The Hidden Key to *Growth*

How local services stimulate economic expansion.

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

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

Why, then, do so many policymakers omit local services from their development plans? Part of the reason is that service work has a poor reputation. Low-skill, low-wage, ephemeral jobs in fast food joints and beauty parlors hardly seem the

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building blocks of a modern economy. But such jobs form the minority of service employment: even in the United States, widely thought to have too many of them, they represent only 22 percent of the huge range of total service employment. In fact, services comprise many activities critical to economic growth, like power supply, transport, and telecommunications, as well as numerous high-skill, high-wage occupations, such as accountants, researchers, and professionals in health and financial services.

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

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FASTER GROWTH AND MORE GOOD JOBS

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

More good jobs. Since 1997, employment has declined in the goods-producing sectors of most developed and many developing economies, leaving service industries responsible for all net job cre-

What Are Services?

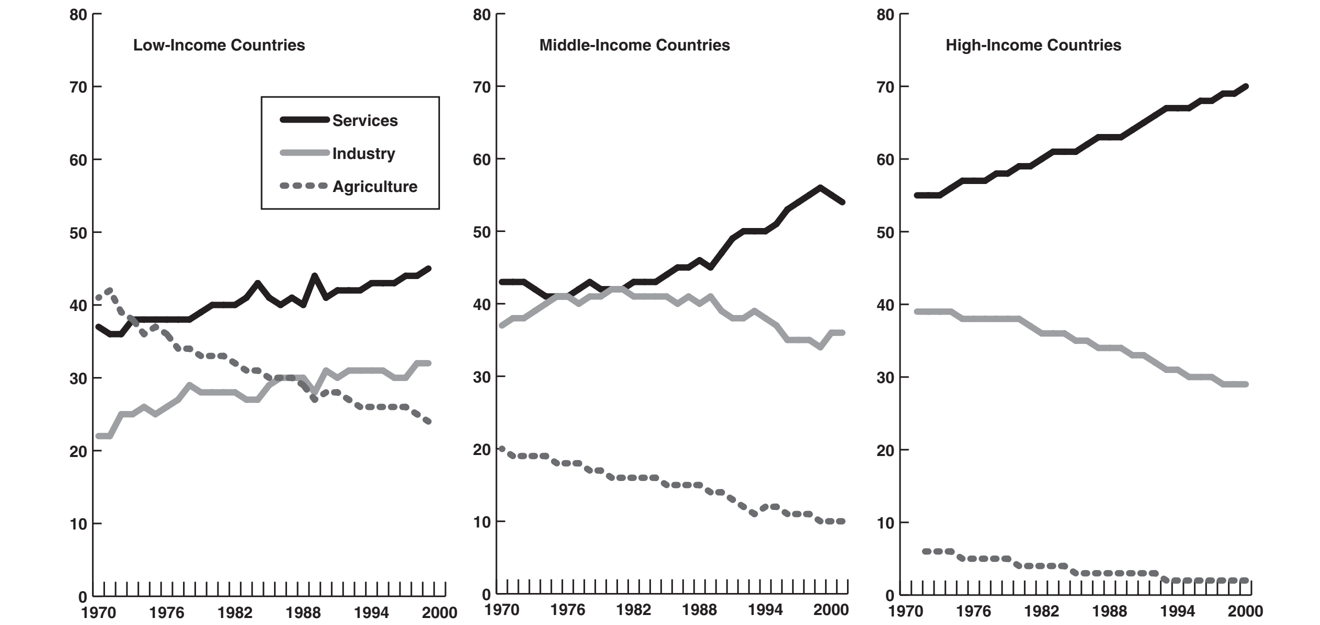
Market service activities in today's economies are tremendously diverse. The EU Services Directive divides them into three categories: services provided to consumers, services provided to other businesses, and services provided to both consumers and businesses.

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

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

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

1 Service Sector Growth During Economic Evolution
Percent of GDP, 1970–2001



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

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

Source: World Bank; World Development Indicators.

ation. Among middle- and high-income economies today, services generate 62 percent of all employment on average, and the higher a country's GDP per capita, the higher the share of service employment (Figure 2).

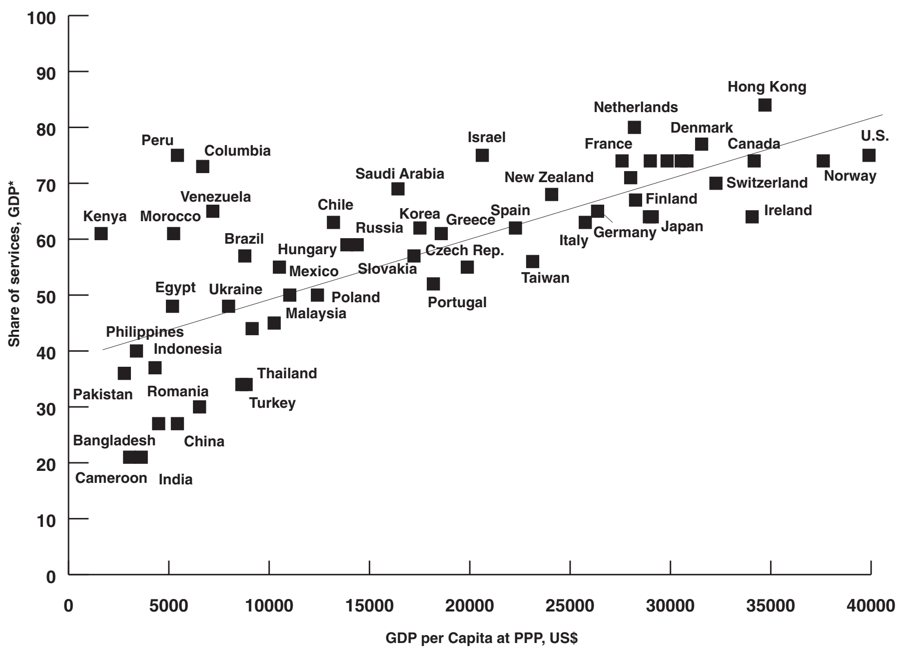
Manufacturing employment is shrinking worldwide as a result of more efficient use of labor, automation, and new IT. Roughly 22 million manufacturing jobs disappeared worldwide between 1995 and 2002, despite policy efforts to preserve them. Even China, the world's "factory floor," lost 15 million manufacturing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

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

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

Faster growth. Because of their sheer size, local service sectors like retail and construction are important drivers of overall GDP growth. And access to high-quality local services affects rates of growth in all other sectors because every enterprise uses them. Good local services can also make a difference in attracting foreign direct investment. Electricity, communications, and transport quality and cost all influence the overall attractiveness of an offshore location to multinational companies choosing where to invest. In the early 1990s, for instance, India's nascent offshore sector was hobbled by unreliable phone and Internet connections. It was only after local telecom services improved that offshoring in India took off. Indeed, McKinsey Global Institute interviews with executives at multinationals show that they value a stronger infrastructure and reliable network services more than direct incentives from governments. Managers at Brazilian auto OEMs and Indian offshore service companies that received direct government incentives told us they would rather the money had gone on improving ports and roads in Brazil and telecommunications in India.

2 Share Of Services Is High and Increases With GDP Per Capita



*Includes all other sectors except agriculture, manufacturing, and mining.

Source: World Development Indicators, Global Insight.

MYTHS ABOUT SERVICES

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

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

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

Indeed, McKinsey Global Institute's studies of countries around the world show that gaps between productivity levels in their large, employment-intensive local service sectors, such as retail and construction, explain a substantial amount of the gaps between their respective GDP per head figures. In Korea, McKinsey Global Institute found retail sector labor productivity was only 32 percent of the U.S.

level, compared with an average of 53 percent across all the sectors we studied there. In Turkey, labor productivity in manufacturing averaged 64 percent of the U.S. level, while it was only 33 percent in services.

Retail sector reforms are particularly important in triggering productivity growth, partly because these sectors employ so many people, partly because improvements here stimulate productivity advances among upstream suppliers. For example, the liberalized retail sector in the United States has been one of the top three contributors to aggregate productivity increases since 1995. Research has shown that removing restrictions on outlet size, opening hours, or product selection from retailers in other OECD countries would allow their retailers likewise to streamline distribution systems and grow both sales volumes and employment. Their consumers, too, would benefit from lower prices and a broader array of services.

The experience of some countries in Europe shows that trying to contain growth in low-skill service jobs by imposing high minimum wages and other labor market restrictions results in higher overall unemployment, not more high-skill jobs.

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

Myth 2. Increasing service sector productivity will rapidly increase unemployment.

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

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

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

Myth 3. Services are an unreliable source of jobs.

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

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

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entrants. Creating a dynamic service sector therefore reliably guarantees lifetime employment opportunities for everyone, if not the same job for life.

For example, from 1977–87, the U.S. auto repair industry lost 49 percent of its jobs, but at the same time took on new employees in jobs equivalent to 56 percent of total employment in the industry. So although almost half of all auto repair jobs ended over the period, net employment in the sector grew by 7 percent. Data from middle-income economies, albeit limited, suggest their dynamics of service job destruction and creation are similar.

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

Neglecting and over-regulating service industries also has the perverse consequence of encouraging growth in the informal service sector. In many developing and middle-income economies, the majority of output in services such as retail and construction comes from informal firms that neither pay full taxes, nor abide by worker safety and other regulations, nor even register. Their unearned cost advantage allows low-productivity players to survive and prevents more productive formal companies from taking market share. In Brazil's food retail sector, for example, McKinsey Global Institute found that tax-paying, productive, modern format retailers are at a large cost disadvantage to small, unproductive, informal players that evade tax. Acquiring the informal players is no remedy as the scale gains would be too small to offset the extra tax burden. As a result, growth in more productive, higher-wage jobs in services is capped, and average productivity in Brazil's retail sector is only 16 percent of the U.S. level.

HOW TO DEVELOP A DYNAMIC LOCAL SERVICE SECTOR

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

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

Open up capital markets to local services. Investments in services should be assessed against the same criteria as manufacturing investments. In many countries, this is not the case. Directed lending policies in banking remain prevalent. In South Korea, for instance, during its push for manufacturing-led growth, banks were prohibited outright from lending to consumer service sectors like leisure and real estate. In China today, state-owned manufacturing enterprises account for 65 percent of all loans, even though they produce just 35 percent of industrial output. Meanwhile, IPO rules in most developing countries' stock markets allow only large companies to list, thereby discriminating against service sectors that have smaller players. Policymakers need to liberalize financial systems so they will allocate capital to the projects with highest returns, regardless of sector.

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

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

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

Remove the product market barriers limiting competition in services. McKinsey Global Institute productivity studies have shown that inappropriate product market regulations governing service sectors are the biggest barrier to increased competition, which drives the diffusion of more productive processes. Product market regulations govern company ownership, trade, foreign direct investment, land use, prices, and products. Misconceived regulations make competition less intense by limiting the entry of new players (particularly global ones), discouraging innovation among existing competitors, and restricting enterprise scale.

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

Remove barriers to FDI in services. This can open the door to substantial inflows of capital. Moreover, it allows countries to benefit from the best practices and increased competition provided by global companies, which will impel service productivity upwards. For example, when foreign direct investment restrictions in retail banking were removed in many Latin American countries during the 1990s, foreign companies invested over $50 billion in their banking sectors alone over the next ten years. Similarly, in India, foreign investment played a key role in introducing competition to the formerly protected auto assembly sector after it was liberalized in 1991 and helped to spur productivity improvements.

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

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more easily and put to its most productive use. Many governments also restrict store sizes to protect mom-and-pop stores from large-scale retail outlets, but at the cost of higher retail productivity. For instance, French zoning laws have required retailers to get local authorization before opening new stores bigger than three hundred square meters, or expanding existing stores.

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

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

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

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

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

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

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

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