



**SERVICE SECTOR PRODUCTIVITY
IN FINLAND**

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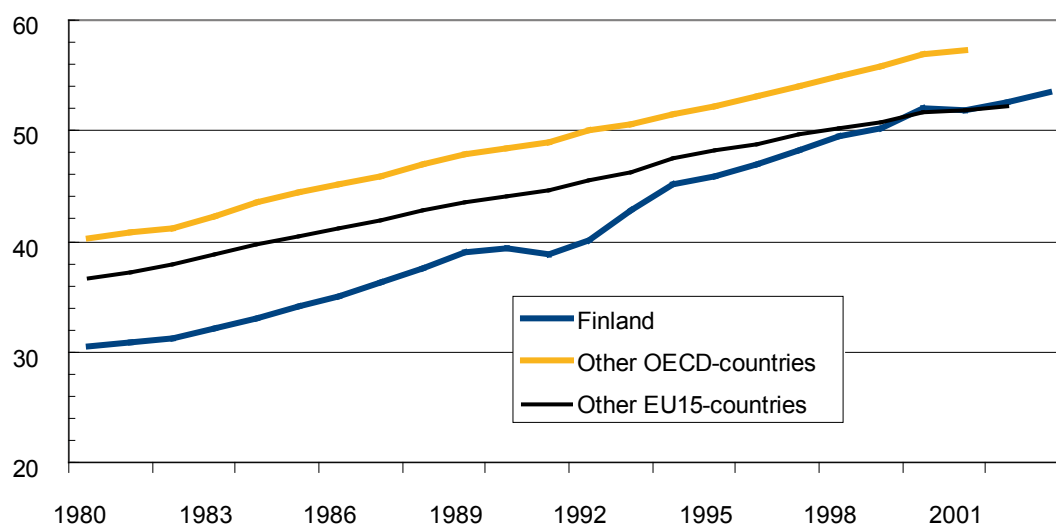
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SERVICE SECTOR PRODUCTIVITY IN FINLAND

Rising productivity is a key economic policy objective. Overall productivity can also be influenced by policy measures. Productivity growth is often associated with new technological development. The ability of companies to adopt and apply new technology effectively in their operations and to organize their business operations more efficiently can raise productivity without substantial and heavy fixed investments.

A study of service sector productivity, ordered by the Central Chamber of Commerce of Finland and carried out by the ETLA Economic Research Institute¹⁾, shows that labour productivity in the Finnish national economy has reached nearly the average level for developed economies (figure 1). In manufacturing industry Finland is one of the leaders, in construction it is at least at the average level and in private services it is close to the average (figures 2 and 3). According to present knowledge, public sector productivity is below the average of reference countries.

Figure 1. Labour productivity of the total economy 1980-2003.
Value added per employed person, thousand 2002 euro, ppp



Source: OECD/STAN, Kaitila et al. (2006)

¹⁾ V. Kaitila, R. Mankinen ja N. Nikula 2006: *Yksityisten palvelualojen kansainvälinen tuottavuusvertailu* (in Finnish, *An International Productivity Comparison of private services*, ETLA discussion papers no. 1043, 2006)

Figure 2. Labour productivity of total economy

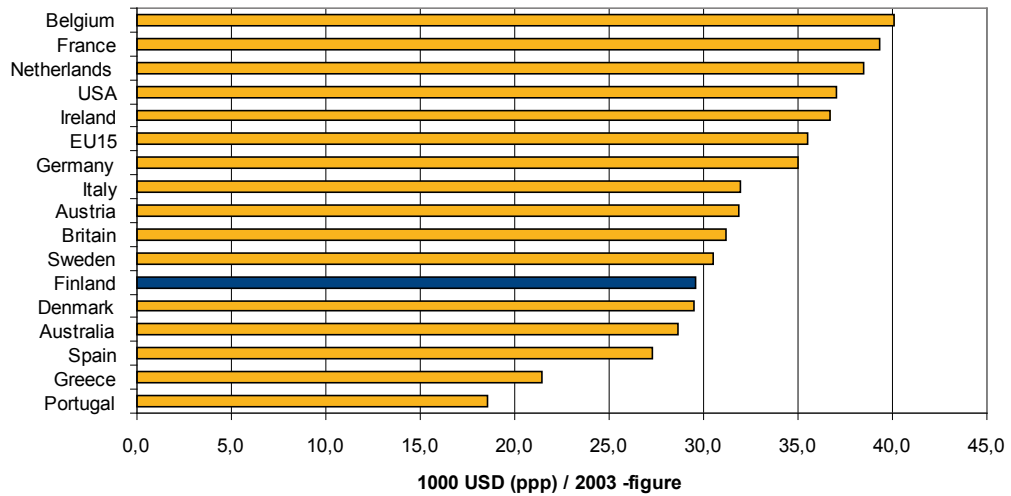
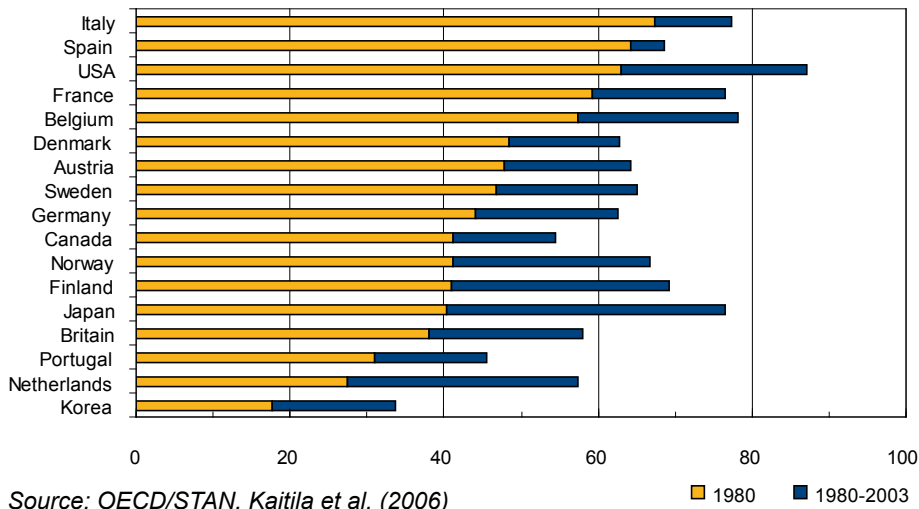


Figure 3. Labour productivity in private services 1980 and growth until year 2003 (value added volume/employed, ppm-correction), TEUR



Source: OECD/STAN, Kaitila et al. (2006)

A leader in developing postal, telecommunications, financial and insurance services

According to the Kaitila et al. (2006) comparison of labour productivity in the service sector, Finland placed highest in telecommunications and postal services, and in financial services (figure 4). Productivity in the sectors of commerce and transport as a whole is around the average for reference countries. In other business services as well as in a hotels and catering, international statistical comparisons yield a less clear picture. However there are signs that, in other business services, Finland is not a leader in productivity and productivity growth.

Using figures from the national accounts of EU15 countries and adjusting them merely for purchasing power, Finnish productivity (value added per hours worked) for commerce as a whole is slightly above average but for retailing alone slightly below it. Certain studies employing newer and methodologically more precise methods, by using e.g. double deflation to take into account the prices of intermediate inputs purchased, have produced findings that generally raise the computational productivity of the commerce sector in Europe compared with the United States. The higher that value added and product taxes are, the greater the increase. The new methodology improves computed productivity in the Nordic countries in particular.

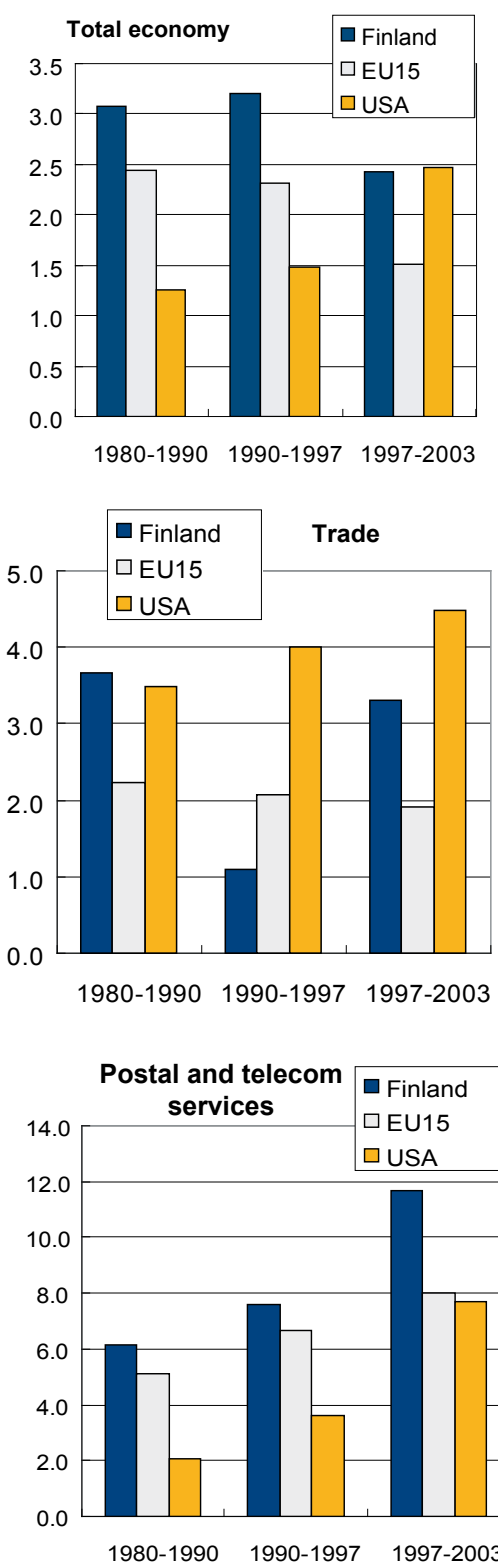
Between 1997 and 2003 productivity growth in Finland was distinctly faster than in EU15 countries but slower than in the United States. The US uses a hedonistic price index which is creating a boost in productivity growth in wholesaling compared with Europe. The differences in statistical methods go on to influence the results of international comparisons. Retailing productivity in Finland since 1985 has risen far faster than the EU15 average but did not reach US growth rates in 1997-2003.

Statistics for the hotel and catering sector provide very dissimilar pictures depending on whether the figures used are from national accounts or from the SBS statistical material published by the EU, which is based on sampling. According to the former, Finnish hotel and catering productivity is the lowest among the reference countries while according to the latter it is the highest.

Productivity in telecommunications and postal services has increased very briskly in recent years, partly because of strong technical development and the emergence of new business areas. According to national accounts, productivity in Finland is third highest after the Netherlands and the United States. Furthermore it increased in Finland during 1980-2003 faster than the EU15 average or than in the United States.

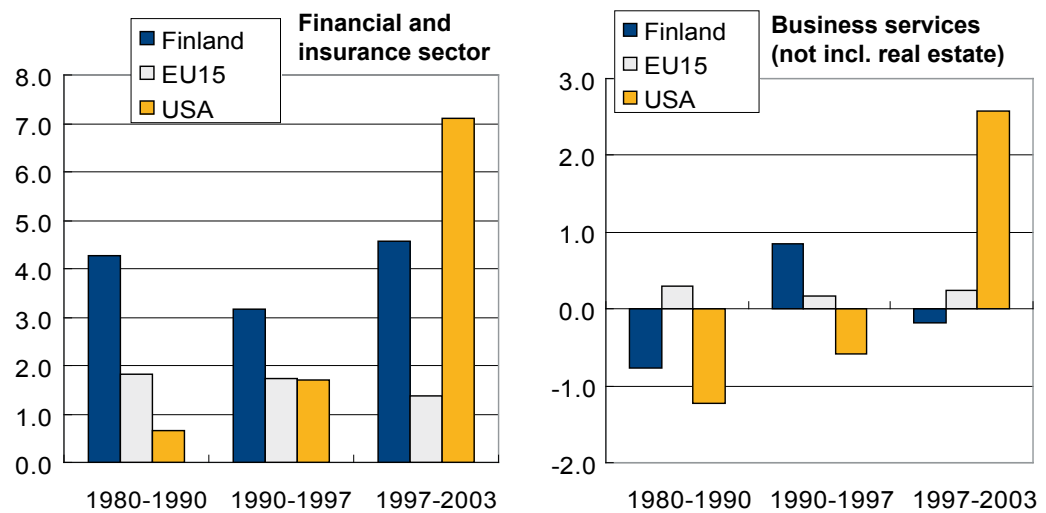
Productivity measurements for the financial sector (including banking and insurance) should be treated with caution, partly because of the way that value added is calculated. The OECD has not calculated separate purchasing

Figure 4. Average labour productivity (value added per hours worked) growth in Finland, EU15 and USA, %



Sources: Groningen Growth and Development Centre, 60-Industry Database, <http://www.ggdc.net/>; OECD (2005); Kaitila et al. (2006).

Figure 4 (continued). Average labour productivity (value added per hours worked) growth in Finland, EU15 and USA, %



Sources: Groningen Growth and Development Centre, 60-Industry Database, <http://www.ggdc.net/>; OECD (2005); Kaitila et al. (2006).

power parities for correcting values in this sector. National accounts show Finland's finance sector productivity to be at the top of the table of reference countries. Moreover productivity increases in Finland were significantly faster than the EU15 average in 1980-2003 and also much faster than in the United States in 1980-97.

Total factor productivity growth the greatest in telecommunications and postal services

The Kaitila et al. (2006) study shows that in Finland telecommunications and postal services have succeeded best among private services in harnessing technological advances (table 1). In the past ten years total factor productivity in this sector has risen

Table 1. Total factor productivity in Finland
Average annual change 1980 - 1990, 1990 - 1995 and 1995 - 2005, %

Sector	1980-1990	1990-1995	1995-2005
Total economy	1,6	1,4	2,2
Manufacturing	3,2	5,0	6,0
Construction	0,5	-1,3	-0,1
Private services	1,4	0,8	1,5
- Postal and telecom services	4,4	4,0	9,1
- Trade	2,4	-0,3	3,8
- Transport	2,3	1,9	1,7
- Financial and insurance services	4,1	2,3	0,8
- Hotel and catering services	1,1	3,0	0,7
- Property- and business services*	-4,8	-0,9	0,5

* not including housing ownership

Note: New chain-index method for national accounts used as a statistical source.

Source: Statistics Finland/Kaitila et al. (2006)

even faster than the average for manufacturing industry. In the commerce sector, the effect of overall productivity on labour productivity has clearly strengthened in the past decade. On the other hand in finance and insurance operations, the growth of overall productivity seems to be past its peak. In the last period observed in the Kaitila et al. (2006) study, there was actually a significant fall in overall productivity.

In the hotel and catering sector and in transport services, total factor productivity growth is slower than in other service sectors. In business services, overall productivity has declined except during the second half of the last decade. The sector itself is extremely broad and its analysis requires more precise and better statistics than those used in the Kaitila et al. (2006) study. In any case, there is a great need for increased productivity in business services.

Productivity the key to success in years ahead

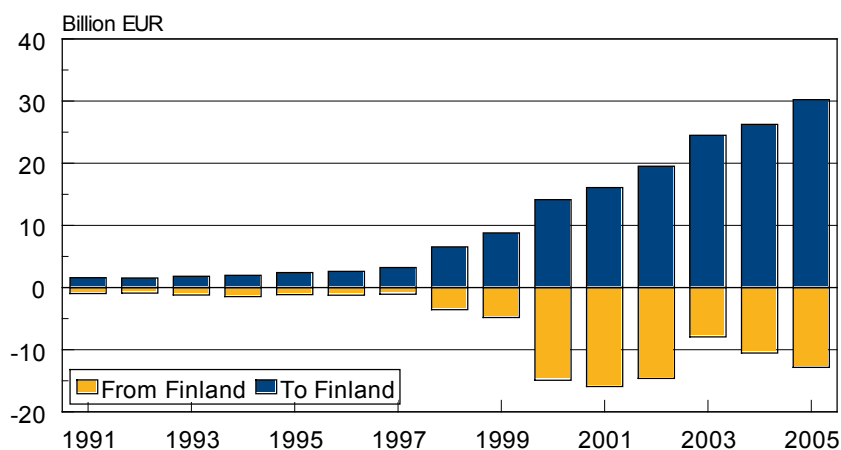
It will become harder in future to raise the standard of living in Finland. The labour supply is shrinking and international competition is becoming more demanding. Finland is located away from the fastest growing international markets. Public sector finance will remain scanty and tax competition will restrict the policy alternatives available. Information and communications technology will allow the reorganization of many services but reluctance to reshape established practices may constitute a bottleneck.

Whatever the uncertainties about underlying conditions, the need to accelerate productivity will serve as a policy recommendation. Economic growth and rising living standards depend on higher productivity. The less manpower and capital are available, the more productivity growth must be accelerated.

Late internationalization of the Finnish service sector

Internationalization came comparatively late to the Finnish service sector but the pace has picked up since the 1990s (figure 5). The stock of direct foreign investment in

Figure 5. Foreign direct investment to and from Finland - stock / Service sector



Note: Stock from Finland to abroad here with a negative sign.

Source: Bank of Finland

Finland was just over 30 billion euros at the end of 2005, and two-thirds had been channelled into service businesses. As recently as 2000, the stock of investments in services was still only about 14 billion euros, just over half the stock of direct foreign investments in Finland.

The average size of Finnish service companies has been small, with limited international competitiveness. Market shares of service companies in Finnish ownership have fallen in many business areas. On the other hand foreign investments have brought international capital and skills in innovation and marketing which were not previously available.

The late and restrained internationalization of Finland's service sector shows particularly in the direct investments abroad of Finnish service companies. Their stock at the end of 2005 was less than 13 billion euros and had shown no increase since the turn of the new millennium. In the last few years, however, Finnish service companies have made some breakthroughs in the international arena and it is to be hoped that this will continue in the years ahead. Increasingly often, internationalization is launched in the Baltic States and Russian markets.

Finnish service exports have risen substantially. Since 2000 they have increased even faster than merchandise exports.

POLICY RECOMMENDATIONS TO PROMOTE SERVICE SECTOR PRODUCTIVITY AND GROWTH

1 Functioning markets and effective competition increase productivity

There is a strong relationship between competition and productivity. Effective competition based on a functioning market boosts productivity. A low degree of regulation and a favourable attitude to innovativeness are characteristics of a functioning market. Barriers to market entry prevent a market from functioning properly. Effective competition keeps the quality of services high and the price of services in check. Effective competition on the domestic market will also improve the international competitiveness of companies.

2 National regulations and licensing should be cut back

The highest relative productivity in the Finnish economy, compared with other economies, is in industry. Productivity in financial services, telecommunications and postal services is also at an internationally high level. In their role as enforcers of competition legislation, the competition authorities have key responsibility for the functioning of national markets.

The development of a legislative climate that promotes competition plays an important role in creating a functioning market. When new legislation is being drafted the effects on competition must be taken into account. The growth of productivity in the service

sector could be greatly stimulated by abolishing national regulations that needlessly restrict business and competition.

It is easier to reallocate resources in service business areas where market entry is not regulated. Although significant progress has been made in many important areas in Finland, active measures are still required to dismantle laws that restrict competition. In the field of commerce, in particular, the limits on shop opening hours and restrictions on the construction of large retail outlets should be abolished.

In the 1990s, Finland dismantled a wide range of licensing systems that applied to services, but taxi operations and pharmacies are significant examples of businesses where licensing continues to restrict competition by preventing new enterprises from entering the field. Unfortunately these areas are outside the ambit of the service directive, so national action is needed to promote competition.

3 The service directive must be made to serve growth of the internal market

When the EU directive opening the cross-border market in services takes force, even in its watered-down form, the service directive will improve the supply of services in the EU's internal market. Although important areas have been exempted from the directive, it still covers almost all business services, which is where the internal market has great growth potential. In business services, knowledge-intensive services cover many areas and constitute an increasingly important link between the public and private sectors.

Implementation of the service directive requires that service providers are treated equally regardless of nationality. Licensing and other official measures must not restrict market entry by service sector businesses originating in other EU countries. National officials must cooperate more efficiently than today to ensure common implementation methods of the directive throughout the EU.

4 Tight networking between public and private sector service markets

The best way of ensuring cost-effective production of public services is to create a functioning market for publicly financed services, where there is genuine competition between service providers. It is also important that the ultimate choice is made by the consumer of the service.

To ensure service provision on market terms, municipalities and other suppliers of public services should adopt the buyer-supplier approach and use the public private partnership model for services that the municipality is required to provide. With the new Public Procurement Act, municipalities need to improve their understanding of the market and their skills in buying services. Where the public sector produces its own services, this must be done in a way that is competition-neutral and efficient.

New operating methods will increase productivity. By using the innovative service solutions of enterprises, it will be possible to supply services of higher quality than before.

The opportunities offered by private service companies must also be exploited when the public sector is unable to arrange services or develop them.

5 Efficient infrastructure is important to service enterprise growth

Good and comprehensive traffic routes and communications connections will strengthen national competitiveness, including that of the service sector. Developing traffic routes and public transport solutions are ways of significantly enlarging work catchment areas and promoting regional mobility of labour. Finland needs considerably more effective implementation of ICT and other new technology.

Decision-making must take into account the positive impact on enterprise and the whole national economy of traffic investments. Developing overland traffic routes and aviation is a long-term strategic investment that promotes competitiveness. A comprehensive airport network is of particular importance for tourism.

6 Competitive taxation that creates incentives will support the service sector

Finland must ensure that its taxation is competitive. Successive governments must continue a managed reduction of taxation on earnings. The top marginal rate must be reduced to no more than 50%. A reasonable overall tax rate will support employment, encourage enterprise and create new growth impetus. Legislation about tax at source for foreign workers should be extended from 2008 onwards as far into the future as feasible.

7 Promoting internationalization of the service sector and the education system

Growth of service sector productivity must be promoted by reinforcing the trend to internationalization. Service sector competitiveness can be reinforced not only through productivity but also with creativity and quality. High-quality requires a command of many different areas. Service sector know-how must be made a component of education and research.

8 Ensuring a supply of labour and skills

A skilled labour force is a particularly important factor for the service sector, where intellectual capital is crucial. A key mission of the education system is to improve the professional skills of Finnish employees and the international competitiveness of companies. To ensure the availability of labour, active support must be given to occupational immigration policy.

The education system needs to follow more closely the changes in the environment where companies operate. University degrees and schooling must be of a high quality and must correspond to business needs.



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