

SERVICE-DOMINANT LOGIC:

WHY, WHERE AND WHAT IT MEANS FOR INNOVATION?

'People don't want to buy a quarter-inch drill. They want a quarter-inch hole!'

--- Theodore Levitt

TOPIC: 'All sectors are providing services now.' Discuss why commentators claim this, what evidence there is for it, and what the implications are for innovation.

AUTHOR: Adam Hazdra

DATE: 6 May 2010

The following essay is concerned with the claim that all sectors are providing services nowadays. First, *services* and *service sectors* are explored and their importance in the economy is shown. Then, the reasons are analyzed why there is *service-dominant logic* and what are the historical predecessors of this perspective. Finally, the motivation to adopt universal service approach is discussed, why does it make sense only in economically developed countries, and what are the key implications for innovation. The key argument of this essay is that service sectors are more emphasized in developed countries and even there not all industries do provide services. Hence it is argued that the claim in question is rather a demonstration of a mindset suitable for business operation in highly competitive environments in developed markets.

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1. SERVICE SECTORS AND ECONOMY

1.1. Service Defined: Or Is It?

At the beginning it is important to define what services actually are. There are several angles from which services can be seen and defined, first of which is a marketing perspective. Wilson *et al* (2008) define services using (opposite) *product dimensions*: services are intangible, perishable, difficult to standardize, and their consumption is inseparable from production. Lusch and Vargo (2006), pioneers and advocates of the service-dominant logic which will be discussed in more depth in following sections, treat services as application of *specialized knowledge and skills* which is the fundamental unit of exchange, rather than their tangible results in a form of products. In the last point these two views differ, but both agree services provide value through market interaction.

Another perspective sees services not as a discrete category that can be opposed to products, but as a *scale* ordered by certain aspect such as a degree of intangibility (Shostack 1977, Fig.1.).

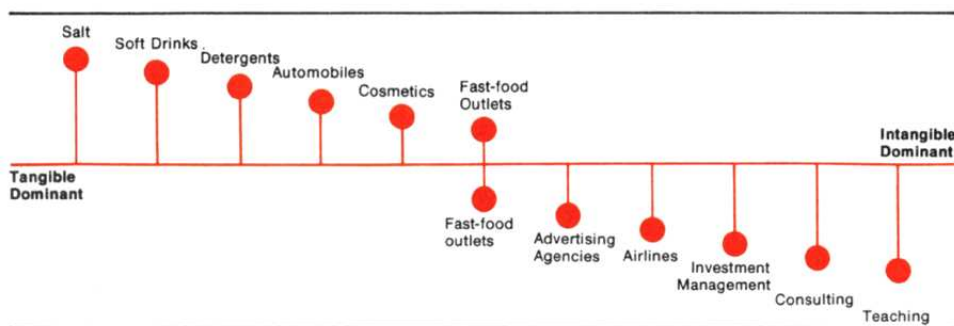


Fig 1. Tangibility spectrum depicting service classification.
 Source: Shostack (1977), p. 77.

The definitions provided by official bodies can be also considered. OECD (2000, p. 7) defines services as ‘a diverse group of economic activities not directly associated with the manufacture of goods, mining or agriculture ... [which] involve the provision of human value added in the form of labour, advice, managerial skill, entertainment, training, intermediation and the like.’ Similarly, DTI (2007) advises to consider services *intermediation* (transport) or *contact* (medical services) *activities* which are characterized by simultaneous production and consumption. Services may be also specified by *functional benefits* they provide, i.e. by sectors such as the NACE categories (EC 2002) or by *utility* they provide ranging from short-term (fast food, cinema) to long-term (life insurance, mortgage financing) (Daniels 1993). This corresponds with the view of service innovation studies; Miles (1993) proposed services effect *transformations* in state of material goods, people or information. All definitions emphasize process nature of services and were used mainly to distinguish services from manufacturing and primary sectors.

It is obvious from this rather eclectic overview how difficult is to clearly define a service and its nature. Therefore, in the following discussion will be used an approximate definition of services as *process goods*, i.e. in the exchange of value (be it direct in market or indirect in case of public services), it is the process that is sought and not only its result. By defining services this way, the value they provide during exchange is recognized and their process nature emphasized. However, this is of course a simplification of the above discussed complexity.

1.2. The Growth of Service Sectors

The importance of service industries has grown over the past decades. As Miles (1993) points out, service sectors were originally regarded as auxiliary and were classified into a 'residue' category next to manufacturing agricultural activities. Since the post-war times, when services presented such inferior category and were regarded unproductive, the emphasis has shifted, service productivity improved, and these numerous residual activities grown in significance (Channon 1978, Daniels 1993, OECD 2005).

Nowadays, service sectors contribute 60% on average to gross domestic products with some countries having more than 70% share (OECD 2000). Services also represent significant portion of employment in developed countries (Eurostat 2008, Fig. 2.). However, services have lower rates of productivity growth when compared to manufacturing and there are structural differences in terms of growth among particular sectors (e.g. high productivity growth in IT service and finance, low in hotels and restaurants) (Wölfl 2005, OECD 2005).

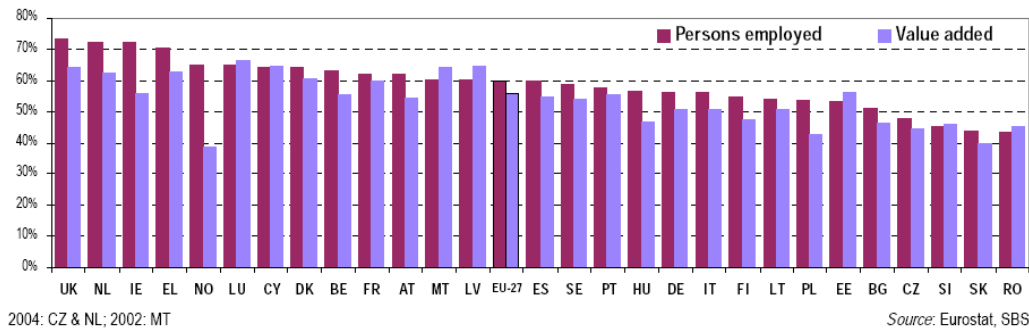


Fig. 2. EU countries specialisation in Services (NACE Sections G to I and K), 2005; % of the non-financial business economy. Source: Eurostat (2008), p. 1.

Despite certain level of possible inaccuracy in the data (Gordon 1996), service sectors have experienced significant growth and are crucial to modern economies. How can the change be explained? Partly by increased demand for final goods and services. Oyejide and Bankole (2001, p. 1) explain,

'[We can see the rise of service sectors] because as people become richer, consumption of such services as tourism, education, health, hotels, restaurants, and transportation tends to expand, in some cases more rapidly than that of manufactured and other tangible goods.'

However, *consumer demand* is only one factor responsible for the growth in service industries. Expanded provision of *social and community service* and increased demand for *services that facilitate production* must be taken into account as well. 'The production of a car, for instance, would not be able without services activities such as market research, technical research and development, human resource management, or business consulting.' (Wölfl 2005, p. 36). Interestingly, modest improvements in service productivity may be another cause for the employment expansion as it requires larger workforce to satisfy increased demands for services (Daniels 1993).

The question is if the rise has been so significant in all regions of the world. Surprisingly, even in the developed countries the trend to support strong service economies is not straightforward and services share remains rather stable (Fig. 3.).

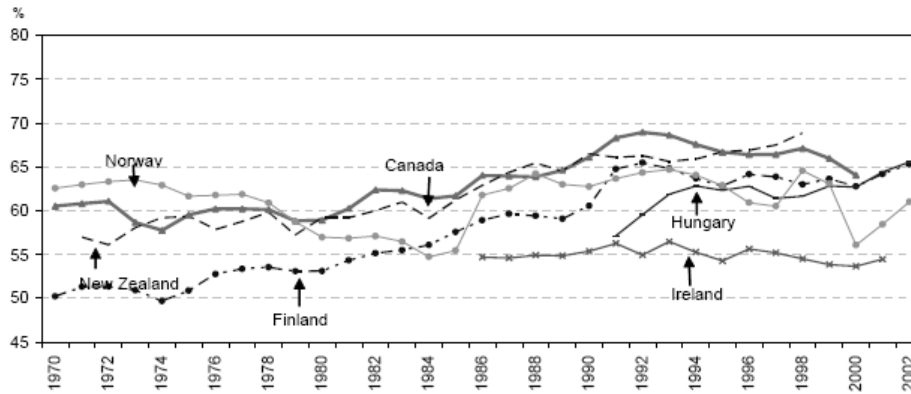


Fig. 3. Countries with value added shares below 65% in 2001.
Source: Wölfl (2005), p. 29.

As regards developing countries, despite the effort to expand service sectors (see e.g. Oyejide and Bankole 2001, or Goyal 2006), the World Bank data shows that the importance of service sectors still significantly differs across the globe with China and parts of Africa lagging behind due to prevalent industrialization (Fig. 4.).

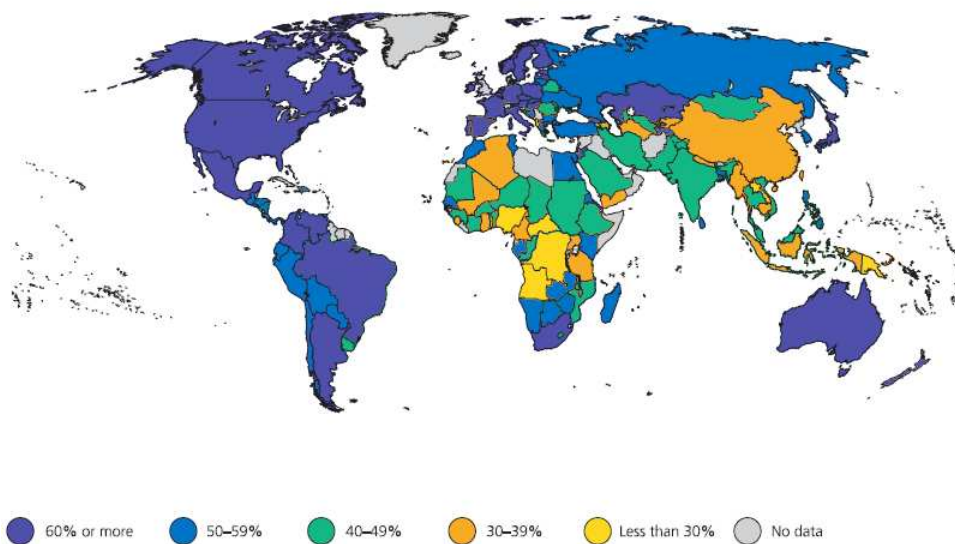


Fig. 4. The Share of Services in GDP, 1999.
Source: Soubbotina (2004), p. 66.

At this point it is obvious – at least according to the official statistics – that not all industries are providing services. Undoubtedly, the proliferation of service industries intensified during the last few decades and services became crucial part of developed economies. Also, progress towards strong service sectors is considered a best practice for countries that strive to align with the most developed ones (Soubbotina 2004).

Nevertheless, the data suggests that in a number of countries service sectors are far from being ubiquitous and even in the develop countries the trend toward service-only economies is ambiguous. Therefore the motivation behind the claim that ‘all industries provide services now’ needs closer examination if we want to properly understand its meaning.

2. SERVICE-DOMINANT PERSPECTIVE AND ITS CURRENT RE-DISCOVERY

'... all firms are service firms; all markets are centered on the exchange of service, and all economies and societies are service based.'

--- Robert F. Lusch and Stephen L. Vargo

2.1. What Is Service-Dominant Logic?

Service-dominant logic (SDL) is a term coined and popularized by Robert F. Lusch and Stephen L. Vargo since their 2004 article in the *Journal of Marketing* (Vargo and Lusch 2004). SDL is based on idea that goods – tangible or intangible – provide services to customers and that it is the skills and knowledge what is really being exchanged in market interactions. Lusch and Vargo distinguish between *operand* and *operant* resources, the former being the medium, the latter the change agent which transforms operand resources into a usable goods. Products (e.g. shoes) are only distribution vehicles that provide a customer with certain service (protection, comfort, fashionable look). Provision of a service doesn't even require an operand resource and may be entirely provided by application of mental skills.

The SDL theory is rooted in the concept of core competencies (Prahalad and Hamel 1990), because it considers operant resources of crucial importance for the company. Hence the key implication is a change in how the marketing interaction is approached. Following the SDL, customer is placed in the centre of the process and he/she determines the 'value in use'. Firms can make only value propositions. Physical goods matter but these are only operand resources that enable the delivery of a particular service.

And here is revealed the crucial concept for this essay. If all market interactions are seen as service provision, than we can claim that all industries provide services. And indeed, Lusch and Vargo made 'All economies are service economies' one of their key foundational premise to show that

'[s]ervices are not just now becoming important, but just now they are becoming more apparent in the economy as specialization increases and as less of what is exchanged fits the dominant manufactured-output classification system of economic activity.' (Lusch and Vargo 2004, p. 10).

SDL calls itself revolutionary or paradigmatic and it is certainly plausible that it offers a different view of the marketing activities. However, when analyzed in context of marketing history, similar approaches can be found.

2.2. Historical Developments and Criticism

Vargo *et al* (2006) show there are several economists and marketing experts that followed similar line of thought throughout the history. Frédéric Bastiat in the mid-19th century criticised conventional theory of value attachment to physical objects and argued for focusing on utility provision, but it wasn't until the post World War II expansion that the 'value in use' concept was adopted - namely by Wroe Alderson and Peter Drucker – after the formative years of the marketing discipline.

The service logic can be also found in more recent work of Lynn Shostack, Evert Gummesson (Vargo *et al* 2006) and is also behind Theodore Levitt's famous quote that '[p]eople don't want to buy a quarter-inch drill. They want a quarter-inch hole!' (Christensen *et al* 2005, p. 4). Most current

examples include Christensen and Raynor's (2003, p. 74) observation that 'customers "hire" products to do specific "jobs"' and Grönroos' (2007) concepts of service perspective and service competition.

This abridged list of examples of similar 'logic' during the modern history somehow devaluates the allegedly radical contribution of the SDL. Achrol and Kotler's (2006) critical review of the SDL approach helps to set its key contributions into a proper context. There is no radical shift in underlying theory of the market exchange. The notion of exchanging value for value and being concerned with what customers require is embedded in the marketing philosophy from the outset.

Therefore the SDL argument is mainly 'a great impetus to *look more closely at how and how much value creation is done by customer in the consumption process*, and how this is shifting among service deliverers, support services, and postconsumption services.' (Achrol and Kotler 2006, p. 327, emphasis added). However, before this observation will be elaborated in the next section, the reasons behind the recent interest in SDL must be explored.

2.3. Why now: Reasons for Revived Interest

There is a little detailed explanation in Lusch and Vargo's original or subsequent work of *why* is a change in the 'worldview' necessary (Lusch and Vargo 2004 and 2006, Lusch *et al* 2007, Michael *et al* 2008, Merz *et al* 2009, Lusch *et al* 2010). Therefore a brief analysis of underlying trends affecting the environment is needed.

First is a change in supply. On a general level, expansion of international trade after WWII increased the flow of goods and services which consequently increased competition on domestic markets (Hirst and Thompson 1999). For example United States saw a 'dramatic increase in imported varieties, from about 75,000 varieties in 1972 ... to almost 260,000 varieties in 2001 ...' (WTO 2008, p. 48).



Fig. 5. Orange juice selection in supermarket in Orlando. --- USA experienced more than 200% increase in imported varieties over last four decades (WTO 2008).

On a market level this implies that companies can no longer offer their products and services through traditional mass media marketing channels. Because of intense competition, attention that a customer can devote to a particular product or service has rapidly decreased (Godin 1999). Hence there is a need to analyze what constitutes the key value in the company offerings and to find effective ways of delivering it. (Godin proposes *permission marketing*, i.e. attracting customers through high value-added rather than targeting them through traditional mass marketing tools.)

But it is also demand that is driving consumer-oriented approach nowadays. Von Hippel (2005) showed that there is a group of very demanding users that require highly customized goods and who are even willing to develop (and have affordable tools to do so) the solution themselves if it is not available from market. Innovation is *democratizing* in terms of production and so companies again have to focus on what value they produce for their customers.

Finally, the prevalence of service industries is changing the nature of tools through which companies compete. As described in the first section, services differ from products in terms of tangibility, storability, parallel production and consumption; hence the manufacturing-based means of strategic

protection (e.g. IPRs, technologically advanced production lines, or flexible storage facilities) are no longer effective. Instead, analysis of recent volumes of *Journal of Service Management* and service marketing publications (Grönroos 2007, Wilson *et al* 2008) shows the key topics are *customer loyalty* and *service quality*. This is also reflected by the emergence of design thinking - a holistic approach to service innovation which creates new services from the perspective of customer experience - throughout the 1990s which is now receiving public acceptance (Mager 2006, Verganti 2009, Guardian 2010).

These trends may be intuitively plausible, but again they must be put into the context of global development. Liberalization of international trade (exports and imports) has different consequences in different countries. Whereas in countries with concentrated industries imports increase competition, in developing countries they cover increasing unserved demand (WTO 2008). Therefore, the discussed trends reflect conditions and changes only in the developed economies.

3. THE IMPLICATIONS OF SERVICE-DOMINANT LOGIC FOR INNOVATION

It was shown that there is not convincing empirical evidence to claim that all industries provide services. Then it was argued that it is more a matter of new marketing approach in highly industrialized markets and the approach was explained and framed. Now the focus will be on what the concept means for innovation. The implications can be categorized according to the level of detail.

3.1. Micro-level Implications: Business

SDL offers practical tool for navigation in the highly competitive post-industrial markets. Different nature of services makes the business model more vulnerable to imitation and therefore marketing experts are concern with maintaining customer loyalty and delivering high service quality, as discussed above.

When approached from the SDL perspective, companies can analyze key value they deliver to customers and develop a unique system of delivery while evolving their core competencies over time. Or as DTI (2007, p. 4) put it, '[i]ncreasingly, firms do not consider themselves to be "services" or "manufacturing" but providing solutions for customers that involve a combination of products and services.'

Another implication is that the attention must be given to the *moment of truth*, the moment of actual delivery of the service, as it may significantly influence the value co-production (Grönroos 2007). For example, unpleasant waiter may ruin the whole experience that customer gains from an evening in a luxury restaurant. (This is echoed by the recent MBS research on employee and customer perceptions which might be summarized as 'Employees should be king - not customers.' MBS 2010).

3.2. Mezzo-level Implications: Competition

The vulnerability of service innovation to imitation and the perishable nature of services can spur innovation also on the industry level. Due to the lack of other protection means, firms may turn to trade secrets, e.g. by dividing a service into visible front-end (user interface) and hidden back office operations (mechanism of delivery). This may result in a simple service based on a complex system - *complication* in the words of Lusch and Vargo (2006) or *simplicity* according to Kluger (2008).

Google may well serve as an example here. Its flagship service - internet search - is very simple to use by customers and yet, it is based on a very complicated system of algorithms and customized search queries and protected by secrecy (Auletta 2010).

3.3. Macro-level Implications: Policy

Finally, change in structure of economy towards service industries requires change in political discourse. When the manufacturing prevailed, government protected the development through granting IPRs, setting up technology incubators and investing in technological R&D.

However, regulation tailored for manufacturing is not suitable for service industries. Law has to reflect the intangibility and simultaneous production and consumption of services. It also has to protect customer against insufficient delivery.

Current Czech legislation may serve as an illustration here: The Civil Code guarantees customer the right to have his/her product repaired in case of failure and after two unsuccessful repairs, the merchant is obliged to refund the full price. However, this applies also to services and so if a customer is not satisfied with his/her haircut, the hairdresser has a right to repair the service twice, which might seem absurd but it is according to the law.



*Fig. 6. Don't like your haircut?
Two repairs than a refund. ---
Services require different
means of customer protection.*

Furthermore, the growth of service sectors affects the global economy. When compared to goods, international trade of services remains low (Wölfl 2005). This has two reasons,

'first, unlike most goods, the market for services remains far too restricted, generating costs for operators and consumers alike, and holding down productivity. The second aspect is that ... many services that are traditionally the preserve of the domestic market are much better placed than they were, say, 10-15 years ago, to benefit from freer access to the international marketplace.' (Pilat 2005).

It is clear from the discussion in this section that service perspective is a vital approach to innovation on both company and industry level. However, on the policy level there are still some measures required to reflect the new situation.

4. CONCLUDING REMARKS: A PARADIGM SHIFT OR A REFLECTION OF CHANGED ENVIRONMENT?

The essay was concerned with the claim that all industries provide services now. Using official statistical data, it was shown that the service industries create majority of GDP and significantly contribute to domestic employment in developed countries. However, the trend toward service economy is not clear in all of them and the share of service sectors is low in the developing countries. First conclusion was that the claim highlights the importance of growth of the service sectors and represents shift in marketing approach rather than offering a sound empirical finding.

Therefore it was necessary to understand the rationale behind this change. The key concept of this approach - service-dominant logic - was explained and critically assessed to show it is particularly

suitable for analysis of customer motivation for exchange in the markets that are characterized by intense competition and democratized innovation.

Finally, the implication for innovation in business, markets and (inter)national systems were discussed to demonstrate that service logic can be a vital source of changes required by the current circumstances.

Having the whole discussion in mind, the logic of customer oriented approach - the adoption of the perspective that industry is providing services no matter what is its actual specialization – seems to be an appropriate reflection of the changed situation in developed markets rather than a truly revolutionary shift in marketing theory.

The last remark is that the analysis deliberately neglected two topics that are associated with the growth of service industries: 1) the migration of manufacturers toward service provision (e.g. Oliva and Kallenberg 2003) and 2) the suitability of current categorization of services for statistical measurement (e.g. Gordon 1996).

5. ABBREVIATIONS USED IN THE ESSAY

DTI	Department of Trade and Industry (United Kingdom)
EC.....	European Commission
EU	European Union
IPRs	Intellectual Property Rights
MBS	Manchester Business School
OECD.....	Organization for Economic Cooperation and Development
SDL.....	Service-dominant Logic
WTO.....	World Trade Organization
WWII.....	World War II

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