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Critical Issues in India's Services-led Growth

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Introduction

India's emergence as one of the fastest growing economies in the 1990s is largely attributed to the rapid growth of its services sector. The sector grew in this decade at an average of 7.9% per annum, far ahead of agriculture (3%) and manufacturing (5.2%). Consequently, the contribution of services to gross domestic product (GDP) has been more than 60% per annum since 2000. The share of services in trade has also increased substantially.[1] This growth has been accompanied by increasing foreign direct investment (FDI) approvals in the services sector.[2]

Though these trends are in line with global trends, two features are distinctive to India's services sector. First, in the period 1950s–1990s, the share of agriculture in GDP declined by about 25 percentage points, while industry and services gained equally. The share of industry has stabilized since 1990 and consequently, the entire subsequent decline in the share of agriculture in GDP has been picked up by the services sector. This trend (rising share of services in GDP and corresponding decline in the share of agriculture and manufacturing sector) is seen in the growth process of high-income countries and not in general in developing countries. During the 1990s, the contribution of the services sector to the growth of GDP in India was nearly 46%, in contrast to 54% in middle-income countries, 43% in least developed countries, and 34% in China.

Secondly, employment in services has not been in proportion to their rising share in GDP and trade in India, unlike in the rest of the world. In 1999-2000, services contributed around 24% of employment in India, in contrast to 30% in middle-income countries, 70% in Singapore, and around 35% in Thailand.

These features of India's services-led growth cast doubts on its sustainability in the long run. The main objective of this paper is to examine the reasons of these features and suggest policy directions to

[1] Services trade has grown at the same rate as goods trade over the 1990s, i.e. about 6.5%.

[2] FDI approvals in services sector are around 30% of FDI approvals. The share of services in employment was around 24% on an average during 1990-2000.

make this growth sustainable. We first look at the growth pattern and employment potential of disaggregated services. We next examine the trade potential of different services to ascertain the sustainability of growth of the services sector.

Growth in India's services sector has not been uniform across services. While some sectors experienced a double-digit growth rate some others had a negative growth rate. Prime drivers of growth were business services (growing by almost 20%), communication services (about 13.6%), banking (about 13%) and hotels and restaurants (around 9%). Among the services witnessing a decline in growth were railways, dwellings and real estate, legal services, public administration, and defense services. In terms of share in GDP the most important services are wholesale and retail trade (14%) followed by community services (8.4%) and banking and insurance services (7%).

Growth of employment differed significantly across services in the period 1994–2000 as compared to 1983–1994. Growth of employment fell in community, social and personal services from 3.85% to –2.08%. Fall in employment in this sector has important implications for employment potential of the entire services sector since this sector witnessed a rise in its growth[3] and share in GDP in the 1990s. Another sector where employment growth fell is electricity, gas, and water supply. In 1999-2000, the share of different services in employment was as follows: trade, hotels and restaurants (around 34%), community, social and personal services (around 31%), construction (16%), and transport, storage, and communication services (13%).

The trends in employment elasticity of different services sectors have also changed considerably in the 1990s (Table 1). The trends show that employment elasticity in the economy declined sharply from 0.41 in the 1980s to 0.15 in the 1990s but it increased substantially in transport, storage, and communication sector. However, employment elasticity has fallen in sectors that are faster growing and make a relatively higher contribution to GDP, namely, community, social, and personal services and financial services. Employment elasticity fell also in wholesale and retail trade, which provided maximum employment in the services sector.

[3] Community, social, and personal services grew by 7.9% on an average during 1994–2004.

Table 1. Trends in Employment Elasticity

Sector	*1983-84 to 1993-94*	*1993-94 to 1999-2000*
Electricity, gas, and water supply	0.33	0.26
Construction	1.00	1.00
Trade	0.63	0.55
Transport, storage, and communication	0.49	0.69
Financial services	0.92	0.73
Community, social, and personal services	0.50	0.07
Total	0.41	0.15

Source: Report of Special Group on Targeting 10 million Employment Opportunities a Year in Tenth Plan, Planning Commission (2002).

It is thus seen that though services have been the fastest growing sector in the last decade and have contributed more than 50% to GDP, they provide less than 25% of total employment. Within the services sector, employment growth has been uneven. Services that have witnessed very high growth rates, e.g. business and communications services, have a low share in GDP or employment. In most of the services with significant share in GDP (trade, community services and banking and insurance) employment elasticity has declined in the latter half of the 1990s.

Reasons for this 'Jobless Growth'

This 'jobless growth' has three plausible explanations. First, sectors that have large potential for generating employment, e.g. construction, transport and professional services, have grown slowly. Faster growing sectors, e.g. services and communications and financial business services, have a low potential for employment generation. In addition, employment elasticity has declined in the fast growing services like financial and community services.

The rising productivity levels in the faster growing services themselves may be a reason for lack of growth in their employment potential. Few studies have estimated productivity growth in services because of the difficulty in measuring their output. One of these studies, by McKinsey & Co. (2001) estimates labor productivity in six segments of India's services sector, namely, telecommunication, software, retail banking, housing construction, energy distribution (electricity) and retail distribution. It finds that software services have the highest productivity levels, followed by telecommunication, banking, and construction. These are also services that are growing faster and have high shares in GDP and employment. Higher labor productivity in these segments may have slowed down growth in employment in services.

Also, communication and software services, which have witnessed an increase in their trade, and therefore have grown substantially, have a small employment potential. Therefore, trade liberalization in services has not helped in generating large employment.

What Explains India's Services Sector Growth

Studies by Gordon and Gupta (2004) and Banga and Goldar (2004), which empirically assess the reasons for the growth of India's services sector in the 1990s, conclude that both demand and supply factors have led to this growth. On the demand side, the high growth of services output was mostly attributed to factors such as increasing input usage of services by other sectors, mainly manufacturing sector (i.e. higher domestic demand); higher foreign demand due to trade liberalization; and high income elasticity for services. On the supply side, the increased trade in services following trade liberalization policies and other reforms in the 1990s induced this growth.

On the demand side, Banga and Goldar (2004) show that the contribution of services input to output growth in manufacturing (organized), which was about 1% in the 1980s, increased to about 25% in the next decade. Gordon and Gupta (2004) show that the use of services sector input to industry increased by about 40% between 1979-80 and 1993-94. The role of elastic final demand for services is difficult to measure, since it is difficult to split the growth in private final consumption expenditure into expenditure on goods and that on services. Nonetheless, they use a rough estimate and conclude that there has been a sharp growth in the final demand for services in the 1990s.

On the supply side, the percentage share of exports of services vis-à-vis merchandise exports in GDP has steadily risen. In 1998, the share of services in trade increased to 24.9% from 19.3% in 1995. Services that contributed substantially to India's exports in the early 1990s were transport, travel, communication, and financial services. However, the composition of India's exports of services has changed over the years. In the period 1990–95 to 1996–2002, the relative share of travel in exports has fallen from 39% to 23%, and of transportation services from 24% to 15%. In contrast, the share of software services has risen sharply from 34% to 60%. In fact, India has become a net foreign exchange earner in total services after 1997-98. Net foreign exchange earning services are mainly travel, communication, and software services. India, however, is a net importer in services like transport, management, and financial services.

Thus, the growth of India's services sector may be attributed to:

- Structural changes that have led to increase in usage of services by other sectors;
- Trade liberalization in services; and
- Other reforms carried out in the 1990s.

Policy Directions: What Needs to be Done

India's services sector has witnessed tremendous growth in the last ten years but its employment potential has not grown proportionately. Neither has there been a corresponding growth in manufacturing, one of the largest consumers of services. This has cast doubts on the sustainability of services-led growth. Not only do services that have increased their share in GDP and trade have small employment potential, their employment elasticity has fallen due to rising labor productivity.

One possible reason for this lopsided growth in services is lack of a coherent policy with respect to services. For lack of an integrated services policy analogous to the industrial policy and agricultural policy, reforms at the sectoral level have evolved in an ad-hoc, uneven manner. Liberalizing a particular service, e.g. retail trade, will fall short of the desired impact if it is not supported by liberalization in real estate. Similarly, reforms in tourism will remain half measures unless corresponding reforms are undertaken in domestic air travel.

Moreover, given the large externalities of services,[4] it is important to provide services as efficiently as possible. The three services having the

[4] Hansda (2001) estimates the Ramsmussen index of backward and forward linkage for 115 activities in different sectors and finds that services have maximum forward as well as backward linkages.

largest backward and forward linkages are trade, transport, and construction. Transport (road, railways, and air) and construction services have large external economies and linkages, but in India these two sectors have been slow-growing. Improving these infrastructure facilities will not only enhance the country's attractiveness to foreign investment but also improve the competitiveness of domestic investment. These sectors also have large potential for generating employment.

Trade in services can suffer from both external and domestic constraints. External constraints or trade barriers are mainly in the form of limits on foreign equity participation, recognition, and licensing of provisions, immigration and labor market regulations, and discriminatory treatment with respect to taxes, subsidies, and other policies. Domestic constraints may result from infrastructure inadequacies, poor quality and standards, lack of clear-cut responsibilities between central and state governments, and other policy-related disincentives.

In order to examine the extent of external and domestic constraints to trade in India's services sector we classify services in terms of their external trade barriers, i.e. extent of liberalization (which is captured by the FDI cap and restrictions on trade in Mode 4), growth rates, and share in exports of services (Table 2).

It is seen from Table 2 that not all services that have low external trade barriers and high growth rates have a high share in exports. In particular, health and education services have low external trade barriers and experience high growth rates but have a low share in exports. This reflects high domestic constraints in these services. It also indicates that there exists a high potential to trade in health and education services but domestic policies or infrastructure restricts trade.

Given the large potential for trade in these services, specific policies should be designed to encourage trade in health and education sectors. In particular, given the low-cost quality treatment available in India, there is a large scope for health tourism. India also has a competitive advantage in the practice of alternative medicine. These areas should be developed and exploited for trade opportunities. Since the health sector is on the concurrent list, i.e. both state and central governments have jurisdiction over this sector, a number of regulations are imposed by the state governments.[5] Thus, though there is no cap on FDI in health

[5] There are also state-specific regulations of the town and planning departments on the design and construction of healthcare infrastructure, which form important domestic constraints to trade in health services.

Table 2. Categorization of Services: Extent of Trade Liberalization, Export Share, and Growth

	Substantially Liberalized	*Moderately Liberalized*	*Less than Moderately Liberalized/ Restricted*
High growth (10% and above)	Software services↑ Telecommunication→	Banking→ Insurance→ Travel↑ Health↓ Education↓	
Moderate growth (5–9%)			Legal↓
Low growth (0–5%)	Transport (road)↓	Construction↓ Air transport→	Professional services↓ like Postal, Accountancy, etc. and Rail transport↓

Note: The categorization of the extent of liberalization in different sectors is based on World Bank (2004), *Sustaining India's Services Revolution*, World Bank Group, South Asia Region: India.
↑ = High share in exports of services (10% and above);
→ = Moderate share in exports of services (5–9%);
↓ = Low share in exports of services (less than 5%).

services, the share of health services in total trade and FDI remains low (only 0.4% of FDI approvals in health). There is therefore a need to have a clear-cut demarcation of responsibilities of Center and State in this sphere.

To improve trade in education services, there is a need to study the system of regulation and accreditation of educational institutions in foreign countries and accordingly develop own accreditation system.[6] There is also a need to improve on educational database regarding

[6] To compete successfully with the existing educational testing services of repute such as GRE, GMAT and TOFEL, our testing services of repute such as CAT, GATE, JEE, and others must upgrade and modernize.

number of educational institutions, their enrolments (domestic and foreign), faculty strength, financial sources, and quality and accreditation.

Further, there are services that are less than moderately liberalized or are restricted with high external trade barriers and low growth, e.g. professional services like legal and accountancy and rail transport. These services also have a low share in exports, which reflects both domestic and external constraints to their trade.

On the whole, infrastructure services (e.g. transport and construction) are slow growing and have a low share in trade in spite of the efforts to lower external trade barriers to them. In other words, high domestic constraints impede their growth and trade. In contrast, the financial infrastructure of India appears to be stronger and services like software, banking, insurance, and telecommunications show low external trade barriers and high growth rates, with high to moderate share in total exports. Health and education have experienced high growth rates and have a large potential for trade.

In trade liberalization of services, however, the social costs involved also need to be considered. For the Indian economy, this is particularly relevant, given the employment dimension of the services sector.[7] An argument put forward against trade liberalization in services is the displacement of labor towards sectors where an economy has competitive advantage. If these sectors lack large employment potential trade can lead to growth in unemployment.

Also, some of the services that have traditionally been under the public sector (e.g. railways) have surplus labor. Higher extent of trade liberalization in these sectors might result in large displacement of labor. Similar concerns also apply to sectors like retail distribution, which employs a large number of unskilled labor. Displacement of labor in these sectors might cause considerable social unrest. Hence, trade liberalization in these sectors must be undertaken in a phased manner, accompanied by appropriate policies to curb unemployment.

Last but not least, empirical research in services in India is limited. Reliable, timely, and easily interpretable data are lacking. Trade data on services at a more disaggregated level, consistent with value-added and employment data and comparable across time would go a long way in promoting research in this field.

[7] The services sector in 1999-2000 accounted for almost 68% of urban employment.

Constructing an index for services would also help in assessing services. Such an index can be constructed by first identifying suitable measures for the output of different services and then attaching appropriate weights to different services. This will not only help in assessing the growth in different services but also help in formulating policies vis-à-vis disaggregated services.

In conclusion, it is of utmost importance to have a coherent and integrated services policy (analogous to the industrial policy and agricultural policy). This would lead to systematic reforms in different services. Services that have large potential for employment, e.g. construction, transport, and professional services should be encouraged to grow faster. The high trade potential of sectors such as health and education should be exploited. Liberalization should, however, be followed in a phased manner, accompanied by social policies in sectors that have surplus labor, e.g. retail and wholesale trade and railways.

Finally, full gains of trade liberalization in services will follow only if certain economy-wide efforts are made to make the general environment more conducive to trade and investments in services. Macroeconomic policies like high tariff rates, large fiscal deficits, and rigid labor laws may adversely affect the competitiveness of services. Economy-wide efforts to improve the business environment and remove domestic constraints can go a long way to sustain the dynamism of India's services sector.

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