Service-sector productivity largely determines a nation’s ability to compete in today’s global economy. An analysis of the comparative productivity levels of several leading countries provides insights into the factors that make a difference.

**Wedded to outdated** ideas about the importance of manufacturing, economists of all stripes have usually given short shrift to the service sector. When they did pay it attention, it was often to conjure up derisive images of unskilled, low-wage armies of “burger flippers” and supermarket clerks. This was always wrong. It is now dangerous. The conventional wisdom about services is seriously in error.

Manufacturing is, and of course, will remain, genuinely important to the economic health of industrial nations. Today, however, in terms of employment, income, international trade, and even production costs, services have become yet more important. This is the inescapable conclusion of a recent study by the McKinsey Global Institute of service-sector productivity in the United States, the United Kingdom, Japan, France, and the former West Germany.¹ For background information on this report, see sidebar “Studying productivity.”

The evidence is compelling: discussions of international competitiveness based solely or primarily on what goes on in factories fail to reflect the true flows of value-creating activity. Just consider:

- As Exhibit 1 indicates, the share of employment accounted for by services has grown steadily for more than a century in the countries studied. Exhibit 2 shows the distribution of these jobs across the major categories of services in one representative year, 1988.

Studying productivity

We focused on productivity because it is the most fundamental measure of economic performance. Productivity is the ratio between the output of goods and services and the input of resources used to produce them. On a national basis, productivity is an important indicator of a country’s economic strength. Regardless of national employment levels, the higher the productivity, the higher the living standards. Increasing productivity is the engine driving economic growth, which in turn provides society with additional goods and services for consumption and investment.

The point of departure of the project was the observation that the Organisation for Economic Co-operation and Development (OECD) results for GDP per capita at purchasing-power parity showed that other countries had not fully caught up with the United States’ lead since 1945. This result was a surprise. Our objective has been to find the reasons behind the figures. The fact that service industries now comprise over half of all fully developed economies led us to the hypothesis that service-sector performance would provide a substantial part of the explanation. Hence the focus of this project.

Framework

To identify and explain the causes of the productivity differences we observed, we developed a framework that captures all the major possible factors. We assumed that the productivity differences must have some direct or indirect causes. In other words, US industries must be doing something different that makes them more or less productive than their European or Japanese counterparts. The service production process itself is one source of possible differences. Here we have to examine such factors as economies of scale, capital intensity and vintage of capital, skill and organization of labor, and differences in output mix and quality.

These factors directly determine the labor productivity of an industry. They are what management must change in order to make a difference in productivity. But this raises the next question: Why does management decide to provide certain services by using a particular production process that might be more or less productive than some other process?

The answer to this question lies in the behavior of managers—or rather, in the skills and objectives that shape it. To understand why managers behave different from country to country, we have to explore the external forces that they face and respond to. These external factors can be divided into factors reflecting market conditions (for example, varying demand; relative input prices) and factors reflecting government policies and regulations (for example, competition; state or private ownership; and labor rules).
The conduct of this project is part of the execution of the McKinsey Global Institute mission to help business leaders: (1) understand global developments, (2) improve the performance of their corporations, and (3) work for better national and international policies. Under the guidance of an advisory committee chaired by Professor Robert Solow of MIT and consisting of Martin Baily (University of Maryland), Francis Bator (Harvard University), and Ted Hall (McKinsey), the working team for this project was a group of four McKinsey consultants transferred from their home offices to the Global Institute. The working team, which included John Britti from the Washington, DC, office, was assisted by the Eisenhower Center, Columbia University, especially on the airline and restaurant case studies.

Exhibit 1  Share of employment, %

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>Japan¹</th>
<th>West Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>50/33/31</td>
<td>70/23/34</td>
<td>49/43/40</td>
</tr>
<tr>
<td>Manufacturing, construction, mining, utilities</td>
<td>24/54/63</td>
<td>29/22/35</td>
<td>22/35/55</td>
</tr>
</tbody>
</table>
| Services, including government | 26/30/29 | 8/58 | 5 |%

¹For Japan in 1870, 30% for services represents the combined total of services, manufacturing, construction, mining, and utilities.

Source: Angus Maddison, Dynamic Forces in Capitalist Development, Oxford University Press, 1991
Exhibit 2  
Employment in market services by industry, 1988

<table>
<thead>
<tr>
<th>Industry</th>
<th>United States</th>
<th>Japan</th>
<th>West Germany</th>
<th>France</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transportation and communications</td>
<td>9</td>
<td>11</td>
<td>9</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
<td>Finance and insurance</td>
<td>11</td>
<td>13</td>
<td>17</td>
<td>15</td>
<td>22</td>
</tr>
<tr>
<td>Business, professional, personal, and social services; restaurants; and hotels</td>
<td>32</td>
<td>38</td>
<td>35</td>
<td>41</td>
<td>23</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>48</td>
<td>41</td>
<td>39</td>
<td>37</td>
<td>43</td>
</tr>
</tbody>
</table>

1Reflects jobs rather than persons employed (double counting).
2For the United States, restaurants are included in wholesale and retail trade. For the United Kingdom, hotels and restaurants are included in wholesale and retail trade; business services are included in finance and insurance.

Source: Organisation for Economic Co-operation and Development (OECD); US Bureau of Economic Analysis; the United Kingdom’s Office for National Statistics; McKinsey analysis

• With a majority of workers in these countries now employed in the service sector, service-related earnings have become a prime determinant of national income. Not only that, the familiar claim that work in the services is poorly paid needs qualification.

In the United States, for example, a fair number of service industries pay relatively high levels of compensation (see Exhibit 3). Some pay as much or more than the average manufacturing wage. True, service-industry compensation as a whole is still below the national average, but rising productivity levels in services will likely boost the living standards of all wage earners.

• In recent years, the service sector has become an increasingly important element in world trade. US service exports grew from 15 percent of all US exports in 1975 to 26 percent by 1990. This contributed to a positive $64 billion net foreign balance in the US services current account for 1990.
For US industries, 1990

**Exhibit 3**

<table>
<thead>
<tr>
<th>Service industries</th>
<th>Share of total employment, %</th>
<th>Average annual compensation per FTE, index: manufacturing = 100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, fishing</td>
<td>1.5</td>
<td>47</td>
</tr>
<tr>
<td>Retailing</td>
<td>15.8</td>
<td>51</td>
</tr>
<tr>
<td>Other services</td>
<td>24.9</td>
<td>76</td>
</tr>
<tr>
<td>Transportation</td>
<td>3.2</td>
<td>96</td>
</tr>
<tr>
<td>Construction</td>
<td>4.7</td>
<td>90</td>
</tr>
<tr>
<td>Government</td>
<td>17.6</td>
<td>97</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>17.7</td>
<td>100</td>
</tr>
<tr>
<td>Finance, insurance, and real estate</td>
<td>6.2</td>
<td>101</td>
</tr>
<tr>
<td>Wholesaling</td>
<td>5.7</td>
<td>127</td>
</tr>
<tr>
<td>Mining</td>
<td>0.7</td>
<td>101</td>
</tr>
<tr>
<td>Communications</td>
<td>1.1</td>
<td>130</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.9</td>
<td>131</td>
</tr>
</tbody>
</table>

1 FTE = full-time equivalent.

Source: US Bureau of Economic Analysis
Exhibit 4
Service-sector productivity; index: US labor productivity = 100

<table>
<thead>
<tr>
<th></th>
<th>West Germany</th>
<th>France</th>
<th>United Kingdom</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airlines (average for Western Europe)</td>
<td>72</td>
<td>72</td>
<td>72</td>
<td>N/A</td>
</tr>
<tr>
<td>General-merchandise retailing</td>
<td>96</td>
<td>69</td>
<td>82</td>
<td>44</td>
</tr>
<tr>
<td>Restaurants</td>
<td>92</td>
<td>104</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Retail banking</td>
<td>68</td>
<td>N/A</td>
<td>64</td>
<td>N/A</td>
</tr>
<tr>
<td>Telecom (total factor productivity)</td>
<td>52</td>
<td>62</td>
<td>54</td>
<td>77</td>
</tr>
</tbody>
</table>

United States 100 100 100 100

Source: McKinsey Global Institute analysis

- Improvements in service productivity also have a direct impact on the international competitiveness of manufacturing firms. These firms are customers of the service sector and must be concerned about the price and quality of what they buy. We estimate that the service sector represents about 23 percent of the value of sales of the industrial sector of the US economy. As a result, a productivity disadvantage of, say, 20 percent in services would mean a disadvantage of 4.6 percent (20 percent of 23 percent) of sales cost—a gap that would sharply reduce or even eliminate the profits available to some manufacturing companies from international trade.

For US policy makers, these findings take on special importance as a corrective to overblown concerns about national competitiveness. Of the 70 percent of the nation’s GDP represented by real “market sector” activity, 56 percent is in services. Thus, productivity differences in this sector may determine, in large measure, the overall productivity differences between national economies. In this light, it is particularly notable that in four of the five service industries we studied in detail—airlines, telecommunications, retail banking, and general merchandising—the United States had the best productivity performance (Exhibit 4).

Unconventional wisdom

Our case-by-case analyses of these five service industries called in question a number of long-held assumptions about service-sector productivity. Contrary to expectations, we found that:

Higher productivity in the US industries was not achieved at the expense of lower service quality or restricted service offerings. In fact, US industries often offer a broader range of services than
their counterparts in other countries. Consider the frequency of flights and number of destinations in the US hub-and-spoke airline networks, the variety of deposit accounts in US retail banking, and the many telephone services offered to US residential customers.

Economies of scale are not the most significant source of differences in labor productivity. Though there are obvious differences in the scale of markets or total industries between the United States and other countries in the study, there was no evidence that they caused differences in labor productivity. All the industries we analyzed seem to have large enough markets within their geographic boundaries to allow companies and their outlets to achieve a minimum critical size beyond which scale economies have only a limited—if any—positive effect. Ultimately, it is companies and their outlets which must reap any benefits that can be derived from economies of scale. In retail banking, for instance, the average bank branch in the United States is smaller than its UK counterpart. But the United Kingdom's apparent advantage of scale does not confer productivity benefits.

This is not to deny that economies of scale have any role in productivity differences. A restructuring and concentration of the European airline industry, for example, could yield scale benefits in such functions as marketing, sales, and maintenance. Where scale disadvantages exist, however, they can often be managed. Airlines in Europe contract out some maintenance routines to other airlines. Thus, differences of scale may place a contributing but not determining part in overall productivity.

Intensity of capital and vintage of capital—the degree to which labor input is leveraged by larger or more modern physical capital stock—play a surprisingly minor role in productivity. Differences in the ratio of labor inputs to capital inputs can occur if the same capital goods are not available in all countries, or if managers decide to use less capital in their industry than managers in other countries. We did not find any cases where productivity differences derive from differences in the availability of capital.

Hardware technologies used in US industries are also available to managers in Europe or Japan, so access to them does not explain productivity differences across countries. But given uniform availability, managers make different decisions about how to mix labor and capital in the production process. This does affect productivity.

In retail banking, intensity of capital in the form of hardware technologies has had an important impact on employees' productivity levels. Banks in the United States have invested considerably more in information technology over the past ten years than those in the United Kingdom or Germany. The more intensive use of automated teller machines (ATM) and online terminals in the United States has led to higher average labor productivity levels than the United Kingdom and German industries have achieved.
Telecommunications companies in the United States illustrate how the vintage of capital can contribute to a capital-productivity advantage. They have invested in more efficient electronic and digital-switching equipment and fiber-optic transmission links with the capacity to accommodate an enormous volume of information. Per dollar spent, these new hardware technologies can provide more service output at higher quality.

There was no evidence that pure differences in the skill of nonmanagerial labor caused the productivity gaps we observed. While extent of education, formal training, and other inputs to labor skills can be measured, actual skills and their impact on labor productivity are almost impossible to measure and to distinguish from labor organization. The conclusion we drew is based primarily on our judgment that the individual skills of US service-industry employees are not higher than in other countries. In fact, skill differences sometimes appear to work against the United States; the average bank employee in Germany, for instance, is more thoroughly trained than his or her US counterpart. Where such situations exist, productivity differences would probably be even larger if skills in the United States matched or surpassed those in other countries.

There are several explanations for our somewhat surprising finding that nonmanagerial skill differences do not cause the productivity gaps we discovered. First, we might have selected industries where skill differences either do not exist—for instances, all pilots can fly—or are not important for productivity—for instance, better trained German bank clerks are not necessarily more productive if they cannot apply, or do not need, all their skills.

More important, there is a trend for more and more skills to be incorporated into or supported by "systems." Employees in fast-food restaurants or at scanner cash registers are expected to be friendly, but they do not have to be highly skilled in terms of manual or cognitive abilities. Designing the purchasing, distribution, and "kitchen" systems for a fast-food chain clearly requires a higher level of skill. In retail banking, information systems help clerks at the teller windows by structuring procedures for handling customer requests. These examples illustrate that high skills are needed to organize businesses to employ low-skilled workers productively.

Managers and system specialists can build into their organizations procedures and information systems that allow even "low-skilled" labor to be very effective and productive. It is not the absolute skill level of employees that counts, but rather matching employees who have certain skills with jobs requiring those skills. The US companies in our case studies manage this match so well that we could not identify differences in employee skill levels as an important cause of productivity differences. The difference that more productive "systems" make to skills has been classified under the next point: organization of labor.
In fact, the most important factor explaining productivity differences is the organization of labor—how labor is used in combination with other input factors to provide the service output.

The organization of labor includes such factors as how labor is divided on specific tasks, how core processes are designed, how capacity is planned and adjusted to a volatile workload, and how labor is motivated. Differences here have a high impact on labor productivity, and they can be isolated when functional productivity is measured. Functional productivity is the productivity of separate business activities, such as aircraft flying, maintenance, and baggage handling in airlines. To assess how far labor organizational differences account for the measured differences in functional productivity, we checked first for differences in output mix, economies of scale, and capital input. If these factors failed to explain the productivity gap, we turned to labor.

Having eliminated, as we saw, significant skill differences as a causal factor, we were left with the way labor is applied. Anecdotal evidence and the assessment of McKinsey industry experts helped confirm the organization of labor as the prevailing cause of productivity differences. In three out of the five sectors we studied, labor organization turned out to be the single most important causal factor.

A good example of a difference in labor organization is in airlines, where maintenance productivity for the European industry is significantly below that of the United States, even though the safety and reliability performance of all the major airlines is very close. This difference also applies to ground personnel. Airlines maintain a productivity lead in ground personnel despite the need for a higher labor input since converting to a hub-and-spoke system.

The organization of labor in the production process, like the issues of scale and capital intensity, is manageable in general. Labor laws or union agreements can admittedly constrain management in how they apply a workforce. But union agreements are not fixed and can change over time on either the corporate or the industry level. Organizations can be changed; productivity disadvantages caused by organizational factors can be overcome.

If organizational and other manageable differences are the major reasons for productivity gaps, it follows that productivity differences are neither accidental nor inevitable. They are, rather, a consequence of the different management decisions that create the production process. But why
don’t managers choose more productive forms of organization and production processes? To find an answer, we have to analyze the external factors that managers take into account as they create and improve the production process within their companies.

**Managerial decisions**

If we assume that managers behave rationally—that is, they pursue their objectives as best they can, and respond to external incentives in deciding which objectives to pursue—then different management behavior and decisions must be explained by differences either in the skills of managers or in their objectives. Both, in our view, are ultimately determined by the environment—the external factors—which management faces in different industries and countries.

External incentives and constraints thus determine the objectives that largely dictate management behavior. Only in very rare cases can managers act independently of such external factors. In highly concentrated industries, such as telecommunications, a small number of individuals may have a big impact on a whole industry’s objectives, but it is usually the external economic, political, and social environment that is the main shaping force. If the external context changes, management objectives will change, and production processes and productivity will change along with them.

Managers take into account both market conditions and government policies and regulations in setting objectives and deciding how to build, organize, and operate the production processes that generate productivity performance. In service industries, the most important incentives for management are set by the relevant legislations and regulations. Public policy thus has a greater effect on productivity than do market forces. The key factors influencing productivity in the policy context are competition and concentration rules and government ownership.

Among market forces, the factors that drive differences in productivity are demand and relative input prices (which also reflect differences in availability). However, differences in relative input prices do not explain national productivity differences. The prices of labor and capital are sufficiently close in most industries to have very little impact.

**Demand**

We found that demand factors affect productivity in general-merchandise retailing, telecommunications and, to a lesser extent, in retail banking:

- In *general-merchandise retailing*, higher levels of income and wealth in an economy provide potential for higher productivity levels. This effect stems from the higher levels of service and quality demanded by higher-income consumers. How far productivity gains
are captured for the whole industry depends on whether managers exploit this potential advantage by successfully segmenting demand and tailoring formats to the higher-income segments.

• In **telecommunications**, capital productivity and total productivity depend heavily on the extent to which high fixed-investment costs can be spread over the volume of calls. In the United States, calls per customer are much higher than in the other countries studied, in part because of pricing structures designed to exploit demand elasticity, and also, perhaps, because of social customs. This difference in demand translates into greater use of the network and higher capital and total productivity.

• The behavior of **retail bankers** in Germany also appears to have been significantly influenced by the nature of customer demand. Over recent decades, security and safety have taken priority over higher returns. Such values are understandable in generations who experienced the high inflation of the 1920s, the depression of the 1930s, and the destruction of assets in the 1940s. However, this pattern of demand will change with the postwar generation, which has grown up in an era of economic and political stability. As a consequence, bankers in Germany will no longer be able to avoid price competition, and increasing pressure on profitability will lead to higher levels of labor productivity.

In the short term, these differences in demand restrict management’s opportunities to improve productivity. However, demand is not a constant: it will change if constraints on supply are removed, and consumer preferences can be altered over time. Corporations can offer customers incentives—through price signals, for example—to change their consumption toward a pattern which allows a more productive and cost-efficient production process. Managers can develop strategies to create and benefit from changes in demand. In an industry open to new entrants, entrepreneurs may create and exploit such opportunities if old players do not.

**Public policy**

Public policy exerts its greatest influence on productivity through the competition and concentration rules that operate at country or industry level. Among the various competition rules, the most important are those that help or hinder the freedom to enter a market and to offer services at unrestricted prices. Wherever we observed regulatory interference with one of the basic market elements—freedom of entry and pricing—the affected industry seemed to pay for the interference with lower levels of productivity.
Market entry

When entry into industries and markets is allowed, dynamic companies have incentives to develop innovations that improve value to the customer by offering more service per dollar. If there is vigorous competition, new entrants cannot charge high prices or gain market share by innovating and then resting on their laurels. Competitors will respond to service improvements or price cuts by introducing innovations of their own, which will cause prices to fall and value to be transferred to the customer. To earn superior returns, corporations have to innovate continuously by offering either better service or the same service at lower prices.

Innovation and market entry perpetually exert pressure toward higher levels of productivity. Each innovation temporarily creates a monopoly or an oligopoly. But provided concentration or antitrust rules allow and enforce intense competition, the oligopolies will be competitive. They arise and are then destroyed as new oligopolies with superior innovations are formed. If long-term monopolies and oligopolies are not allowed, corporations gain only a temporary performance advantage from each innovation. But the continuous process of innovation generates both increasing value to the consumer and higher productivity on a sustained basis. (For more, see sidebar “Productivity and innovation.”)

The extent of freedom to enter a market, the degree of threat of entries, and the resulting market concentration explain many of the differences in productivity found in airlines, retail banking, and general-merchandise retailing.

New entrants in the US airlines industry at the time of deregulation triggered a fundamental restructuring of the industry. The appearance of new competitors spurred established operators to considerably higher levels of measured and unmeasured productivity. Most of these new entrants have subsequently exited the market, despite their low-cost position. They lacked the sustainable route networks and the scale to provide the convenience customers wanted from nationwide hub-and-spoke systems. This outcome could not have been predicted in advance. This case illustrates how the free-market mechanism leads to higher productivity in “ironic” ways that planners miss.

In the United States, unprofitable airlines have exited at a higher rate, but in Europe, the publicly-owned national flag carriers have not been allowed to fail or be taken over, partly because of public sensitivity. Whereas there is intense competition among airlines in the United States, each of the European routes has been a regulated duopoly, on which prices are fixed. At least until very recently competitive intensity was weak among European airlines, and there was little pressure to improve performance and increase productivity.
Productivity and innovation

Although we did not investigate innovation as thoroughly as productivity, our findings indicate that, in the industries we studied, those located in the United States are often more innovative than those in Europe and Japan. Innovation is the introduction of new or improved products and services into the marketplaces, or the use of new methods in production. An industry or company is innovative if it continuously provides new services or repeatedly finds significant new processes to deliver them. This interpretation of innovation emphasizes the result, rather than the process.

Higher measured productivity and higher innovativeness, it seems, go hand in hand. We believe that when a company increases productivity, it often does so by using improved processes or by introducing new and more productive services. We expect that the same factors that led to productivity differences among industries can cause differences in the rate of innovation. For instance, a competitive industry environment that allows market entries and exits can set managers incentives to foster both productivity and product and process innovation.

In our case studies, the higher innovativeness of US industries emerged when we compared output mix and usage of information technology. After World War II, the US banking industry took over leadership in innovation from the United Kingdom, and many new services either originated in the United States or were first widely disseminated there. Recent examples include linked checking and savings accounts and ATMs as deposit takers. Innovation in this case also extends beyond hardware to the organization of labor. For example, US banks have adopted such organizational changes as single-line, multiserver waiting lines (“snake queues”) to increase utilization and improve customer service.

This is not to suggest that the United States has any kind of monopoly on innovation. Examples of important innovations from other countries are easy to find. In airlines, Sir Freddie Laker introduced regularly scheduled, no-frills transatlantic transportation. In general-merchandise retailing, IKEA and Castorama are two of the pioneer “category killers,” and Japan’s Ito Yokado is an acknowledged world leader for innovation in formation-based strategy and logistics. When conditions are right, innovation can occur anywhere.

If our hypothesis that the more productive industries are also the more innovative is correct, it has important implications for our conclusions about the productivity differences consumers experience. Competitive industries with a high rate of innovation normally cannot avoid giving some of the value of their innovations as a surplus to their customers. This creates a dilemma for our productivity research. We cannot measure or adjust for this part of the industry output, but we include the input needed to produce it. Our productivity measures therefore tend to understate the productivity of more innovative industries.
The primary objectives pursued by management in the United States after deregulation have been purely economic: to gain share in important markets, and to build an attractive route network and strong customer base to be profitable—and to survive. Increasing the “value to the customer,” as well as lowering costs and increasing productivity, helped management to pursue these goals.

In the US retail-banking industry, established competitors were again spurred to higher productivity by the appearance of new entrants and services such as money-market mutual funds. In the highly concentrated UK retail-banking industry, by contrast, the four large banks maintained relatively constant market shares. Prior to the financial deregulation in the early 1980s, their financial performances mirror one another for years. Such a pattern suggests low competitive intensity.

Management in Germany and the United Kingdom could satisfy profitability objectives relatively easily in environments where there was—at least until recently—little threat of new entrants with high-value products (higher interest rates). Low interest rates on deposits have assured profits, and competitive pressure to cut costs or otherwise increase productivity has not developed, resulting in low competitive intensity in the industry. Again, management was able to focus on objectives other than productivity without being damaged by competition.

General-merchandise retailing is much less regulated than airlines, retail banking, or telecommunications. In a completely deregulated environment, economic success and productivity in every country would depend on whether managers could segment demand successfully and match the variety and quality of goods they offer in a particular shopping format to what a particular consumer segment wants.

Innovation of this kind could generate large profits—at least until competitors caught up. In addition to improving value for the customer by increasing convenience through longer opening hours and a wider range of products, managers could also cut costs and boost productivity by shifting to an industry structure that eliminated wholesaling.

The appearance of new formats, including so-called category killers, has significantly increased productivity in the United States by driving older and less productive formats out of the market. However, in France and Germany, regulations have discouraged developments of this kind. Rather, such regulations give the managers and proprietors of small retail outlets the opportunity to pursue “job security” and protect their interests against newcomers.

In Japan, similarly, large retailers have until recently been prevented from opening stores by laws that require small local merchants to approve new competition. Japanese policy makers believe such restrictions because they maintain social harmony and avoid the disruption of individual lives that would result from unrestricted competition.
While such measures have preserved industry structure and existing jobs, they have hurt innovation and productivity. Economic success is no longer a condition of staying in business, economic objectives dwindle in importance in managers’ eyes, and chances to increase productivity fail to be exploited.

The surprisingly large productivity differences between the United States and Japan are, we think, a consequence of very different approaches toward competition and antitrust policy. Japan has adopted policies that favor established economic interests over general efficiency. It has selected key industries to be externally oriented and competitive, a strategy that has been tremendously successful in autos, consumer electronics, semiconductors, and so on. But Japanese government and management have, by formal and informal means, protected much of the nation’s economy from domestic or international competition.

**Government ownership**

Another area where public policy affects productivity is that of state ownership. Unlike privately owned corporations, state-owned corporations are not under intense pressure to produce profits for shareholders. State-owned corporations are also subject to governments’ attempts to achieve their employment objectives. Social policies in Europe aimed at avoiding labor dislocation can most effectively be implemented through state-owned entities.

Ownership differences have undoubtedly been important factors in the airline and telecommunications industries, which are still state owned in some countries. We know of cases where the managements of state-owned airlines were constrained in their strategic options for improving productivity; for instance, reducing costs by laying off employees was specifically prohibited.

We also believe that the higher productivity of the private US telecommunications industry stems partly from the pressure to produce profits that exists even within an environment that is still regulated. Government-owned telecommunications companies in Europe are sheltered from competition by government policy. They are unlikely to have the incentives or to feel the pressure to increase labor productivity at the expense of unpopular measures, especially if they include sacking employees.

**Productivity and policy**

Unexploited opportunities for productivity improvement exist in the service industries of Europe, Japan, and the United States. Consumer demand and competition will, we believe, exert increasing pressure on management to achieve higher levels of productivity.
The major obstacle to successful exploitation of such opportunities is government policy and regulation restricting competition. Openness to competition is, it seems, the most important factor in the productivity differences we found between service industries in Europe, Japan, and the United States. This conclusion suggests several specific policy proposals: (a) reducing or eliminating barriers to market entry; (b) relaxing regulations that prevent firms from discharging labor when that is necessary to adapt to new technologies or market changes; and (c) imposing and enforcing prohibitions against anticompetitive activities such as market-sharing arrangements.

Government policy, however, is intended to serve many ends. Not all of its concerns are income- and wealth-related. Clearly, economic productivity cannot be the only government objective, and policy will reflect trade-offs between productivity and other goals, such as protecting the environment, ensuring public safety, certifying product content, and—importantly—protecting existing jobs. Different countries place different weight on such objectives, and therefore operate different policies and regulations that affect productivity.

Openness to competition implies that there will be winners and losers, at least temporarily, in the economy. So the simple prescription to increase productivity by increasing competition must touch a sore spot for many policy makers. In fact, there seems to be widespread misunderstanding about the nature of the trade-off between productivity and overall employment in existing and future jobs. One of its consequences is the proliferation of legislation explicitly designed to protect specific jobs and incomes. Most often, although not always, it is manufacturing employment that is protected, even when service employment is more visible and more promising.

Such policies are more common in Europe and Japan than in the United States, though they can be found everywhere. They may occasionally be defensible, if intended and implemented only to preserve social harmony and cohesion by smoothing the shocks that accompany rapid economic change—and if the benefits compare favorably with the costs. But they often have complex effects unforeseen by policy makers. In particular, they may be a bad bargain because they give temporary shelter to existing jobs and incomes at the expense of future jobs and incomes.

Policies in favor of competition would indeed sometimes cause labor to be temporarily displaced. Such policies should, we believe, be coupled with policies that compensate labor for the loss of job security. Labor policy must strike the delicate balance between creating incentives to find new employment and alleviating undue individual hardship. Retraining programs, generous unemployment-insurance benefits of fixed duration, and a serious commitment to macro policies to promote high employment in the economy at large, should all be components of the policy.
Action of this kind will both lessen the pain from loss of existing jobs and increase output and income overall. In the long run, higher productivity levels, combined with appropriate labor and macro policies, lead to greater national economic well-being for everyone.

Europe and Japan have explicitly placed more value on social objectives and maintaining social harmony. The extent of the sacrifice in economic performance incurred as a result of policies directed toward noneconomic objectives is unclear. However, our analysis at the sector and industry level, which frequently indicated productivity differences of between 20 and 40 percent, suggests that the cost may be significant.

There is no “right” way of balancing economic performance with social objectives. The benefits of achieving social objectives fall outside this analysis. In democracies, social and economic objectives are balanced through the political process, and the balance changes over time. Our results suggest, however, that the productivity of the leading economies will not fully converge as long as the balance between social and economic objectives differs among them—or until ways are found to pursue social objectives that weigh less on innovation and efficiency.

Overall, our case-study findings indicate that the objectives pursued by management vary according to the environment in which management operates. The more strongly the industry environment encourages competitive intensity, the more management is forced to concentrate on pursuing objectives related to the economic well-being of its company—and the more productivity seems to benefit. Ultimately, however, productivity differences are a direct reflection of the differences between the economic and social policies of the leading economies of the world.

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