

Developing the Service Sector as an Engine of Growth for Asia

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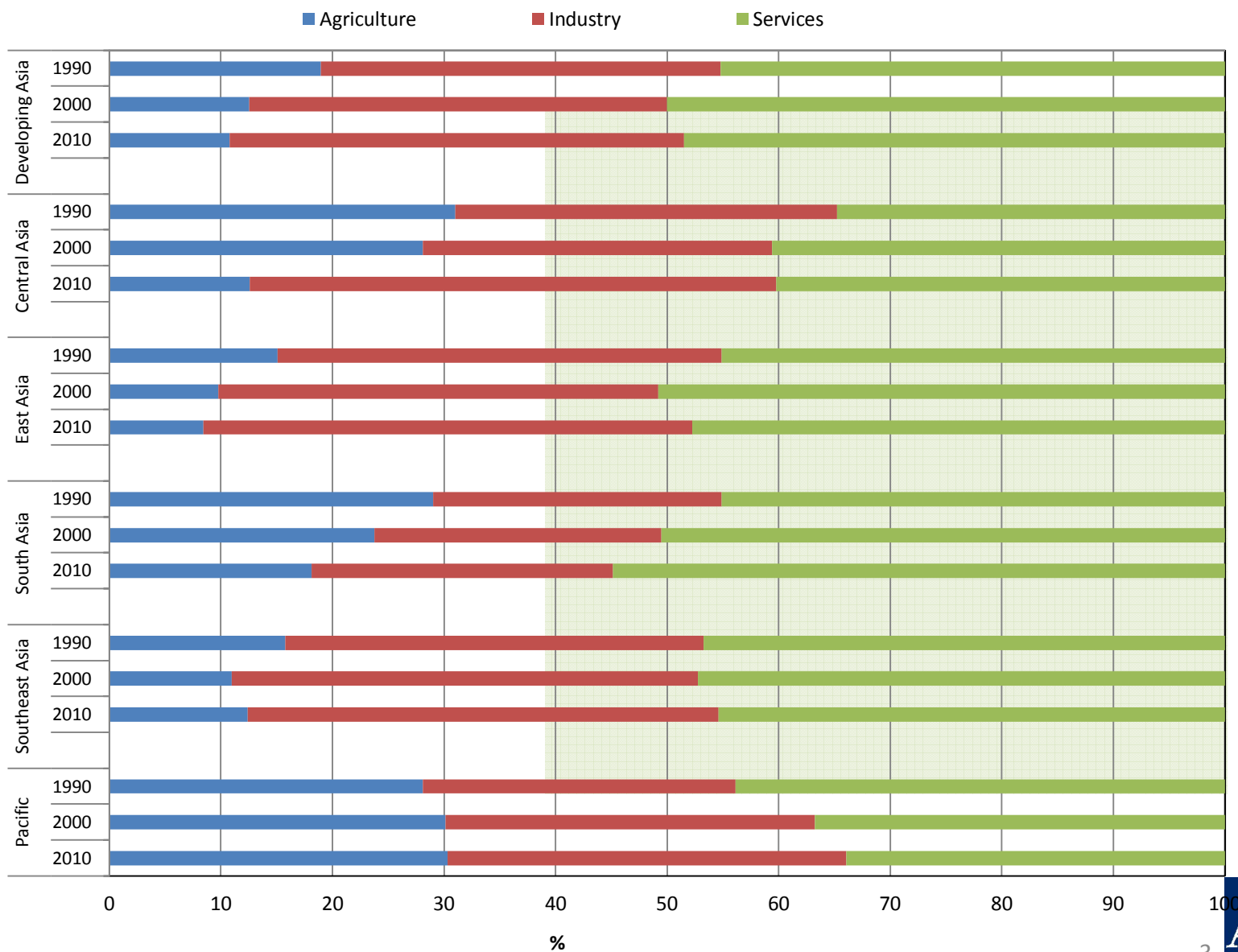
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Key facts and findings

- **The service sector already plays a major role in developing Asia's economies.**
 - International historical experience suggests that the share of services in output tends to rise as an economy grows richer.
 - Asia is no exception in this regard, and services have grown in relative importance over time.
 - Services accounted for 48.5% of the region's output in 2010.
 - Their contribution to economic growth has also been large.
 - They accounted for 66% of India's growth and 43% of the growth in the People's Republic of China (PRC) from 2000 to 2010.

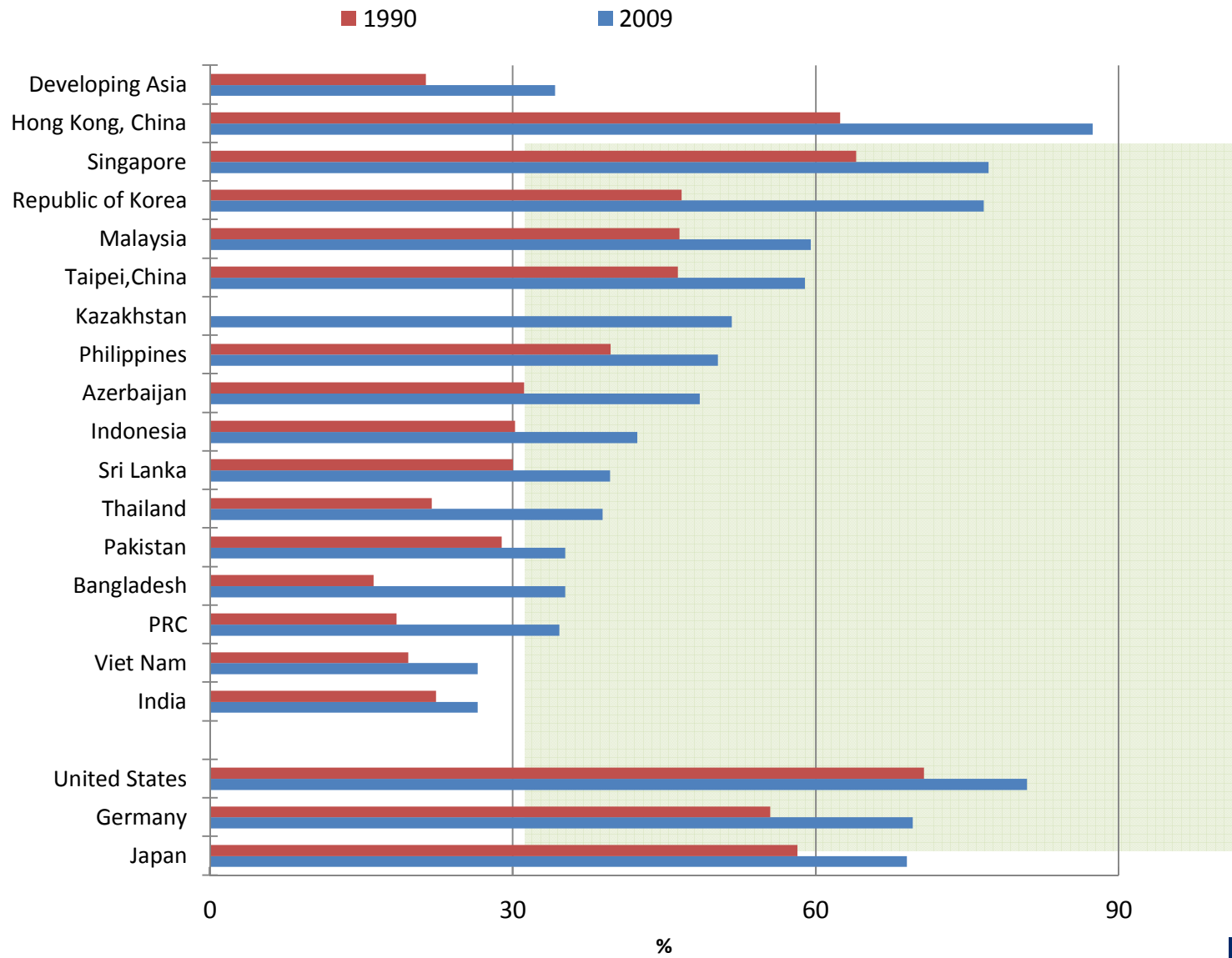
Shares of GDP, 2010



Key facts and findings

- **Services are a large and growing source of jobs across the region.**
 - The service sector is a big employer in the region; the share of the Asian labor force engaged in services has grown rapidly to about 34% of all workers.
 - The share has risen by 10%–20% in most countries during the past 2 decades. The large and growing role of services as a creator of jobs suggests that the sector is making a major contribution to inclusive growth.

Shares of employment, 2010



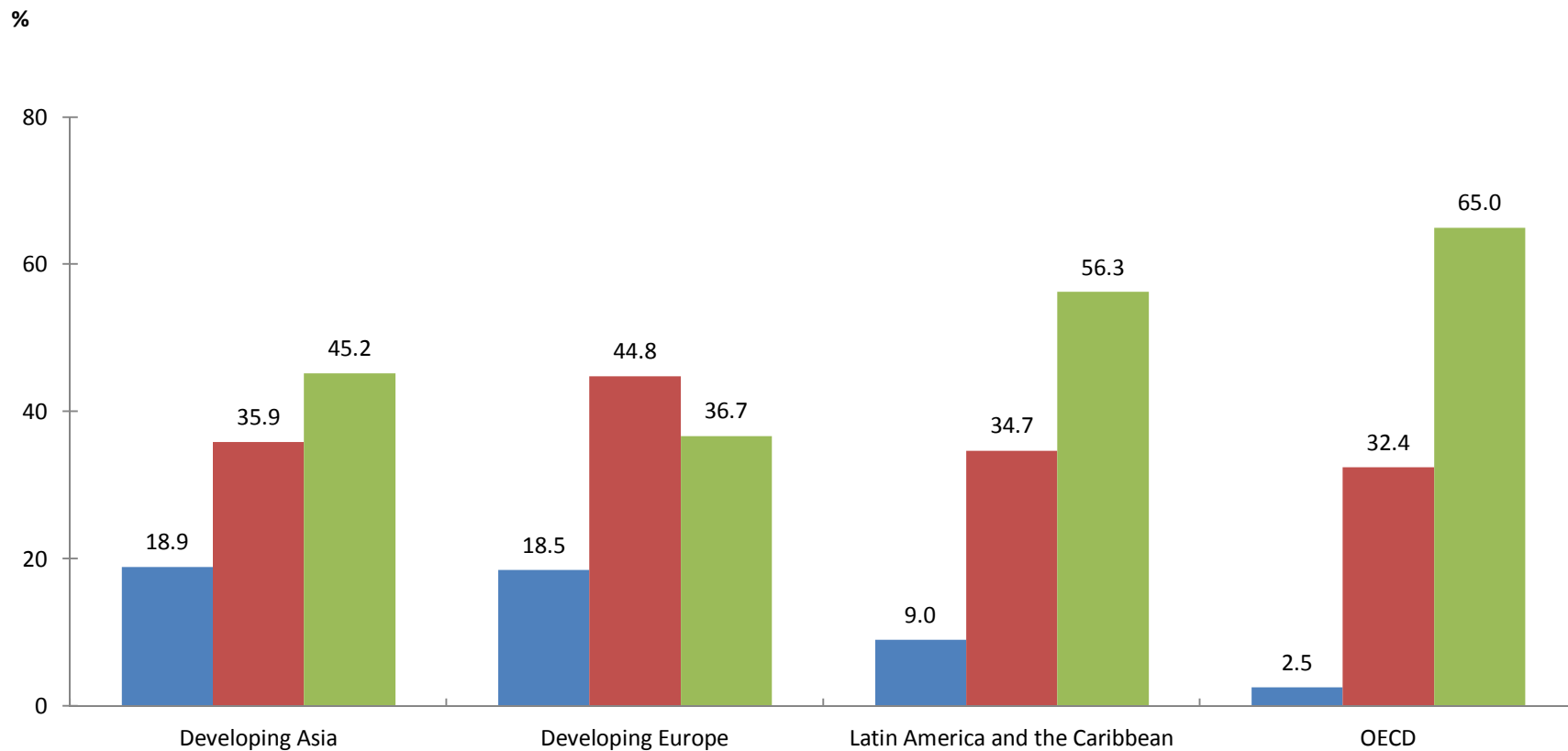
Key facts and findings

- **Services are set to expand even further in the coming years.**
 - Historical trends point to services becoming an even bigger economic force in Asia's future.
 - As the region's incomes continue to grow, the shares of services in output and employment will also grow, all the more so since currently they are below those of Latin America and developing European countries.
 - Rising incomes, an expanding middle class, and rapid urbanization are boosting the demand for services.

Sector shares by country group, 2010

■ Agriculture ■ Industry ■ Services

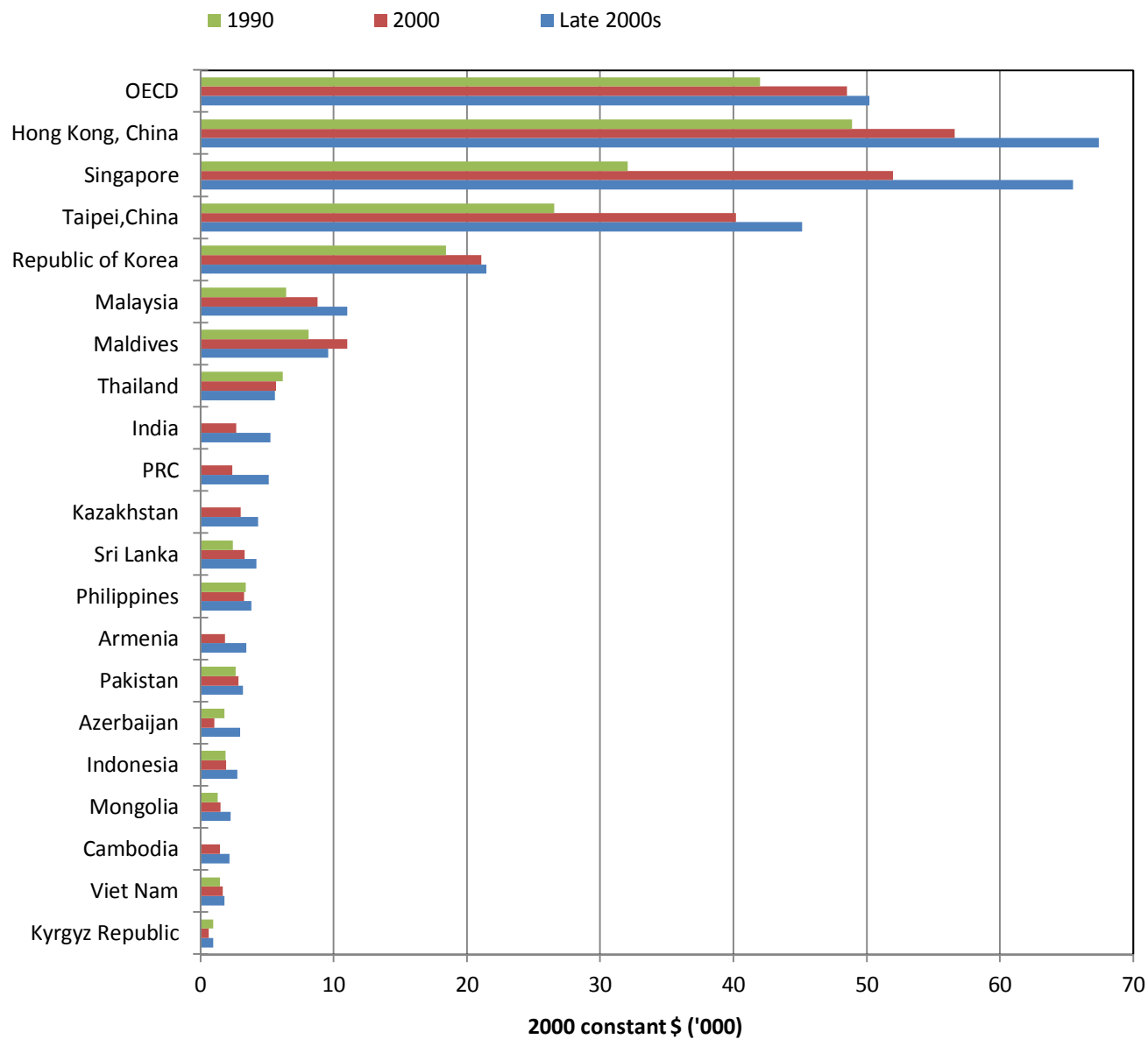
1990



Key facts and findings

- **Developing Asia's service sector suffers from markedly low labor productivity.**
 - While services are large and growing, labor productivity—the amount of output each worker produces—lags far behind that of advanced economies.
 - For most economies in the region, labor productivity is less than 20% of that in advanced countries. It languishes at around 10% in the PRC.
 - In the worst cases, it may take up to 30 years to reach 20%.

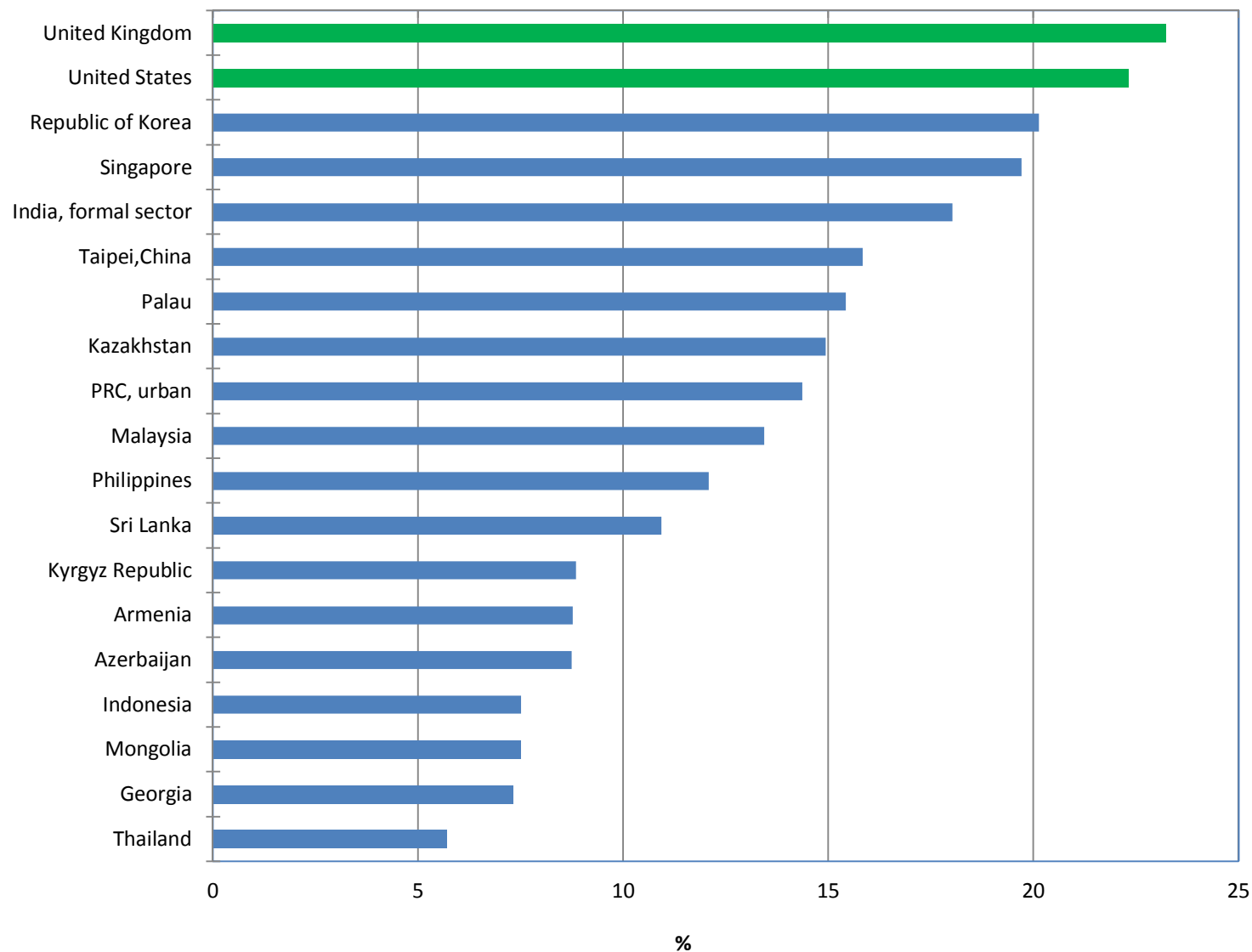
Labor productivity in services



Key facts and findings

- **Low labor productivity partly reflects the dominant role of traditional services.**
 - Productivity and value added are generally higher in modern services such as finance and professional business services than in traditional services such as wholesale and retail trade and personal services.
 - In Asia, traditional services still account for the bulk of service sector output.
 - Modern services often make up less than 10% of Asian service economies, well below the 20%–25% in advanced economies.

Share of business services in employment



Key facts and findings

- **Regulatory, infrastructure, and human capital bottlenecks constrain service sector productivity.**
 - Infrastructure for services such as information and communication technology (ICT) still lags behind that in advanced economies.
 - The highly skilled workers required for modern services such as scientists and bankers are in short supply in Asia.
 - Above all, excessive regulations that protect incumbent firms and other vested interests make markets less competitive and thus undercut prospects for improved efficiency and innovation.

Key facts and findings

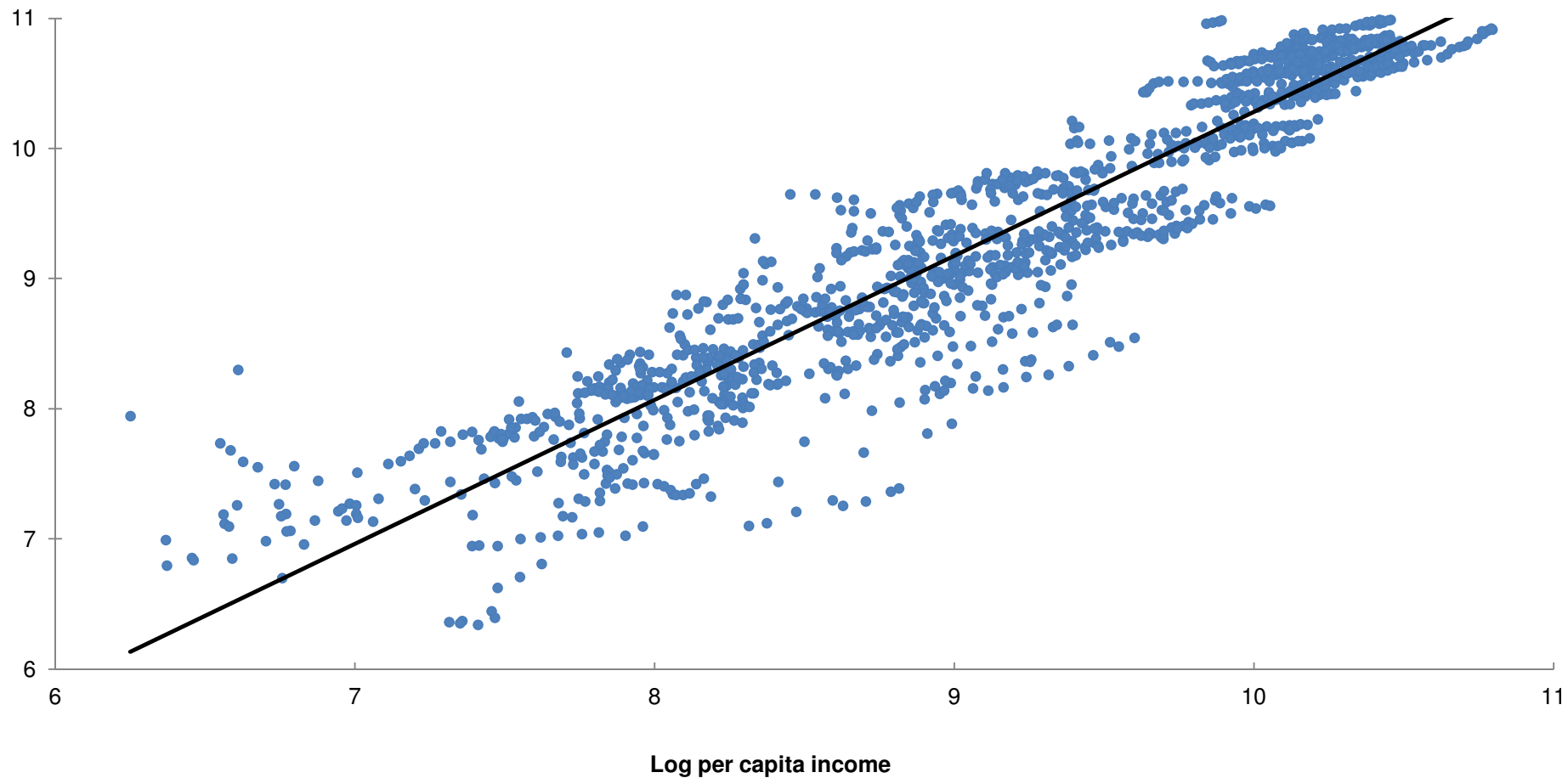
- **Modern services of particular importance to Asia are business-related services.**
 - Services such as ICT, finance, professional services, business consulting, and management support are currently underdeveloped in Asia due largely to the lack of necessary skills.
 - These business services do, however, complement the manufacturing sector, so developing them can lift the productivity of both the manufacturing and the service sectors.

Key facts and findings

- **Growing per capita gross domestic product will help to lift labor productivity in developing Asia's service sector.**
 - According to our econometric analysis, the lower the initial per capita gross domestic product (GDP), the higher the subsequent growth rate of labor productivity in the service sector.
 - This finding bodes well for labor productivity growth in developing Asian countries where income levels are still relatively low.
 - It also suggests that the potential returns on productivity-enhancing reforms in the region would be high.

Labor productivity in services and per capita income

Log labor productivity in services



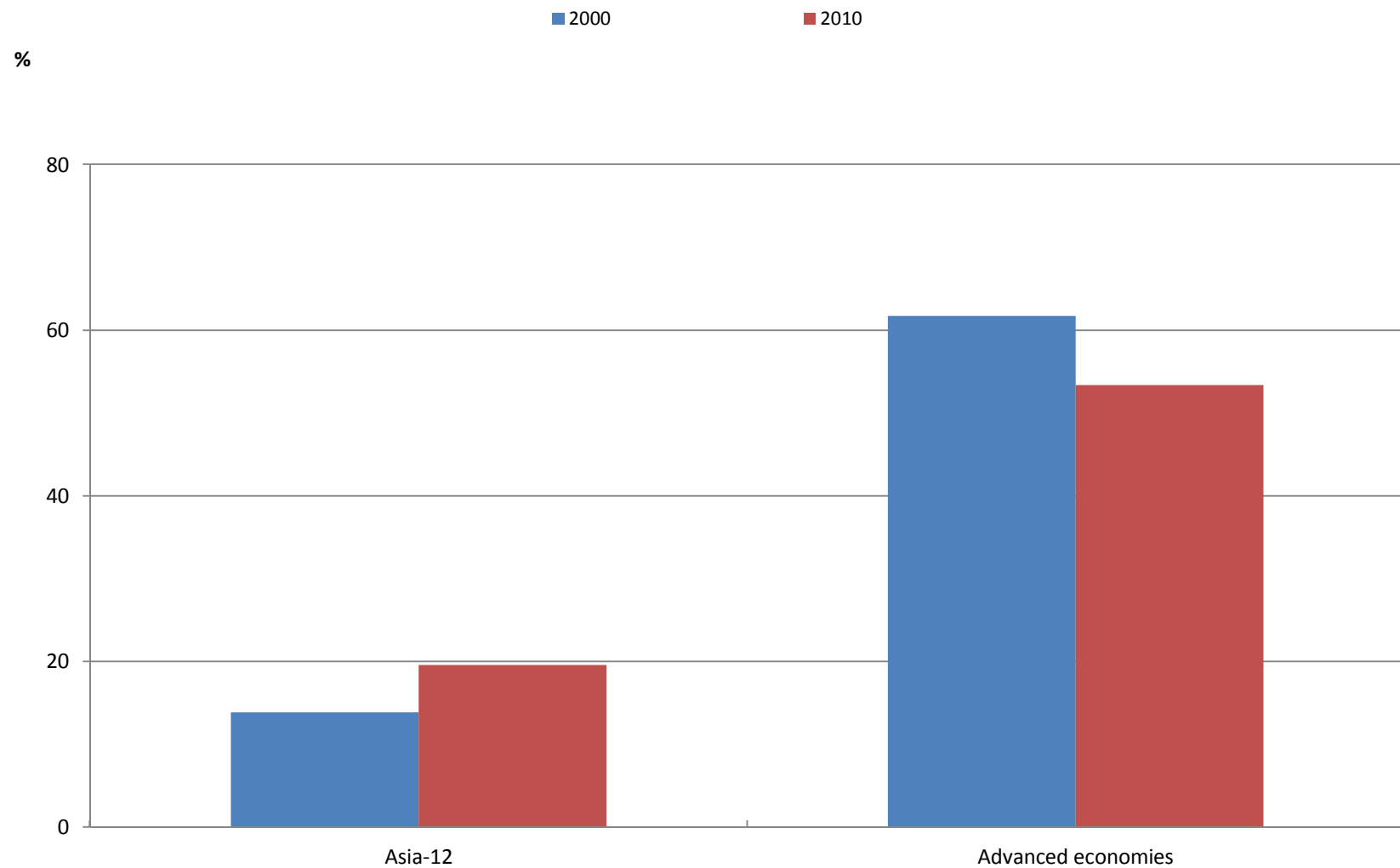
Key facts and findings

- **Trade in services also boosts productivity.**
 - Our econometric analysis finds that trade in services contributes to improved labor productivity in the service sector.
 - Specifically, the share of service trade in GDP is positively associated with productivity growth.
 - This is plausible since imports of services from foreign firms expose domestic service providers to greater competition.
 - Likewise, exporting services forces domestic firms to become more efficient.

Key facts and findings

- **Developing Asia's service trade has been growing, and there is scope for further growth.**
 - The share of service output that is traded is on the rise in Asia and elsewhere.
 - Asia's share of global service trade has grown.
 - For example, the PRC's share rose from 2% in 2000 to 5% in 2010, and India and the Philippines have emerged as global leaders in ICT service exports.
 - Many major Asian economies, however, have high trade barriers that stand in the way of even more service trade.

Share of global service trade



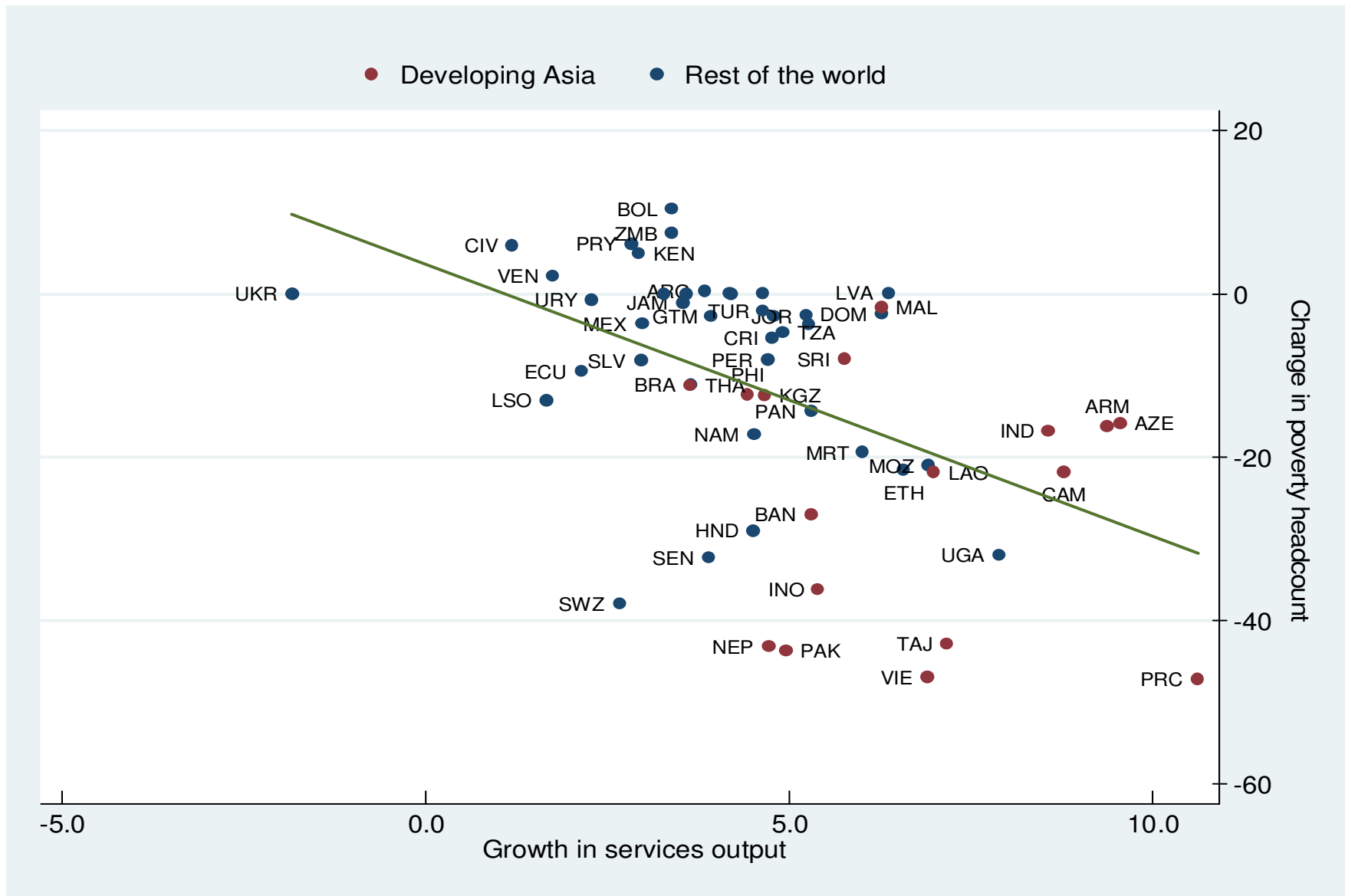
Key facts and findings

- **The region's service industries face an inadequate regulatory environment.**
 - Firms in developing Asia generally face a heavier regulatory burden than firms in advanced countries.
 - For example, the regulatory burden in the PRC, India, and Indonesia is about twice as high as it is Organisation for Economic Co-operation and Development (OECD) members.
 - Asian service firms often suffer from the lack of a sound, transparent, responsive regulatory framework conducive for competition and innovation in service markets.

Key facts and findings

- **Service sector development can contribute to poverty reduction and inclusive growth in developing Asia.**
 - Service industries tend to be more labor intensive than manufacturing industries, and employment growth is beneficial for poverty reduction; therefore in theory, service sector development can contribute to inclusive growth.
 - Our econometric analysis found a positive association between service sector development and poverty reduction.
 - This suggests that a stronger sector can help reduce poverty in developing Asia.

Change in poverty and service output growth, 1990-2010



Policy options

- The service sector has contributed greatly to output, employment, and growth in developing Asia.
- As the share of services in output and employment tends to rise with income, and as regional income is rising quickly, services will inevitably become even more important.
- Yet service sector labor productivity in most Asian countries is only a fraction of what it is in the OECD.
- The challenge across the region is to remove barriers to improving labor productivity in services and to develop modern service industries with high labor productivity.

Policy options

- Diversity in the service sector and across Asia means that barriers and policy options will largely be specific to individual countries and industries.
- Some common themes regarding the enabling environment for service sector development nevertheless emerge, notably gaps in regulations, infrastructure, and human capital.
- Meanwhile, the scarcity of high-quality data constrains the research and analysis that policymakers depend on to formulate effective measures to fill these gaps.

Policy options – regulatory gaps

- A well-functioning regulatory environment protects consumers and maintains competitive markets.
- According to product market regulation (PMR) indicators, China, India and Indonesia suffer a regulatory burden twice that of OECD members.
 - 3 domains: state control, barriers to entrepreneurship, and barriers to trade and investment
 - India has 13 regulatory bodies for higher education
- The heavy presence of SOEs in many Asian service industries stifles service sector development.
 - Regulations often protect SOEs from domestic competition from private firms and new entrants.
 - Indian railways and postal services are state monopolies.²⁴

Policy options – regulatory gaps

- Asia maintains some of the world's most restrictive policies on service trade.
 - PRC, India, Indonesia, Malaysia, the Philippines, and Thailand as having notably high barriers.
- Asian governments, especially in East and SE Asian, have biased policies which favor manufacturing.
 - In China, tax rate on finance is 39% and wholesale and trade is 30%, but tax rate on manufacturing is only 21%
- Guiding principle for regulatory reform should be to tackle entrenched vested interests to create more competitive service markets

Policy options – regulatory gaps

- Vested interests, whether public or private, limit competition and hence efficiency and productivity.
 - A classic example is fixed-line telephony in India. Even after liberalization, the private sector faced difficulty entering and operating in the market for lack of third party access, opaque procedures for sharing scarce resources, and other obstacles that protected incumbent SOEs in the industry. The result is fixed-line telephone density in India languishing at 2.9%, a seventh of the 21.9% recorded in the PRC and a twentieth of the 59.2% recorded in the Republic of Korea. In striking contrast, India's mobile penetration which did not have public monopoly service providers stands at a much higher 61.4%

Policy options – regulatory gaps

- Political will is needed to tackle the entrenched vested interests that hinder competition in the service sectors of many Asian countries.
 - Enact and implement competition laws
- Often what is needed is better regulation rather than less regulation.
 - India's airport liberalization in the early 1990s proceeded long before the regulator was established.
- Developing Asia should promote trade and foreign direct investment (FDI) in services
 - Services are increasingly tradable
 - Large potential gains from both exports and imports

Policy options – regulatory gaps

- Policies and tax inequities that promote manufacturing at the expense of services should be phased out.
 - The preference of policy makers for manufacturing was understandable when Asian economies were more backward, as the first stage of structural transformation is the shift from agriculture to manufacturing.
 - But now market forces should be allowed to play a greater role in allocating resources to different sectors.
- An important caveat is that regulatory reform may dislocate previously protected firms in the short run
 - In Korea, regulations and restrictions protect SMEs

Policy options – infrastructure gaps

- Basic infrastructure for electricity, transportation, and communication affects the productivity of the entire economy, including the service sector.
 - An erratic power supply forces most Indian information technology-business process outsourcing companies to invest in captive power units which increases their costs
 - Poor transportation infrastructure limits tourism to the Philippines which attracts substantially fewer tourists than Malaysia or Thailand despite boasting comparable tourism potential
 - Even countries with good infrastructure overall suffer from inadequate investment in certain areas
 - Korean service sector's ICT investment lags relative to OECD

Policy options – infrastructure gaps

- It is especially important to address infrastructure gaps in industries such as ICT that have the potential to catalyze large gains across the economy.
 - The contributions of ICT to economic and productivity growth in a number of countries have been widely documented as flowing through three channels.
 - First, ICT is an important capital input in production.
 - Second, it reduces inefficiency, creates complementary effects, and stimulates technological change.
 - Finally, productivity improvements in industries that manufacture ICT goods magnify the impact of growth.
 - ICT can promote inclusive growth by expanding access to basic services for the poor through mobile phone banking and remote education, for example.

Policy options – infrastructure gaps

- The rates of ICT diffusion are highly uneven across countries in the region. While some enjoy access to ICT comparable to that of advanced countries, lower-income economies still suffer limited access.
 - Greater investment is needed to address ICT infrastructure gaps in areas such as mobile broadband technology.
 - For developing countries, access to mobile technology and related innovations can foster growth by expanding opportunities for entrepreneurship, enhancing access to financing, facilitating agricultural transactions and the dissemination of market information, improving the delivery of healthcare, and making the public sector more transparent and accountable

Policy options – infrastructure gaps

- Across the region, there is a huge need to improve infrastructure in the years to come.
 - Developing Asia needs to invest some \$8 trillion in physical infrastructure from 2010 to 2020 just to maintain growth rates like those enjoyed in recent years
- Policy makers in the region will need to look beyond direct public investment in infrastructure to meet these huge investment demands while maintaining fiscal soundness
 - Fiscal constraints point to the need to prioritize public infrastructure investment into areas with large collateral benefits, in particular ICT including broadband

Policy options – infrastructure gaps

- In addition to making business services, tourism, and other industries more productive, ICT can promote inclusive growth.
- To complement public infrastructure spending, policymakers must also attract private investment
 - Asian governments may offer tax breaks and other financial incentives for private investment in ICT infrastructure
 - Governments must actively explore public–private partnerships and create an investment climate conducive to private sector participation in infrastructure

Policy options – human capital gaps

- Relatively low educational attainment and skill shortages are major barriers to building more vibrant services in Asia, especially modern services.
 - The positive relationship worldwide between education and service development is also evident in Asia.
 - Better-educated Asian countries tend to have larger service sectors, and a country's service sector tends to expand as it becomes more educated.
 - Human capital is critical to developing business services.
 - An abundance of skilled workers helps to explain the comparative advantage of the United States (US) and other advanced economies in business services. By the same token, developing Asia's lower educational attainment helps to explain the region's comparative disadvantage.

Policy options – human capital gaps

- Asia currently suffers from sometimes acute shortages of a wide range of skills (ADB 2008).
 - Educational attainment in developing Asia still lags behind that of advanced economies by a substantial margin, although it has been catching up rapidly.
 - Especially evident are shortages of the highly skilled professionals—accountants, business managers, engineers, lawyers, medical doctors, scientists, and software specialists—who are indispensable to modern service industries.
 - Notwithstanding the general improvement of education in Asia, the lack of higher skills slows the transition from traditional to modern services.

Policy options – human capital gaps

- Skill shortages are not limited to a few critical areas but are prevalent enough to pose a genuine risk to regional growth over the long run (ADB 2008).
 - The shortfall stems largely from Asia’s rapid economic growth and fast-rising incomes which have fueled demand for skill-intensive goods and services.
 - Surveys of employers found that the shortage of qualified staff ranked first among employers’ concerns in the PRC and Southeast Asia, and the same pattern was evident in other parts of Asia with higher-level skills most acutely in short supply (ADB 2008).

Policy options – human capital gaps

- Education reforms should aim to match the skills of graduates with industry requirements to narrow the human capital gap.
 - Investment in primary and secondary education, in which the state typically plays a larger role, remains important; however, Asia’s skill crisis primarily reflects the failure of Asian universities to produce enough graduates with the strong skills and qualifications required by modern service industries.
 - The fundamental solution to the crisis thus lies in building stronger education systems capable of delivering better-qualified graduates with more skills. The guiding principle of education reform must be to foster more competitive education markets.

Policy options – human capital gaps

- Building world-class tertiary education systems by whatever path is key to filling human capital gaps in modern service industries.
 - One way is to allow greater private sector participation. As skill training is profitable, there should be plenty of interest in the private sector.
 - Microsoft’s partnership with top universities in the PRC is a good example of the benefits of private sector participation. To mitigate its own skill shortage, Microsoft formed partnerships with four universities to set up software labs where interns learn practical software development.

Policy options – human capital gaps

- Fostering competition among public educational institutions is also important.
 - The Republic of Korea recently slashed public funding for under-performing universities.
- Public–private partnerships are yet another mechanism for encouraging entry into education and hence competition.
- As education reform is inevitably both costly and long term, the time to act is now given the urgent need to transform the service sector.
- Policy options over the shorter term include adopting Singapore’s exceptional openness to skilled workers from overseas which has contributed greatly to its success as a global financial service center.

Policy options – other areas

- Governments can promote greater investment in service research and development by providing fiscal incentives such as tax credits and grants.
 - Parsimonious research and development can be a significant barrier to innovation and movement up the value ladder to services with a higher value added.
- Lower-income countries that lack capacity for research and development can import advanced service technology through trade and FDI.
- Another approach is to speed the development of inclusive finance to provide more and cheaper loans to the entrepreneurs and small and medium-sized enterprises that drive service industries.

Policy options – data gaps

- The lack of high-quality data on Asia's service sector limits understanding of it and thus constrains the ability of policy makers to formulate and implement appropriate policies.
 - By far the most important constraint on timely, conceptually sound, and comprehensive analyses of services is the lack of high-quality, publicly available data.
 - The sheer diversity of services, their intangible nature, and their multiple modes of delivery make them difficult and costly to measure consistently, comprehensively, and validly.
 - This is not unique to developing Asia or to emerging economies in general.

Policy options – data gaps

- To facilitate more accurate understanding of services and their constraints, governments in the region should strive to collect better data on the sector and to publish it more promptly.
 - The size and growing importance of the sector justify investing more government resources in it; otherwise, governments will remain hard pressed to put in place policies that foster service sector development.
 - Better data would directly inform policy makers and provide indispensable inputs to empirical research that would ultimately deepen knowledge of the sector.
- The huge diversity of services argues for prioritizing the collection of industry data.
 - If several different bodies produce data, effective coordination to ensure consistency is essential.

Policy options – data gaps

- Several priorities stand out.
 - National statistical systems should advocate for the collection and dissemination of service statistics thereby raising awareness and securing the means to improve human resources and the statistical infrastructure for better data collection. They should reassure respondents of their commitment to preserving confidentiality.
 - Systems should improve the coordination of administrative sources of data and of access to them which may require legal changes.
 - Finally, they should develop road maps for sustainably improving statistics on services

Policy options – data gaps

- Meanwhile, the international community should provide training and technical assistance to build capacity in handling statistics and should support research into more cost-effective methods of handling data.
 - It should actively facilitate collaboration, share experiences, and promote staff exchanges with national statistical systems encouraging South–South cooperation.
 - Development partners should support the implementation of new frameworks, manuals, and guidelines, in particular more specific guidelines on compiling service statistics that especially target statistical systems in developing countries.

Final thoughts

- The service sector will lead structural change in Asia's economy in the coming years.
 - Asia is largely following the international historical pattern and can expect services to provide a rising share of output and employment.
 - Furthermore, the region's rapid growth is giving rise to a large and growing middle class that typically has a healthy appetite for services like healthcare, education, finance, leisure, and others.

Final thoughts

- The quantitative expansion of services is in and of itself neither good news nor bad news for Asia.
 - On the negative side, the sector is often the last resort for workers unable to find jobs in manufacturing and provides only marginal, low-wage employment; in fact, labor productivity in Asia's service sector currently falls far short of standards in advanced economies.
 - Therefore, the region faces the fundamental challenge to foster the expansion of vibrant, highly productive services.

Final thoughts

- The guiding principle for Asian policy makers must be to create more competitive environments for their service industries.
 - Many are dominated by SOEs protected by regulatory barriers to competition from domestic start-ups.
 - Trade and FDI barriers similarly protect them from foreign competitors.
 - Removing these and other anti-competitive impediments is key to promoting competition.
 - More competition will raise service sector productivity which can in turn lift productivity in other sectors.

Final thoughts

- The future of the sector depends on whether the expansion of services in Asia is driven by dynamic, open competition or by the inflexible protection of vested interests.
 - If competition prevails, Asia can establish a robust, highly productive sector generating collateral benefits for other industries and providing services that power inclusive growth.
 - Competition, in particular foreign competition, worked miracles for manufacturing in Asia as the region transformed itself into the factory of the world.
 - It can work new miracles for the region's service sectors and for the broader economy.