BRW November 1-7 2007, p.62-64

At your service

Service innovation is something almost every business would profit from, but success is often elusive. By **Anthony Sibillin**

THE WORLD'S FIRST modern economist was not the last to underestimate the services sector. "Services generally perish in the very instant of their performance, and seldom leave any trade or value behind them," Adam Smith wrote in *The Wealth of Nations*.

More than two centuries on, the value services leave behind equals 70 per cent of the total output of the Organisation for Economic Co-operation and Development economies. Australian services are valued at three-quarters of the country's total output. Yet, until very recently, the sector continued to rank well below the manufacturing, farming and mining sectors on research and political agendas.

Belatedly, both researchers and policymakers are realising the economic importance of services, not just in their own right, but as important ingredients in manufactured, farmed and mined products as well. "There is blurring between products and services," Professor Steve Worthington of Monash University says. "All organisations, by and large, are now involved in some sort of service innovation."

Encouragingly, research suggests Australian firms are more innovative in services than they are usually given credit for. Less positively, they also have little record of the disruptive service innovation that, as Leonard Berry and colleagues at the Texas A&M University Mays Business School write, "creates an entirely new market or so reshapes a market that the company enjoys unforeseen profits for a considerable time".

The poor innovation reputation of the services sector stems from its sluggish productivity on conventional measures. Service industries, with the exceptions of communications and wholesale trade, raised their output per worker by much less than manufacturers and farmers over the period 1993-94 to 2003-04, according to figures from the federal government's Productivity Commission.

Defenders of the sector retort that conventional measures of output understate service innovation by ignoring investments in intangible assets such as new designs, brands and managerial expertise. A University of London study, published in June, What Happened to the Knowledge Economy? ICT, Intangible Investment and Britain's Productivity Record Revisited, found that for every pound that British businesses spend on plant and equipment and other physical assets, they invest another in intangible ones.

Official statisticians also define away the very possibility that government, health and other services not sold in the marketplace can become more productive. By equating the value of their output with the cost of providing them, they ignore the higher cancer survival rates, better exam results and other non-monetary productivity benefits these services can bring.

One attempt to redress this oversight is the Innovation Index of Australian Industry, launched in May by IBM Australia and the Melbourne Institute of Applied Economic and Social Research. The index adds measures of intangible assets to productivity statistics to compare the inventiveness of different industries.

The three stand-out performers between 1990 and 2005 under this broader measure were service industries: wholesale trade, finance and insurance, and communication services. And the best improvement in 2005 was found in health and community services, and transport and storage.

However, a close look at the Australian Bureau of Statistics innovation data that underlies the IIAI suggests all this activity is leading mostly to incremental service improvements rather than innovation that creates

Road to recovery

On August 23, Country Road reported a 181.1 per cent increase in pre-tax profits in 2006-07 to $9.2 million, underpinned by a 15.9 per cent rise in full-year sales to $237.6 million. The results confirmed the recovery of the listed clothing retailer from its nadir in 2000-01, when it lost $7.9 million.

While shedding 40 head-office staff, the Melbourne company was sustained by a dramatic change to its business model. Country Road was previously part-retailer and part-wholesaler. But tired of seeing its brand discounted in the war between its two biggest wholesale customers – Myer and David Jones – chief executive Ian Moir switched to a retail-only model.

Moir ended all wholesale supply arrangements at the beginning of this year, replacing them with 74 concession outlets in Myer and David Jones managed and staffed by Country Road employees. Sales from these concessions, $30 million in 2006-07, are already making up for the $22.1 million loss of wholesale sales.

At the same time, Moir is changing the rostering of concession and other sales staff to a new model. The retailer is using new technology to tackle the old problem of having too many, or too few, staff in-store to meet customer demand.

The technology is from Workplace Systems, a British software maker, and allows managers to predict demand for individual stores based on past sales data. "It might be that in a normal week in one store between 9am and 10am in the women's wear department there are four transactions," commercial operations manager Matt Jones says. "We can use that information to make sure we have the right staff there."

The system is being fine-tuned in three pilot stores using traffic-counting software from developer Beonic, and will be launched nationally by Christmas.

BRW November 1-7 2007, p.62-64

markets. Survey respondents from most service industries reported introducing fewer new or substantially improved products or services than manufacturers did.

Consider finance and insurance. While the industry is number two in the IIAI overall, just 18.9 per cent of businesses could claim a market-creating innovation in the ABS survey, compared with 26.9 per cent of manufacturers.

Monash's Worthington blames the federal government's "four-pillars" policy. By stopping Australia's biggest banks from merging or being taken over by an overseas institution, the policy dulls the competitive impulse to innovate. "The result is a cosy, cosy relationship between the banks that is not as competitive as the industry likes to claim," he says.

A lack of innovation created by the market, evident in other industries dominated by a few big players, such as grocery retailing, gives businesses less incentive to push past the many obstacles to breakthrough service innovation. One of these is the difficulty of gaining patent and other legal protection for new services compared with new products. This clears the way for imitators, notes Worthington, and reduces the pay-off from being first-to-market.

To counter this, businesses can try and use scale to ward off quick-to-follow rivals. For most services, however – typically produced and consumed simultaneously – this response is limited by the cost and bother of finding extra staff.

The Holy Grail of service innovation is to separate the production and consumption of services. A classic example is eBay, which has built an online trading platform that can host auctions anywhere in the world without a single human auctioneer.

In Brisbane, the Co-operative Research Centre for Construction Innovation is also enlisting the internet and other technologies to simplify the construction process. Chief executive Keith Hampson says building more components in a factory rather than on-site is safer, greener and saves skilled labour that is growing ever scarcer.

In other industries, however, where the service-delivery staff are part of the customer experience, such labour-saving innovation can be self-defeating. A senior lecturer in organisations and innovation at the Melbourne Business School, Peter Cebon, recalls efforts by banks to not only shed staff by closing branches, but to get customers to do more for themselves online. Staff were demoralised and customers felt swindled, especially when bank fees went up, not down. "Not all innovations are positive from the customers' perspective. Closing branches didn't work, so banks are now opening them again to try to re-establish the relationship with their customers," he says.

The controversial nature of some service innovation, combined with nostalgia for a time when Australia "made things" helps to explain why the services sector has few advocates among policymakers. Symptomatically, the sector receives just 30 per cent of all federal industry assistance.

Just as important, Hampson says, is the kind of assistance provided. The supply chain of a fragmented industry such as construction, in which 95 per cent of businesses employ fewer than five staff, has too many links to benefit from research and development tax breaks and other policies aimed at single firms. "There are some businesses that believe competitive advantage is best secured by building fences around intellectual property," he says. "But very few have the supply chain to themselves. They must work with partners to deliver projects."

Co-operative efforts such as the construction CRC is critical to progress in service industries where first movers are insufficiently rewarded to justify lone investments. But if such efforts come off, Hampson says, increased productivity in construction, which accounts for 15 per cent of the Australian economy, will alone give living standards a "major kick along". Multiply that "kick" five times to account for all service industries, and there is enough reason to leave Adam Smith's words behind for good. ●

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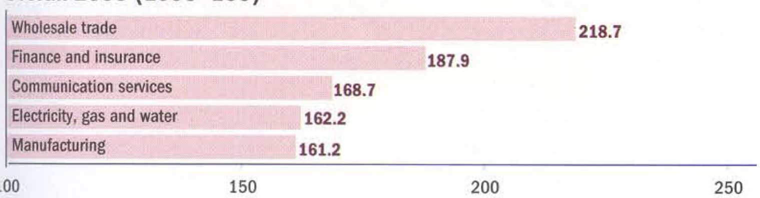
PROPORTION OF AUSTRALIAN BUSINESSES WHICH INTRODUCED OR IMPLEMENTED INNOVATION (2004 & 2005)

Industry	New or improved goods or services (%)	New or improved operational processes (%)	New or improved organisational/ managerial processes (%)
Mining	10.6	17.6	22.2
Manufacturing	26.9	27.3	27.9
Electricity, gas and water supply	23.0	31.5	40.7
Construction	16.5	22.0	26.2
Wholesale Trade	25.5	26.4	33.2
Retail trade	15.8	15.4	18.8
Accommodation, cafes and restaurants	23.6	25.0	27.8
Transport and storage	18.1	25.1	26.9
Communication services	28.5	25.3	27.1
Finance and insurance	18.9	25.7	30.7
Property and business services	16.4	20.1	22.6
Cultural and recreational services	18	18.9	26.3

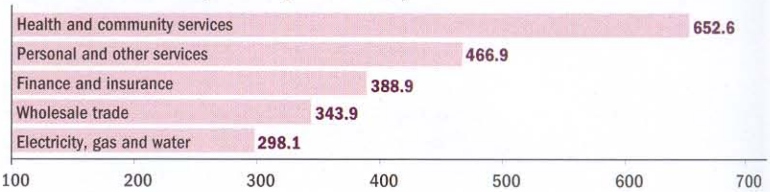
Source: Australian Bureau of Statistics

INNOVATION INDEX: TOP FIVE INDUSTRIES BY SELECTED MEASURES

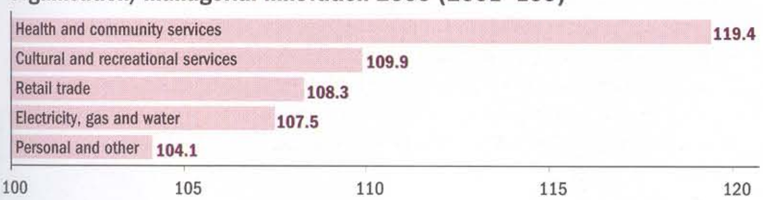
Overall 2005 (1990=100)



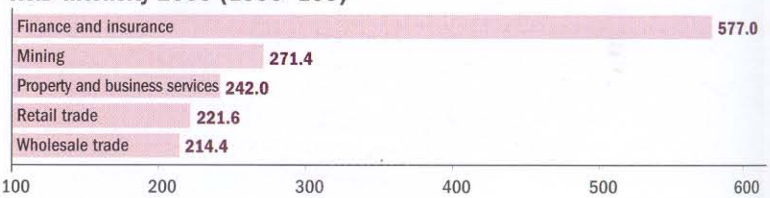
Trademark intensity 2005 (1990=100)



Organisation/managerial innovation 2005 (2001=100)



R&D intensity 2005 (1990=100)



Source: IBM, Melbourne Institute