

# Foreword

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The surprising vigour of the service sector puzzles policy makers and economists alike. Policy makers struggle with the question of whether they should put a lid on public service budgets as the costs of their provision rise. Economists are puzzled by the interplay of slow service and fast goods productivity growth and wonder why the demand for services is so persistent. This book is intended to address both readerships and serves as a useful introduction to service productivity analysis.

Services such as education, cultural activities, and health services are under budgetary pressure. If budgets for services are held constant, but the prices go up, there is a problem. The very existence of some services is under threat. Many economists take this as a fact of life. In their view, if commodities become more expensive, there will be less demand. What is puzzling, however, is that services do not become more costly because their provision becomes less efficient. In a seminal article Baumol (1967) diagnosed the 'disease' of the services as a lagging of productivity growth, compared to manufacturing. The success of technical progress in industry makes manufactured goods ever less expensive and thus increases the *relative* price of services, however unintentionally. Services do not require increasing quantities of resources, but the same amount of resources able to generate ever increasing quantities of manufactured goods is needed to produce services. The absolute resource cost of services does not go up, but the opportunity cost of services does, that is the number of manufactured products foregone.

While Baumol (1967) showed that there is no need to reduce the amount of services we consume, one certainly expects that the pressure on the services mounts as their relative price goes up. Yet this is not what has happened. The services sectors of advanced economies show surprising vigour. The employment of ever larger shares of the labour force comes as no surprise; this phenomenon is a direct consequence of the low productivity performance we just noted. But the fact that the real service share of GDP is also growing or is at least stable is puzzling. The paradox of the services is that, in spite of their exploding costs, demand persists.

A small number of experts from Europe and North America has been invited to address the paradox. What are the facts? Do services really suffer from the cost disease? Is the contribution to the economy in terms of employment, income, or output nonetheless stable? If so, how can we explain the persistence of the services? A very lucid introduction to the cost disease and the persistence of the services is provided by William J. Baumol in Chapter 1 of this volume. In the light of recent data and new economic mechanisms explored in this book he displays ground-breaking optimism as regards the role of the services in modern economies.

In order to organize the analysis of the services, all contributors to this volume received a list of potential resolutions of the service paradox. The possible explanations range from accounting issues to supply and demand effects and are presented by the editors in a simple, two-sector model of the economy in Chapter 2. Three possible explanations are conceptual, involving the appropriate measurement of the service productivity and the service share. The remaining four explanations are economic-behavioural. The first effect is a supply effect: the capacity of the service sector to absorb labour that is surplus to the manufacturing sector because of increased automation. The second is related, but takes into account international trade. Technological progress abroad may shift the domestic comparative advantage to the services. Last, but not least, there are two demand effects. The income effect, a preference for services by richer consumers, may tilt advancing economies towards the services despite the fact that they are becoming costlier. The substitution effect, the replacement of services by manufactures, would seem to predict a reduction of the service share, but this trend may not last as consumers reach saturation point.

The supply-side of the services sector is addressed in the next part of the book, Part 2, 'Supply-side reasons for employment shifts'. In Chapter 3, Erdem and Glyn provide some very useful statistics and analysis of employment in the services. The first supply effect, that the services sector acts as a sponge that absorbs labour supply, is documented and found to be very real. It is particularly relevant to female labour supply. The other supply effect, acting through international trade, is also investigated in an OECD framework by Machin in Chapter 4, but does not resolve the paradox of the services. Machin analyses the fascinating implications of the service sector for skill requirements.

Part 3 investigates the cost disease of the services for the USA (Chapter 5 by Matthey) and Canada (Chapter 6 by Mohnen and ten Raa). The potential conceptual resolutions of the service paradox, dealing with the appropriate measurement of productivity and the real service share, are inspected, but found to carry little weight. The role of demand is more important.

Part 4 focuses on demand effects. In Chapter 7 Appelbaum explores the relationship between demand analysis and the service paradox. An interesting

further twist is given in an input–output framework by Russo and Schettket in Chapter 8, matching service activity to final product categories. The ultimate test for demand effects to explain the persistence of the services requires the estimation of income and price elasticities and this is masterfully done in Chapter 9, by Möller.

What is fascinating about the above analyses of the services is that the results all point to the same resolution of the service paradox. The use of appropriate productivity and share measures may soften the coexistence of the cost disease, but not by much. International trade has the potential to explain the persistence of the service share, but this line of reasoning is not conclusive either. However, demand, and particularly income effects, are important and resolve the paradox. The concluding chapter extracts a useful list of stylized facts about the modern service sectors. The new perspective provides a clear understanding of the coexistence of the cost disease and the persistence of service demand.

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## REFERENCE

Baumol, William J. (1967), 'Macroeconomics of unbalanced growth: the anatomy of urban crisis', *American Economic Review*, **57** (3), 415–26.