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Fostering innovation in services

A KEY DRIVER FOR GROWTH

EXECUTIVE SUMMARY

An effective European innovation policy that better supports innovation in services would greatly contribute to reaching the objectives of the Europe 2020 Strategy and stimulate growth and job creation in Europe.

Yet, BUSINESSEUROPE observes that innovation in services is trailing compared with other parts of the economy. There is a strong need for better awareness of the power of service innovation. Policy-makers at all levels (European, national and regional and local), but also companies should be made aware of its unrealised potential to gain competitive advantages and increase productivity.

To boost service innovation in Europe, remaining barriers to a genuine Single Market must be removed and the right conditions should be put in place to foster innovation in all sectors. Innovation policies need to be adapted where appropriate to new or emerging business realities and reflect the importance of service innovation as a driver for more growth and jobs.

BUSINESSEUROPE emphasises that competition is the best way to foster innovation in services, in business services as well as the operational service sector. Creating the right business environment for companies, and in particular start-ups and SMEs, is key to their ability to innovate.

In the light of the above, this policy paper aims to:

1. Raise awareness of the importance of service innovation as a key driver for growth and job creation.
2. Identify reasons for the lack of sufficient attention to innovation in services.
3. Point to the challenges for service companies to innovate.
4. Address common misconceptions and provide recommendations to boost service innovation in Europe.

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1. Service Innovation in Europe

Europe's economy can be described as a "services economy" with a wide range of services sectors - ranging from manual to business and high tech services - together accounting for 75% of EU GDP and around 70% of total employment. But services not only comprise the largest part of the European economy, they are also the main engine for growth and productivity within advanced economies, with nine out of ten new jobs created in the services sectors.

As services drive competitiveness and growth, and offer wide scope for the creation of new jobs, new sectors and novel markets, innovation in services is of great importance. It can help Europe to transform and modernise the way products and services are offered and contribute to recovering more quickly from the current economic downturn.

Europe also needs to innovate to prepare for future challenges coming from an ageing population, climate change, the environment and energy shortages. Developing a more effective innovation policy that better supports service innovation would help to address these challenges and contribute to reaching the objectives of the Europe 2020 Strategy and stimulate growth and employment.

Yet, BUSINESSEUROPE observes that innovation in services is trailing compared with other parts of the economy. In the period 2004-2006, only 33.1% of service enterprises in the EU introduced a new or improved business concept to the market compared with 42.1% of manufacturing firms.¹

The exception is the knowledge-intensive business service (KIBS) enterprises, which are more likely than manufacturing firms to introduce either a product or process innovation. In the period between 2004 and 2006, 46.8% of KIBS companies in the EU introduced a new or improved business concept to the market. Examples of KIBS sectors are computer and hardware consultancy, data processing, and research and experimental development services that are provided business-to-business.

In general, productivity growth in Europe's service sectors has lagged behind that of the goods sector and there is a considerable potential for improvement.

In the light of the above, it is disappointing to see that many Commission documents, in particular the Europe 2020 Flagship initiative "Innovation Union", which was presented in October 2010, show that policy-making is still very much focused on technological and product innovation and the unrealised potential of boosting service innovation in Europe is not specifically addressed. In these documents, products and services are

¹ Commission Staff Working Document, Brussels, 9.9.2009 SEC (2009) 1195 final. "Challenges for EU support to innovation in services – Fostering new markets and jobs through innovation".

mostly mentioned jointly without taking into account the specificities and conditions for greater support to innovation in services.

BUSINESSEUROPE continues to emphasise that competition is the best way to foster innovation. Dynamic markets are a driver for service innovation. That means it is of utmost importance to continuously strive for the realisation of a genuine Single Market by removing barriers to free movement and correct competition failures. Framework conditions can also be enhanced by smart regulation, the availability of adequate financing and public procurement of innovative solutions.

Although service innovation in itself is often left aside, it is encouraging to see that interest towards services innovation has been increasing. The Commission, and DG Industry and Entrepreneurship in particular, has shown an increased interest in the topic and several expert groups have been set up under the Europe INNOVA banner to point to the power of service innovation. Recently, the Commission's expert panel on service innovation published its report: "*The transformative power of service innovation*", which rightly underlines the need for and potential of promoting innovation in services as a tool to achieve the Europe 2020 objectives.²

This policy paper aims to contribute to raising awareness of the importance of service innovation as a key driver for growth and job creation, and as a potential area for companies to gain competitive advantages. The paper also identifies reasons for the lack of sufficient attention for innovation in services and points to specific challenges for service companies to innovate. Lastly, it provides recommendations to boost service innovation in Europe.

1.1. Specificities of innovation in services

Innovation processes take place *within service industries*³ - **innovation in services sectors** - but also in any other activity with service-like attributes in other parts of the economy, such as manufacturing, agriculture or the public sector. This broader concept of innovation is referred to as **service innovation**.

Both types of innovation should be seen as equally important; however, in this paper the focus will be on the broader concept of service innovation, which can occur in all sectors of the European economy.

To put in place the right conditions to foster service innovation, the following specificities should be taken into account:

- Innovation in services is usually centred on non-technological, intangible forms of innovation. Innovation can result in new improved service products but also occur

² Europe INNOVA, the expert panel on Service Innovation, February 2011, "Meeting the challenges of Europe 2020. The transformative power of service innovation".

³ Service industries comprise knowledge-intensive industries, i.e. business services, IT, equipment renting, etc. Examples of the manual services industries: cleaning services, catering, facility management and private health care services as well as product-related services, i.e. services which are provided by mainly manufacturing companies in close association with the physical product.



in a customer process, a business model or commercialisation process (e.g. sales, marketing or delivery).

- A growing interaction can be observed between technological and non-technological innovation and service innovation should not be seen as merely non-technological. Not only the technology itself is important but also how it is used to better address customers' needs. In this respect, innovative service concepts most often make the decisive difference between "invention" and "innovation". Innovation is no longer about developing the technology itself; it is about exploiting the new technologies. Innovations are increasingly combinations of technological solutions and new service processes. A prime example is rise of many multinational companies that focus on consumer electronics and software, which have managed to combine technological innovation with new services concepts like mobile phone applications in an unprecedented way.
- Services innovation is cross-disciplinary and multidimensional. It is often in deep synergies with other intangible assets (human capital, information system, clients, stakeholders, brand and reputation). A Swedish study found that almost 50% of the new ideas stem from interactions with users, whereas external research only accounts for about 3%.⁴ In this sense, services innovation can be considered as the most prominent "user-driven" innovation (opposed to purely research-driven innovation). In addition, innovative solutions are very often found by people who are in daily contact with end-consumers. The importance of the manual service sectors needs to be better promoted in this respect.
- There is in certain areas a shift away from pure technological and product innovation, which is largely dependent upon R&D, towards user-centric and network models of innovation. The future of service business points towards a more holistic view of the business itself. This will result in a shift from developing individual products and services towards providing solutions and experiences. For instance, rather than offering rental cars, a trader will offer city transport in multiple modes, dinner and guided tour in one business concept. Different services blend and are more and more combined.
- In many cases, the distinction between service and industry has been overstated and does not correspond to recent developments in business. In fact, manufacturing industries are changing to include more and more services. Services are increasingly becoming part of tangible and intangible products. This leads us to an economy where frontiers between industry and services are fading and, at a certain point, perhaps disappearing.

For example, service packages covering installation, maintenance, updating, or training are becoming more and more an integrated part of delivery. Connected to the outsourcing of traditional production to low-cost countries, many European companies concentrate on services and development. In many cases the attached

⁴ ALMEGA, "Innovation in service companies, a survey of 778 Swedish service companies on service innovation and research", 2008.

services become the main products or at least the focal area to gain competitive advantages.

1.2. Specificities of Innovation in Knowledge Intensive Services (KIS)

Knowledge-intensive services (KIS) are services and business operations heavily reliant on professional knowledge and therefore employment structures in these sectors contain mostly scientists and engineers.

These services can be split in two categories: the high tech KIS and knowledge-intensive business services (KIBS), which cover a broad spectrum of services that are primarily traded in business-to-business transactions, ranging from software development through equipment rental to consultancy services.⁵

Innovation in services other than KIS tends to be more of a continuous process consisting of a series of incremental changes rather than being radical. However, the KIS firms show similar innovation patterns to manufacturing firms.

As mentioned above, in the period 2004-2006, only 33.1% of service enterprises in the EU introduced a new or improved business concept to the market compared with 42.1% of manufacturing firms. The exception is the KIBS enterprises, which are more likely than manufacturing firms to introduce either a product or process innovation. In the period between 2004 and 2006, 46.8% of the KIBS companies in the EU introduced a new or improved concept to the market.

As confirmed by many innovation experts, KIS greatly contribute to aggregate economic growth in terms of value added, employment and labour productivity⁶, it is fundamental that the importance of these services is adequately reflected in European and national innovation policies as well, and that existing measures are adequately adapted to also foster innovation in these specific knowledge-intensive services sectors.

2. Key considerations to foster innovation in services

2.1. Build on the right statistics

Sound statistical analysis is the prerequisite for effective policy development. Therefore, it poses a problem that most of the current statistics do not include all the relevant service sectors. For instance statistics on "product-related services", i.e. services which are provided by mainly manufacturing companies in close association with the physical product, and also the "manual service sector" covering for instance cleaning services, catering and security firms, are simply not available. So far service

⁵ Rubalcaba, L. And Kox, H. (2007), *Business Services in European Economic Growth*, Palgrave-MacMillan.

⁶ Idem.

statistics tend towards focusing on KIBS which is certainly also important but not the only service sector that needs consideration.

At macro level, we need to gain a better understanding of the nature and economic impact of innovation in services. At micro level, we need to develop new but robust metrics and indicators to better measure and evaluate innovation.

More statistical data are needed. However, measurement of intangibles remains a difficult task. In this regard, BUSINESSEUROPE urges the OECD and the Commission, and in particular Eurostat to "innovate" new methods to collect statistics on service innovation without placing huge administrative burdens on private companies as has often happened when this kind of data is collected. In this context, universities and business schools could play a key role in a re-focus on innovation in services and data collection in particular.

More generally, there is a need to raise awareness of the power of innovation in achieving growth, creating new jobs and reaching targets, especially those set by the Europe 2020 Strategy.

2.2. Support all forms of innovation, not only technological innovation

BUSINESSEUROPE calls for a broad-based innovation strategy that supports all forms of innovation and includes technological as well as non-technological innovation, in knowledge-intensive industries as well as in manual services industries. In particular, a greater focus is needed on the interaction and synergies between technological and non-technological innovation.

New forms of innovation processes are becoming more and more important. They are more open, faster, and solution-based and include various types of actors. Innovation activities are becoming ever broader, and innovations along with technology often indicate new services or business models. This trend should be noted in EU-level activities and the state aid framework for research, development and innovation.

2.3. Ensure that all EU policies support innovation in Europe

As mentioned above, competition is the best way to foster innovation. In this regard, it is of crucial importance that the Single Market for services functions well. Remaining barriers need to be removed and it must be made easier for service providers to establish themselves abroad. In this context, BUSINESSEUROPE continues to push for high quality and correct implementation of the Services Directive. In an open market with a level playing field for all and the right safeguards in place, competition will foster innovation and European companies can thrive.

BUSINESSEUROPE urges the Commission and individual Member States not to establish new schemes or bodies to focus especially on the "service sector" - since service is to be found in all sectors - but instead to encourage innovation and R&D in service in the already existing initiatives and schemes, most notably, the CIP and the

7th Framework Programme and the future Common Strategic Framework for Research and Innovation (CSFRI).

BUSINESSEUROPE strongly warns against using legal and regulatory frameworks in order to support exclusively service innovation. Especially since innovation in services is a fairly complex matter and the innovation process is not yet properly understood, the EU should not set up further legal or regulatory initiatives that might, in the worst case, be counterproductive. Therefore the EU should not engage in any legal or regulatory "experiments" in this area, and neither should it encourage the Member States to do so.

The Commission should also be cautious about applying innovation schemes specifically aiming at SME service firms - considering the complex nature of service innovation. Instead BUSINESSEUROPE recommends that the Commission and Member States pay more attention to service innovation within existing programmes for SMEs.

In this context, it is important to note that patenting costs in the EU are still ten times higher than in the US. This amounts to a tax on innovation. These costs, which need to be drastically reduced, fall on companies and ultimately on customers. Therefore, BUSINESSEUROPE calls for the adoption of a unitary patent title. Effective protection of intellectual property including trade secret protection is key to boost innovation in Europe's services sectors.

A primary tool to foster service innovation - in particular in the public sector - is the deployment of public-private partnerships (PPPs). PPPs can offer wider choice and innovative solutions to consumers, while ensuring better value for money and offering new sources of financing to public authorities. However, to achieve these aims, the right framework must be put in place to foster PPPs.⁷

BUSINESSEUROPE believes that public procurement can also play an important role in promoting innovation in Europe by helping to shape production and consumption trends and stimulate market uptake. The current public procurement legal framework is adequate. The largest obstacles to contracts promoting innovation are the risk aversion of many public authorities and the lack of competence in assessing the best technical solution, amongst others. The focus should be on using soft measures, including guidance, sharing of best practice and enhanced dialogue between the public and private sectors to make sure that these contracts also foster service innovation.

In order to better match demand and supply in PPPs and to utilise private sector innovation in public service production, experimentation and implementation of pre-commercial procurement (PCP)⁸ practices which exclude the presence of state aid is encouraged.

⁷ For more information on public-private partnerships, we refer you to the BUSINESSEUROPE position paper "Public services in the 21st century: driving for excellence. Towards a stronger public private partnership" of November 2009. The paper is available on www.businessseurope.eu.

⁸ For more information of PCP please see Commission Communication (2008): Pre-commercial Procurement: Driving innovation to ensure sustainable high quality public services in Europe. European Communities.

In addition, BUSINESSEUROPE underlines that these technical specifications must not be too prescriptive, recalling that innovation and research results cannot be dictated. Instead, functional requirements are more appropriate, as these are technology-neutral and leave more room for innovative solutions.

2.4. Adapted EU funding to foster service innovation

The current Framework Programme for Research (FP7) has a budget of EUR 53 billion (2007-2013). More than 9,000 projects have so far been funded. A Commission study has estimated that projects selected for funding in 2011 alone will create up to 165.000 jobs.⁹

The Pro Inno Europe Report of 2009¹⁰ concludes that the public consultation on the effectiveness of innovation support at regional, national and European levels, which was held in spring 2009, underlines that manufacturing firms receive more support for financing of innovation projects than services projects do. Although this is closely linked to the intangible nature of services, this is a finding that needs to be at the centre of attention.

BUSINESSEUROPE has recently adopted a position paper on the overall framework for support to research, development and innovation (RDI) during the next financial perspectives of the EU.¹¹ The importance of service innovation is clearly pointed out in this position, but on the more general level, we call – inter alia – for a substantial increase of RDI's share of the overall EU budget, more business-involvement in setting the agenda for publicly funded RDI, project selection and implementation, radical simplification of governance and administration and coordination of EU RDI efforts.

2.5. Cooperation between regional, national and European innovation to be reinforced

There is a strong need to better align policies in the “knowledge triangle”: education-innovation-research, the European Institute of Innovation and Technology (EIT) should play a very instrumental role in this respect.

BUSINESSEUROPE agrees with the recommendation made by the Commission's expert panel on service innovation in the February 2011 report: “*The transformative power of service innovation*”¹², calling for the setting-up of a European Service Innovation Centre (ESIC). From BUSINESSEUROPE's point of view it is important that such a European Service Innovation Centre is established with close ties to other

⁹ European Commission, Press Release on investment in research and innovation, 19 July 2010.

¹⁰ Pro Inno Europe, 2009, “Challenges for EU support to innovation in services”. Mandated by the European Commission, DG Industry and Entrepreneurship.

¹¹ This position paper has been submitted to the Commission in the context of the public consultation on the Common Strategic Framework for Research and Innovation and is available on www.business-europe.eu.

¹² Europe INNOVA, the expert panel on Service Innovation, February 2011, “Meeting the challenges of Europe 2020. The transformative power of service innovation”.

innovation support bodies in order to ensure the connection between technological and non-technological innovation.

Indeed, we would support the Commission in developing information and communication centre that aims to strengthen the links between policy-makers, business and academics in raising awareness of the importance of service innovation, in particular by offering a platform to collect facts and figures, share best-practices and offer guidance to national and regional authorities when called upon.

However, BUSINESSEUROPE does not support the establishment of new bodies or organisations *specifically focused* on providing companies with specialised coaching and training in market and investment readiness relating to innovation in services. If there is a need for such kind of services, companies should be left to fill the gap on a commercial basis.

Lastly, it should be underlined that the multi-disciplinary composition of the innovation, the alignment between non-technical and technical disciplines, the re-usability of the services between the different industry sectors and the participation of these agents in the FP7 and the coming FP8, require new ways to approach skills, education and research from universities and business schools as outlined above.

3. Recommendations: the way forward to promote innovation in services

Europe needs a Single Market without barriers and systematic failures, a market, which ensures competition and fosters innovation in services as a result. This implies not designing specific or separate policies to stimulate innovation in the services sectors, but ensuring that existing policies better address remaining barriers and take into account the conditions for services innovation. Innovation policies need to be adapted to new or emerging business realities and reflect the importance of service innovation as a driver for more growth and jobs.

To this aim, there is a strong need for better awareness of the power of Europe's service innovation. Policy-makers at all levels (European, national and regional and local), but also companies should be made aware of its untapped potential to gain competitive advantages and increase productivity.

In the light of the above considerations, BUSINESSEUROPE recommends that policy-makers at all levels:

- Ensure competition and create a business environment that fosters innovation in services.
- Create political awareness and pressure to make policy-makers realise the importance of innovation in services, as these sectors provide the largest part of EU GDP and are the main driver for competitiveness, job creation and prosperity in Europe.



- Build political awareness to make the policy-makers more aware of the potential of service innovation in public-private partnerships and public procurements.
- Conduct more and high quality research to gain a better understanding of the nature and economic impact of innovation in services. The key is to use the right indicators in economic analyses and collect statistical data effectively.
- Improve and sufficiently manage existing tools and create synergies between different policy instruments in support of service innovations.
- Clarify the existing legislation on state aid and provide guidance on the use of public financing options offered by the Community framework for state aid on research and development and innovation. The Commission should also complement the “future” state aid rules for R&D with clearer operational guidelines. This can contribute to creating a conducive environment, able to foster industrial investment in R&D and innovation.¹³
- Support access to finance for service innovation and protect intellectual property rights.
- Ensure high quality and correct implementation of the Services Directive as this can foster innovation in services by diminishing market barriers and administrative burdens.
- Enhance capability of listening to customers/surveying as this has proved to be the primary source of service innovation.
- Foster mutual learning between Member States by creating a platform for “best-practice” sharing. This platform or centre should collect facts and figures on the power of service innovation and further promote service innovation at European, national and regional level.

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¹³ Official Journal of 30-12-2006. Community Framework for Research and Development and Innovation (2006/C 323/01).