

EXECUTIVE SUMMARY

Innovation in Services: The Hard Case for Latin America and the Caribbean

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Challenges ahead

The challenge of catching-up requires not only keeping pace with the front runners, but actually outpacing them. The Inter-American Development Bank (IDB) has identified a particular area of weakness in Latin American and Caribbean (LAC) economies; namely - the low productivity levels in the service sector. LAC employment is overwhelmingly concentrated in services, and the sector's productivity levels have been identified as dragging the region's relative aggregate productivity levels downward. The service sector is adding more value to economies in developed regions than in the LAC region.

Recent research conducted by the IDB shows that innovation positively affects productivity growth in the region, although the evidence comes almost exclusively from the manufacturing sector. The dearth of evidence regarding innovation in services is related, at least in part, to uncertainty with respect to how innovation in services actually works, how it can best be measured and whether or not old measurement tools (biased toward manufacturing and R&D) are really applicable to innovation in service sector environments.

Traditional views of services have tended to view it as a sector that is not very prone to innovation, a view that has kept policymakers from considering it a strategic sector in their quest to achieve sustainable growing economies. This viewpoint is becoming outmoded. In fact, services are increasingly recognized as the sector with the greatest potential to affect economic growth; in developed economies the sector is being regarded as a leading job provider and creator, and as one that is capable of spurring economic growth by acting as a chief diffusion agent of general purpose technologies.

Experience with services

If policies to promote innovation are to be effective, they need to reflect the ways in which innovation takes place today. Unfortunately, the little available empirical evidence about innovation in the service sector is largely limited to developed economies or regions; there is no systematic study of innovation in services in LAC.

Recent evidence for developed economies highlights that innovation has become much broader in scope, stemming from a variety of practices and ones that are fundamentally more collaborative in nature. As such, innovation can be found in a variety of sectors (including

government) and in a range of activities (such as those considered low-tech, according to the level of R&D) which have only recently started receiving attention to and we are just now beginning to understand.

So far, the limited empirical evidence available suggests that LAC service firms do in fact innovate, sometimes even more than their manufacturing peers; however, they often face burdensome financial constraints when they want to innovate, and these constraints can sometimes be more binding in the service sector than in manufacturing. A deeper understanding of the dynamics at play in the service sector in LAC and the relationship between productivity and innovation in services (as well as specific sub-sectors of services) represents a policy making opportunity that, if ignored, could contribute to prolonged productivity lags in the region, while, if well designed and implemented, could have large economic payoffs.

Policy Recommendations

Policymakers in LAC are faced with the challenge of striking a balance between learning from the most advanced economies and understanding their own contexts which may compromise direct application of lessons learned from advanced economies. Addressing market failures by means of innovation policy requires understanding firm behavior and how it is affected by incentive schemes. From the information that is currently available, the major obstacles to innovation in services are related to lack of financial support and constraints imposed by lack of human capital and of complementary assets such as broadband connectivity.

Action Plan

With over 20 meetings organized since the creation of the Science, Technology, and Innovation Network (STI) in 2006, the IDB has actively promoted the exchange of ideas, experiences, and lessons learned between policy makers of the Latin American region. The IDB's STI Network has also served as an ideal platform for the identification of regional cooperative initiatives aimed at providing specific solutions to shared challenges and for the identification and exploration of key research topics of interest to member countries. As a result of discussions between IDB member countries during the last Regional Policy Dialogue celebrated in Washington DC in June 2011, one of the main topics for upcoming Dialogues will be innovation in services. Specifically, at the end of 2011, the IDB will have a Policy Dialogue for the Caribbean focused on innovation in services, particularly in the sectors of energy, tourism and ICT.

The IDB plans to carry out the following research to cultivate a better understanding and more empirical evidence about innovation in services in LAC:

1. **Productivity gap analysis** both within the region and between LAC and developed countries.

2. **Enhanced information and analysis about the innovation production function.**
3. **Improved understanding regarding the determinants of productivity and innovation in services in LAC:** qualitative and quantitative research will be conducted on the different market failures that hinder innovation and productivity growth in services.
4. **Closing policymakers' knowledge gaps.** New empirical evidence will supply the starting point for the design of service sector-focused innovation policies. Particular attention will be paid to whether and how to intervene in services and correct for the bias against the sector (i.e., policies rooted in targeting innovation in the manufacturing sector) in the regional policy mix.