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and knowledge-based competitiveness**

Policy options for promoting innovation in the services sector

Note by the secretariat

I. Introduction and summary

1. This document has been prepared in accordance with the Programme of Work of the Committee on Economic Cooperation and Integration for 2009-2010. It is based on the outcomes of the Applied Policy Seminar “Promoting Innovation in the Services Sector”, which was the substantive segment of the third session of the Team of Specialists on Innovation and Competitiveness Policies held in Geneva on 25-26 March 2010.

2. The document is structured as follows. It first introduces the role of services in modern economies and the specific features of innovation in the services sector before considering the rationale for policy interventions and the challenges involved. It presents a number of policy approaches and discusses different instruments that can be used to promote innovation in the services sector. Finally, it concludes with some consideration on the importance of policy learning in this relatively novel policy area and the contribution that international cooperation can make.

II. Services in a modern economy

3. Services play a growing role in economic activity, accounting for up to three quarters of total output in developed market economies. In countries with economies in transition, the shift towards services was part of the transformation towards the market economy. Globalization and increased international opening have also changed the environment in which services operate. Deregulation has increased competitive pressures for some type of services. As technological advances have facilitated tradability, delocalization trends have emerged, as some services activities shift to lower cost countries.

4. The development of services is a major source of productivity growth, as it provides critical inputs for other activities and makes possible new forms of activities and business models. Information and communication technologies, in particular, have a direct impact on organizational innovation capabilities in manufacturing.

5. There are significant differences in productivity in services sectors across countries. To some extent, these are partially explained by national variations in the composition of services. Slow productivity growth in this sector, as a result of low innovation, can be a major drag on economic dynamism. The disparity observed in national performances suggests a role for policy to enhance the competitive position of this sector and, by extension, the whole economy.

6. At the company level, including firms whose primary activity is manufacturing, services represent an important dimension of their competitive position. Moreover, the boundaries between services and manufacturing are often unclear, as services are an important element of the production processes and commercial offerings of manufacturing companies. Intangible add-on activities (for example, after sales services) are a factor in determining the value of manufacturing products. As manufacturing companies are often involved in the production of services, the implications for policies and regulations concerning services extend well beyond the services sector per se.

7. In many cases, successful innovations represent the combination of technology-based products with new services that jointly define compelling commercial proposals. Manufacturing companies are often both consumers and providers of services. The distinction between manufacturing and services is evolving as a reflection of business strategies to adapt and take advantage of changing economic circumstances. Thus, companies may have sought to exploit opportunities in new activities or may have shifted specialisation in response to competitive pressures.

8. Some manufacturers have repositioned themselves as business services companies, in an attempt to move up the value chain. In other cases, manufacturers have seen the potential of delivering services that tap into the knowledge they have of their own products. In some cases, firm dynamics lead to the outsourcing of manufacturing processes while retaining service functions. In others, companies that started initially as service providers evolve to encompass also manufacturing functions.

9. In fact, it has been noted that a certain convergence can be observed in the dynamics of manufacturing and service firms through a process of horizontal integration. Service companies seek to be more closely involved with supply chains and manufacturing companies want to improve the commercial appeal of their products through added services. The concept of “integrated solutions” has blurred the distinction between sectors – in practice, this means that service and manufacturing activities are integrated into complex chains that seek to deliver value for customers and enhance the competitive position of these networks.

10. Given the difficulties in isolating services from other activities, a conceptual difference is often made between innovation in services (i.e. within the services sector) and service innovation (innovation in activities that have the characteristics of services and that can take part in any other sector). However, in practice, data limitations preclude a close examination of services functions embedded in other sectors.

11. There is a general awareness that reforms in the services sector can have significant positive impacts on employment, productivity and innovation. Knowledge-intensive services, in particular, can make a significant contribution to increased productivity in other sectors. A well performing services sector is increasingly seen as an important dimension of an effective innovation system.

12. The acknowledgement that services play an important role in ensuring overall economic dynamism and in enhancing the competitiveness of manufacturing has replaced the more traditional view of services as passive consumers of technological innovation produced elsewhere. Services firms are no longer seen just as consumers of technology but real innovators. From this broader perspective, service innovation is considered as a key factor in economic growth, while avoiding an excessive focus on technological innovation.

13. The increased relevance of services for economic performance has brought a growing interest in understanding the specific drivers that influence innovation in this sector and on how to design and implement supportive policy initiatives. However, despite their economic significance, the recognition of the importance of the services sector in innovation policies is a relatively recent phenomenon that is still not well understood.

III. Innovation in the services sector: some features

14. The services sector includes a wide range of activities with very different characteristics:

(a) They display a large degree of diversity regarding technological orientation and research and development (R&D) intensity, from traditional sectors like retail and tourism to others with higher technological content such as telecommunications and computer services;

(b) Services also show display various degrees of tradability, as a result of their inherent characteristics but also because of the role of regulations at various levels of government; and

(c) They also differ regarding the type and level of skills required and markets served.

15. A common feature, however, is that unlike manufacturing, which typically results in the delivery of material products, many services are essentially intangible. From a policy perspective, this heterogeneity raises the question of whether general policies are appropriate or differentiated forms of intervention would be more suitable to effectively address this variety.

16. Innovation in services is typically multidimensional, as it tends to embrace not only new products (service concepts) but also includes a wide range of non-technological issues, such as changes in the customer interface, the business model and organizational arrangements while incorporating often also a technological aspect. Product and process innovation tend to coincide in the service sector, because of the simultaneity between the production of a service and its consumption. New services are often accompanied by new ways of distributing them or interacting with customers.

17. Overall, innovation in the services sector is often associated with non-technological changes. "Hidden innovation", i.e. not accounted for by traditional innovation indicators and without a technological basis, is particularly important for services. By contrast with manufacturing, the expected impact of innovation in services is likely to be less focussed on achieving a reduction in costs and more on quality, delivery process, access and changing customers' experiences.

18. Users are therefore called to play an important role in the innovation process as the interaction between customers and firms is a critical source of information about their actual and potential needs. The relevance of non-technological innovation and the close interaction with customers emphasizes the importance of skilled staff, who are important agents of change in service companies.

19. Rates of innovation tend to be particularly high in knowledge intensive services (KIS) which have distinctive characteristics, being as technologically forward as manufacturing and displaying a high growth potential. KIS can play an important role in facilitating innovation in general, providing key inputs to other activities.

20. Some KIS subsectors, like information and communication technologies (ICT) have traditionally been the object of specific policy initiatives. The development of ICT has broader implications, driving efficiency gains in other sectors and making possible the emergence of new business models. The availability of KIS services over a certain geographic domain can represent a significant competitiveness factor that confers locational advantages and facilitates the formation of networks.

21. Knowledge intensive service activities (KISA) are sometimes integrated within manufacturing or services companies. Typically, these include functions such as management and employment, research and development, ICT, legal services, accounts or marketing. This sort of activities plays a key role in transferring existing knowledge among or within organizations. Furthermore, they are essential for the shift into higher added value activities by manufacturing firms.

22. As innovation is the result of a collaborative process between different stakeholders, these activities are enablers or carriers of innovation. As ICT, they facilitate the type of collective problem-solving processes that can drive innovation. The availability and use of KISA in firms (including those where their main activity is non-services related) can be linked to its overall innovative capacity, as those types of activities tend to be more common in larger firms with more developed innovation capabilities.

23. Innovation in services can play an important role in addressing social and environmental challenges, while reacting to the market opportunities created by secular trends such as population ageing or sustainability concerns. For example, environmental services, including areas such as recycling and waste disposal, have received growing policy and business attention. In some cases, offering recycling or remanufacturing services is an extension of the activities of traditional manufacturing companies that seek to extend the life of their products.

IV. Innovation policies: need, biases and measurement challenges

24. The typical arguments focusing on various types of market failures as a justification for the need to put in place innovation policies apply also to innovation in the services sector. Some of these market failures would appear to be stronger in the case of services, thus reinforcing the case for policy intervention.

25. There are a number of examples of market failures that may require corrective action:

(a) Innovation in services is harder to protect through patents or other intellectual property mechanisms, which would result in the underprovision of innovation. Innovation in these sectors is often immaterial and more difficult to defend. Thus, new business models and organizational innovation (including when they have a technological base) cannot be protected by patents;

(b) Due to their higher reliance on intangibles and typically smaller size service companies may find particular difficulties in raising venture capital financing;

(c) Markets for services are fragmented and pricing is far from transparent, which may lead to the emergence of localized monopolies, with detrimental effects for innovation; and

(d) Restricted tradability and problems with the evaluation of services before they are consumed may result in information asymmetries.

26. The formulation and implementation of innovation policies regarding the services sector faces a number of specific difficulties. To start with, there is a need to develop concepts and measurements to assess the effectiveness of the initiatives undertaken. Policy actions need to be supported by a clear understanding of the issues that need to be addressed.

27. The diversity of the services sector presents a challenge for analysis. Statistical measures for services handling goods (like retail or transportation) are better established than for those that are not directly related to this type of activities (like business services or communications). However, these are very important as instruments of technological and social change.

28. While the so-called *Oslo Manual*¹ has been updated to cover service innovation, there is still a bias towards technological innovation, which is particularly limitative for services. The extension of the European Union Community Innovation Survey² beyond manufacturing to include services has allowed better insights on innovation processes in this sector. However, the development of indicators that support policymaking based on an improved understanding of innovation in the services sector remains a critical issue. Non-technological innovation is more difficult to track and record. Existing measures only partially capture innovation in services.

29. Reviews of the use of typical instruments of innovation policies, including the development of basic infrastructure, support through tax credits, provision of training or procurement suggest that innovation in services is at disadvantage in many countries. Knowledge transfer between the science base and services companies is also less developed.

30. Overall, innovation policies continue to emphasise the role of technology, but this dimension is less relevant for services companies. The challenge is therefore to develop forms of policy intervention that are not technology-based.

31. As promotion of innovation in the services sector is a relatively new area in many countries, effective design and delivery of policies may require the development of new skills and attitudes among stakeholders and government agencies involved.

V. Innovation in services and R&D

32. The strength of innovation in services companies relies to a lesser extent than that in manufacturing on technological R&D. Other types of innovations, such as those concerning marketing, relations with customers, delivery channels or combinations between services and products tend to have a more widespread application in services. However, R&D is also important for the innovation capabilities of services firms.

33. Business expenditure on R&D in services tends to be lower than in manufacturing but this general statement needs to be qualified, when considering specific subsectors.

¹ Organisation for Economic Cooperation and Development, *The Measurement of Scientific and Technological Activities Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data*, 3rd Edition (Paris), 2005.

² The Community Innovation Surveys undertaken by national statistical offices in EU Member States are based on a common methodological approach to innovation as defined in the *Oslo Manual*. They cover many different aspects of firms' innovation activity and performance, including inputs used in the innovation process, sources of information for innovation, the firms' partners in its innovation efforts as well as different types of innovation outputs.

Moreover, this type of expenditure has grown faster in most countries, as services are becoming more R&D intensive, albeit significant differences remain among various types of activities. In particular, technological R&D is high in knowledge-intensive services. While it is true that the type of knowledge generated through innovation in services cannot be protected through patenting in many cases, the growing importance of R&D suggests that there may be an increased scope for intellectual property rights (IPR) protection, which has policy implications.

34. There are measurement problems concerning R&D in services:

(a) Some R&D is attributed to manufacturing firms while some services companies may underreport the extent of R&D undertaken;

(b) R&D in services is often an informal activity that is difficult to measure, often entangled with R&D in manufacturing. Thus, R&D in services is often not isolated but appears closely related to the production of physical goods.

35. Improvements in measurements may explain part of the increased R&D intensity observed in the services sector. Statistical evidence (as available in the European Union Community Innovation Surveys) shows that services benefit less than manufacturing from public support to innovation, in particular concerning R&D, although there are wide national and subsectoral differences. Knowledge-intensive services perform better than other areas such as trade, transports or finance.

36. Tax credits and other incentives to R&D are based on binding definitions that identify eligible activities. The difficulties in measuring R&D in the services sector have implications for the effectiveness of policies. Policy efforts need to be devoted to improve the statistical understanding of R&D in services and address the bias against these sectors in public support initiatives.

VI. Policy approaches

37. There is a general opinion that innovation policies and strategies in relation to the services sector are less developed than those targeting manufacturing. The recognition of the importance of a dynamic services sector has been accompanied by efforts to ensure that the promotion of innovation in services is duly acknowledged in innovation policies and strategies and that this is backed by appropriate statistics. However, despite the progress observed, the attention received in policy initiatives remains relatively limited. Well-defined frameworks for policy intervention in this area are rare, being only present in a handful of countries.

38. The awareness that innovation policies tend to neglect services has led to initiatives to widen the range of policy measures designed to support manufacturing to the services sector as well. To some extent, this approach represents the extension of a manufacturing-based view of innovation to services, while retaining a privileged focus on technological R&D. This creates a technological bias that may be detrimental to services, given the importance of non-technological forms of innovation in this sector.

39. Other policy approaches underline the specific characteristics of innovation in the services sector, in particular, the relevance of non-technological innovation. The emphasis on differentiation takes place also within the services sector itself. The diversity of activities and their varied characteristics lead to the implementation of subsectoral innovation programmes (focussing, for example, on tourism or financial services), as these are seen as a way to effectively address the different barriers to innovation in a sector which shows a wide range of heterogeneity.

40. By contrast, more recent policy strategies tend to emphasise a more comprehensive view of innovation, which considers services in an integrated fashion. There is a close relation between various forms of innovation in manufacturing and services, which are difficult to disentangle. Successful companies usually present a mixture of these activities employed to develop compelling commercial proposals.

41. This integrated approach considers that the lack of services innovation should be understood as a failure of the overall innovation system. Innovation policies in services would need to be developed as part of general innovation policies:

(a) There are important links between manufacturing and the services sectors and these relations would need to be taken into account when designing policies;

(b) Improving relationships and connectivity between services and manufacturing companies is required to address observed systemic failures in the innovation system; and

(c) Knowledge intensive services are seen as a key input to improve the competitive capacities of manufacturing companies.

VII. Instruments for promoting innovation in the services sector

42. Policy instruments for promoting innovation in the services sector may aim to:

(a) Correct existing biases against services in the conduct of traditional innovation policies;

(b) Devise specific interventions that are tailored to the particular problems of some services activities; and/or

(c) Develop measures that are based on the understanding of the services sector as an essential dimension of the overall innovation capacities of the economy.

43. In practice, concrete interventions may include a mixture of these approaches, often reflecting a combination of sectoral and horizontal policies. The choice of instruments and areas of intervention is usually a reflection of concrete national circumstances, including the particular innovation governance set up. Moreover, the policy mix is an expression of the views on how to develop a strategy for innovation in the services sector.

44. The heterogeneity of the services sector and the difficulties in differentiating services from manufacturing activities may explain the general absence of the broad strategies supporting innovation in services. Innovation initiatives in specific subsectors are much more frequent, with countries targeting areas that are particularly relevant for the national economy.

45. The potential scope of innovation in services is very wide, encompassing, among other possible aspects, new services concepts, business models, organizational arrangements and customer interfaces. Designing innovation policies poses a challenge, as the new agendas involve different target groups. Specific instruments that target innovation in services remain rare.

46. Policy documents at the more general level generally do not discriminate against services and, in some instances, may even make an explicit mention to the promotion of innovation in this sector. However, it is at the level of the design of specific instruments and mechanisms where problems often arise. While the policy instruments available in this area may be sector neutral, the evaluation of proposals or projects often has an implicit bias toward technological innovation that may put services at a disadvantage. It is therefore

critical that instruments appropriately reflect the distinctive features of innovation in the service sector.

47. Overall, innovation in services is sensitive to general framework conditions. In particular, the degree of competition, including foreign competition, and the conditions for labour mobility influence innovation in the services sector.

48. The fact that traditionally services have been sheltered from foreign competition and that they are more difficult to trade across borders may have been one of the factors constraining innovation in some countries. However, with the advance of globalization competitive pressures from international markets are becoming more widespread. The opening of markets has created new opportunities for firms to expand and innovative mechanisms to reach out different markets. Initiatives to widen the markets and increase the internationalization of services are likely to have a positive effect on the rate of innovation.

49. However, services are delivered locally and therefore are very sensitive to local circumstances. Some services operate in areas where there is a high degree of regulation. Policies need to assess the appropriate degree of regulation and find a suitable balance between the need to protect consumers and achieve other goals while providing an impetus to innovation.

50. Labour market policies appear also as particularly relevant for the development of the services sector, which depends on the existence of a qualified and mobile workforce endowed with a varied range of skills to interact with customers and capable of engaging in the labour market in a flexible way. This may include arrangements that facilitate part-time work.

51. The promotion of small and medium-sized enterprises (SMEs) and entrepreneurship may have a particularly favourable impact regarding innovation in the services sector, as small companies are more prevalent in services activities, which often have a more local orientation. High rates of new firm creation are typical of the services sector. This is a factor encouraging innovation that can be nurtured by supportive policies.

52. Internationalization may spur innovation but it also generates significant competitive pressures for SMEs, which may require specific forms of support to address this challenge, providing them with the necessary international marketing and sales capabilities.

53. As non-technological innovation plays a more significant role in services, it is important that innovation policies have a broader focus that encompasses also support to other forms of innovation, including, for example, organizational and marketing arrangements. However, R&D expenditures have also a positive impact in fostering innovation in services, so policy efforts may also be directed towards promoting awareness and the use of R&D in services.

54. Services firms are generally less connected than manufacturing companies with the science and technology base, with the exception of knowledge-intensive services. Addressing these weak links may require the use of specific policy instruments. Innovation vouchers and similar schemes can be used to facilitate the upgrade of innovation capabilities by services providers.

55. However, the absence of a stronger relationship may reflect the fact that existing research outputs are of limited use to services companies. The challenge is how to make the science base more responsive to the needs of services companies, which may not have a special emphasis on technological innovation. Such efforts demand new attempts to create concepts and disciplines that address these tasks.

56. In this regard, “service sciences” have emerged as a multidisciplinary approach that seeks to provide a foundation for the creation of new services and business models in a

systematic manner, in particular in connection with the use of ICT. The availability of individuals who have a varied mix of skills (both technical and managerial) appears as an important ingredient of this approach, which therefore emphasises the need for appropriate training and learning initiatives.

57. In many countries, in particular, in economies in transition, areas such as consumer behaviour, marketing, cultural understanding and communication, have been neglected in comparison with the more technological aspects of innovation. It is important that research and education policies reflect the relevance of these areas for innovation in services.

58. Overall, the services sector need for a wide range of skills implies that vocational training and training on the job play an important role in ensuring the availability of qualified personnel. It is important that policy instruments recognise and encourage this type of qualifications.

59. Effective partnerships between different types of services providers and between services and manufacturing companies are an important factor of economic flexibility and dynamism. The traditional mode of in-house production has been replaced by more complex arrangements than link various companies in developed business networks.

60. Participation in these value chains has both an external (between firms) and internal (within firms) dimensions. Innovation policies face the challenge of how to create conditions that promote the development of these relationships and how to adapt existing instruments to an environment defined by collaboration, specialization and sharing of information.

61. Standards can facilitate the development of complex value chains and support efforts to increase productivity. They are an important ingredient of the institutional framework that provides certainty for business to operate. In a globalized world, this has an important international dimension that may require cross-border coordination efforts.

62. Policy mechanisms could therefore be developed that facilitate networking and cooperation among the various stakeholders on innovation in services processes. This may involve the creation of suitable ICT-based platforms that operate on the basis of open innovation principles.

63. Human capital plays a particularly important role in fostering innovation in the services sector, where there is the need not only to generate new solutions but to implement them on a continued basis in close connection with customers. A high degree of customisation, facilitated by closer interrelationship with customers, is an important ingredient of commercial success.

64. Overall, services companies seem to rely to a larger extent on the skill base of their staff to gain a competitive advantage. A wide range of skills is demanded, including non-technical. Tacit knowledge, often resulting from the interaction with other members of staff, clients and suppliers, is critical for successful adaptation. The involvement of employees in the innovation process, which can be encouraged through appropriate organizational structures and incentive mechanisms, is therefore an important element of services innovation. Given the type of continuing and growing exigencies on the workforce, this may require particular attention to vocational education and life-long learning.

65. Service companies rely less on patents than manufacturing firms to protect their innovations. However, other IPR instruments such as copyrights and trademarks are more significant, as these are more suitable to the characteristics of the sector. Typically, trademarks serve to address the problems of how to evaluate the quality of a service prior to consumption, as they facilitate building the necessary reputation. However, the increased use of R&D in the services sector that can be observed in most countries suggest that awareness of IPR mechanisms is also becoming increasingly relevant.

66. The heterogeneity of the services sector should be recognised when proposing measures targeting IPR. In some subsectors, such as software, engineering and computer services, R&D is more important and therefore, traditional protection through patents would be more appropriate.

67. In any case, the existence of mechanisms of IPR protection that do not have a formal character, including first-mover advantage, should be underlined. IPR systems need also to pay attention to the relevance of collaborative methods in the provision of services. A paramount example is the development of open source software and the creation of open standards. The flexibility and speed provided by these arrangements are important contributors to innovation.

68. As in generalist innovation policies, supply-side measures tend to predominate among the initiatives undertaken to promote innovation in the services sector. While demand-side actions tend to be rare, these have a particular relevance for the services sector. User-demand has an important role in fostering innovation in this sector, as new services often result from the interaction between suppliers and users. The creative industries, which have a great potential in modern economies, is a paramount example of the need to maintain and develop close contacts with users.

69. Services in which close relationships with clients are the norm tend to display higher innovation rates, as these links allow companies to acquire the necessary information to make attractive new proposals and to react quickly to the demands of users. Engaging customers and suppliers represents a source of competitive advantage that reflects well the non-linear nature of innovation and provides a continuous focus on market needs.

70. Clients, who are often closely associated with the design and delivery of services, encourage innovative firms to make adjustments to the services they offer in order to tailor them to their needs. This may continue even after the initial service has been rendered in the form of technical support or after-sales care. Such a high degree of interactivity emphasises again the importance of skills. Policy instruments may be deployed to facilitate and encourage these relations, including through the development of appropriate skills.

71. However, as with manufacturing, weak demand can stifle innovation. Policy measures to encourage the demand for innovation through the use of standards and public procurement are also useful to foster innovation in services. The visibility of new offerings by early adopters from the public sector can contribute to the subsequent diffusion of these innovations. Public procurement can stimulate the offering of new services but for the beneficial effects of such instruments to materialise, it is important to have mechanisms that are open and transparent while seeking the involvement of SMEs and addressing existing barriers to competition.

72. The development of services is often part of policies that seek the general promotion of innovation, in particular, with a territorial dimension. Cluster policies are a clear example, as the development of transport, logistic and business services are seen as means of establishing a favourable environment that encourages the growth of firms and their interaction. A thriving services sector provides locational advantages and a channel for the circulation of information. Cluster policies are particularly relevant also for the promotion of specific types of services like tourism, finance or creative industries, where proximity between companies is a source of economic dynamism and customer attraction.

73. Regional development programmes are often a main conduit for the articulation and implementation of initiatives to foster innovation in services. Central agencies tend to be more concerned with the planning and delivery of public services of general significance but private stakeholders usually operate at the regional and local levels. Regional innovation policies are also more closely aligned with the economic structure of the region.

74. Therefore there is a need to effectively integrate the strategies and measures carried out at different levels of government. Policies should not neglect the importance of small local projects, which are easier to coordinate than large scale national initiatives and which can focus on local needs.

VIII. Policy learning and the role of international cooperation

75. The promotion of innovation in services is a relatively new policy area. Countries are at different stages in the conceptualisation and implementation of relevant strategies. Specific choices need to be made to translate policy documents into concrete operational measures. Overall, there is a need to develop further the understanding of innovation in services and increase policy awareness of the importance of innovation in the services sector but also in service activities in general.

76. This creates a significant scope for policy learning, including at the transnational level. It is therefore important to conduct targeted programme evaluation and policy research which could provide a solid foundation for the assessment of policy experiences and the identification of good practices. As the initiatives undertaken in this area are relatively recent, the available body of knowledge on their impact remains comparatively limited.

77. Given this background, the design and implementation of evidence-based policies would be greatly facilitated by the collection of case studies that provide illustrations and examples of successful experiences, both regarding policy measures and company activities.

78. As good local practices are identified, dissemination efforts should also be a policy target, in order to increase their adoption by business and policy makers. Case-based policies should be grounded on a deep understanding of the conditions required for success. International cooperation can facilitate the wide sharing of the results of these experiences, so to better inform future policy initiatives.

79. While international comparisons can help to identify good practices, policy approaches and the choice and design of instruments should be adapted to national circumstances, taking into account the specific institutional and socio-economic context.
