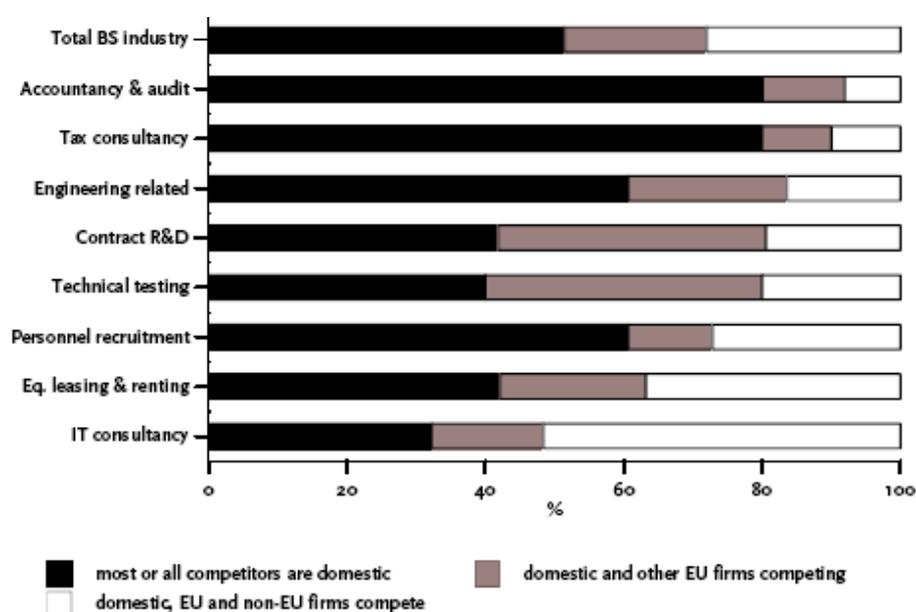
**Table 4.2**  
**Market failure issues in business services development and the *acquis communautaire*: indicative correspondence**

Market failure type	Causative factor	Relevant elements of the <i>acquis communautaire</i>	Examples of relevant aspects
<b>Information asymmetry</b>	Non-transparency of markets for client-specific business services	Freedom to provide services Right of establishment	* Different national quality standards, intra-EU trade
		Competition policy	* Transparent price and tariff structure
		Consumers and health protection	* Quality guarantees law * Quality certification system * Reduce switching costs
<b>Too few positive externalities</b>	Market and system failures in innovation related policies	Science and research, enterprise innovation policy	* Orientation of tangible products and processes * Under-recognition of organisational innovation and other intangible elements
	Lack of intellectual property rights for BS products		* EU patent bureaucracy, innovation incentives
	Limited use of KIS	Small/medium sized enterprises	* Intensity of KIBS use
<b>Too many negative externalities</b>	Slow productivity growth of BS firms	Small/medium sized enterprises	* Permanent education SME firms * Administrative burdens SME * Preconditions for scale effects
		Education and training,	* Availability qualified personnel
		Science and research, Industrial Policy	* Positive incentives for innovative start-ups
		Competition policy	* Abate market collusion * Transparent prices/tariffs
		Freedom to provide services	* Free movement firms EU * Opening up national markets
		Regional policy	* New regional policies oriented to innovation spillovers.
		Telecom and information technol.	* Communication infrastructure
	Employment in business services	Training and education Regional policy, Social policy and employment	* Relevant skills and expertise for KIBS activities * Assist business services policies in new Member States

European BS markets are still dominated mainly by domestic competition, as is shown in Figure 4.1. The IT consultancy, equipment renting and personnel-recruitment branches are the most exposed to foreign competition, while those most sheltered from foreign competition are accountancy and tax consultancy. The international firms active in these branches operate in specific market segments, but the overwhelming majority of firms report that they have only domestic firms as competitors. Nonetheless, increasing the exposure of domestic firms to foreign competition would probably result in a number of beneficial effects: more pressure to improve labour productivity, more product and process innovation. These positive externalities will have a European

dimension. Innovation policies and the technology-transfer policies may have an unbeatable ally in business services. Business services produce innovative effects in companies and generate a change in the state of their technological knowledge. However, at the same time, they are carriers of the most important technological advances in society. This makes them possible pivots in EU policies that seek to stimulate and disseminate innovations.

**Figure 4.1**  
**Exposure of domestic business services markets in the EU to international competition**



Source: results of a European survey among BS firms. CSES (2001: 143).

Other policy areas that concern market failures with an EU-wide dimension include the protection of intellectual property rights and the creation of a system of innovation incentives for European BS firms. Though national preferences can play a role here, it is clearly in everyone’s interest to prevent national systems from being set up according to a beggar-my-neighbour principle. The Kok Report (2004, 20) recognised the importance of business services, calling for sectoral policies: “business *with a fast growth potential must be better supported*” and for the role of knowledge-intensive services to be recognised among other key sectors.

The same holds for quality standards for BS firms: all EU Member States may gain by agreeing on the use of more mutual recognition and some harmonisation of national quality standards for BS firms. Foreign competition can be artificially suppressed by national regulations that offer shelter to domestic BS firms vis-à-vis foreign providers. Market regulations can operate as effective trade barriers, even if that was not the intention of the policy maker. In some knowledge-intensive business services, several market-affecting regulations are left that might function as effective non-tariff barriers to imports and direct investment. In 1993, European industrial organisation specialists

observed that service industries are highly affected by specific regulations, and that ‘in many countries services are subject to more government interventions than most other activities’ (Sapir, Buigues and Jacquemin, 1995). There has been some improvement since then, but the situation in the BS industry is still characterised by a relatively strong presence of market regulation by governments. The integration process of the Internal Market in an enlarged Europe may offer new opportunities to improve the qualifications and mobility of business service professionals. Ensuring competitive and transparent markets for business services is an issue that obviously has EU-wide elements, if only because part of competition policies must be based on European competition law.

For some other policy areas, such as promotion of BS employment, it is far from obvious that this is an area where European policies should prevail over national policy interventions. Since labour market conditions and industrial structure still differ considerably between EU countries, it might be more efficient if national policies have precedence over EU policies. Insofar as business services have constituted the most dynamic sector in job creation in recent years, an active job policy may be contributing to the acceleration of this market process in some countries. It might reduce current levels of unemployment. Jobs generated in the sector will in turn create indirect jobs through positive spillovers: more services and greater competition. Hence, there may be good reasons for national policies to enhance BS employment, e.g. by allowing more scope for part-time jobs, thus creating better conditions for women to take up jobs in BS firms. European policies in this area may be supportive to national policy efforts, but should not replace the latter.

A similar argument holds for removing rigidities in labour markets. The latter may disturb BS growth, because flexible working conditions appear to be a requirement for the growth of some business services branches. Flexibility encourages the appearance and expansion of advanced services, many of which develop with very little structure, part-time jobs and in conditions of high job rotation. If market rigidities are not removed, more BS jobs may migrate to low-wage countries. Given the specific national character of market failures in the relevant labour markets, national policies should – also here – have precedence over EU policies, except for those EU training programmes and similar already existing EU actions which could shape the needs of BS activities. The Kok Report (2004) calls, *inter alia*, for a re-examination of certain non-wage labour costs.<sup>56</sup>

To sum up, an affirmative answer can be given to the question "*Is there a need for EU-wide policies beyond what national governments do (or can do) to improve the market outcomes of national BS sectors?*" There is certainly scope for EU-wide policies in this area, but dealing with market failures in BS development sometimes means that EU policies need to be formulated with a cooperative eye to Member States’ national policies. This may pertain, for instance to quality standards, recognition of professional qualifications, and tax treatment of BS firms. Some policy issues, such as employment policies for the BS industry, might perhaps more efficiently be left to the governments of EU Member States, although some Commission activities and policies could help to

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<sup>56</sup> The discussion of the ideas in the Kok Report (2004), together with the work on the European Employment Strategy, and especially, the on-going works of the Forum on business-related services, may bring new policy actions that may boost employment growth in business services.

promote employment-related actions at regional and national level. In any case, there is no reason to exclude service-related policies in the existing EU policies, whether employment, innovation, internal market or competition they be. A need for shaping EU policies towards services, including business services, is still needed.

In conclusion, there is room for policy actions — at the national and the EU level — that boost and encourage the contribution of business services to economic growth. It is beyond the scope of this study to discuss in detail all the market failure items mentioned in Table 4.2. However several policy elements can be envisaged which will boost the role of business services in European economic growth. This may help to achieve some of the ambitious Lisbon goals with respect to employment, productivity and innovation.

## Annex 1: Decomposition of structural growth of the business-services sector

For analysing the causes of the structural growth of business services compared to the rest of the economy, a simple input-output system may do, as described in Kox (2001). We distinguish three sectors: business services (BS) industry, other market industries and non-market sectors, represented by the suffices B, M and Q, respectively. The input-output system is:

$$x = R y \quad (1)$$

in which  $x$  is a vector of gross production,  $R$  is the Leontief inverse matrix (3 x 3 dimension) of intermediate deliveries, and  $y$  is a vector of final demand. The growth of gross production between period 1 and period 0 is given by:

$$\Delta x = x_1 - x_0 = R_1 y_1 - R_0 y_0 = \Delta R y_0 + R_0 \Delta y + \Delta R \Delta y \quad (2)$$

The change in final demand can be expressed in terms of the initial final demand and a row vector ( $f$ ) that gives growth percentages of total final demand per sector, so that:

$$\Delta x = \Delta R y_0 + R_0 f y_0 + \Delta R f y_0 \quad (3)$$

The base year shares of final demand are used as weights for the growth rates. The framework so far can be applied straightforwardly for tracing the causes of the structural growth rate difference between the B sector and the M sector:

$$\dot{x}_B - \dot{x}_M = \frac{\Delta x_B}{x_{Bo}} - \frac{\Delta x_M}{x_{Mo}} \quad (4)$$

After filling in all elements from the full i/o system, the structural growth rate difference between the B sector and the M sector can be decomposed like in equation (3):

$$\begin{aligned} \dot{x}_B - \dot{x}_M &= y_B y_{Bo} \left[ \frac{r_{BB0} + \Delta r_{BB}}{x_{Bo}} - \frac{r_{MBo} + \Delta x_{MB}}{x_{Mo}} \right] + y_{B0} \left[ \frac{\Delta r_{BB}}{x_{Bo}} - \frac{\Delta r_{MB}}{x_{Mo}} \right] \\ &+ y_M y_{Mo} \left[ \frac{r_{BM0} + \Delta r_{BM}}{x_{Bo}} - \frac{r_{MM0} + \Delta x_{MM}}{x_{Mo}} \right] + y_{Mo} \left[ \frac{\Delta r_{BM}}{x_{Bo}} - \frac{\Delta r_{MM}}{x_{Mo}} \right] \\ &+ y_Q y_{Qo} \left[ \frac{r_{BQo} + \Delta r_{BQ}}{x_{Bo}} - \frac{r_{MQo} + \Delta x_{MQ}}{x_{Mo}} \right] + y_{Qo} \left[ \frac{\Delta r_{BQo}}{x_{Bo}} - \frac{\Delta r_{MQo}}{x_{Mo}} \right] \end{aligned} \quad (5)$$

Using this growth decomposition equation we may distinguish between three factors that could explain structural growth of the business-services industry:

- \* final demand in B sector grows faster than in both other sectors ( $\dot{y}_B > \dot{y}_M, \dot{y}_Q$ );
- \* the B sector benefits most from privatisation in Q sector ( $\Delta r_{BQ} > \Delta r_{MQ}$ );
- \* the B sector gets a larger share in the intermediary deliveries of the M sector ( $[\Delta r_{BM} - \Delta r_{MM}] y_{Mo} > 0$ ), which could be replacement growth if it goes along with an at least equivalent shrinking of value added in the M sector.<sup>57</sup>

<sup>57</sup> This could indicate that the M sector outsources in-house services to the B sector predominantly for reasons of (labour) cost-saving.

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