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Beyond Manufacturing: Developing the Service Sector to Drive Growth in the PRC

WEI WANG, GEMMA ESTRADA, JURGEN CONRAD, SANG-HYOP LEE, AND DONGHYUN PARK

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SUMMARY As demand from global markets declines, slowing exports of manufactured goods from the People's Republic of China means the country must increasingly rely on domestic markets for growth. Unlike manufactured goods, services—those "intangible" products that include everything from transportation to scientific research to real estate services—are geared more toward domestic markets. Services, then, will be key to the rebalancing process. However, while the service sector has grown rapidly in the PRC, it continues to lag behind other countries at similar stages of development. In addition, the sector is dominated by traditional low-end types of services, rather than knowledge-intensive services. Heavy regulatory burdens, barriers to trade in services, and an unfavorable policy environment have been major obstacles to upgrading the sector and improving its competitiveness. Policy reform should focus on strengthening competition to raise productivity, with the goal of increasing not only the number of jobs and contribution to GDP, but also of positioning the service sector to compete internationally and spur export growth.

Services as a Powerful Engine for Growth and Employment

Contrary to popular perceptions, the service sector helped raise the efficiency of the economy

Market-oriented reforms in the People's Republic of China (PRC), along with its opening up to the outside world, brought rapid industrialization, urbanization, and integration into the international trade arena. However, since the global financial crisis of 2008–2009, the external environment has deteriorated substantially. Growth has declined in both advanced and developing countries. Therefore, while exports will continue to be important in the post-crisis period, the PRC will have to rely to a greater extent on domestic demand to sustain economic growth.

The service sector can play a central role in this rebalancing process. Compared to manufacturing, services are more geared toward domestic demand, and especially consumer demand. Stronger private consumption goes hand in hand with a productive service sector that delivers a wide range of affordable, high-quality services that people want. Furthermore, due to synergies between the service and manufacturing sectors, service sector development will help to upgrade the PRC's manufacturing sector. In addition, the labor-intensive nature of services means that the service sector can be an engine of job creation as well as economic growth.

The PRC's service sector witnessed rapid, sustained development, with an average annual growth rate of 10.7 percent during 1978 to 2013.[1] Services greatly contributed to the PRC's economy in terms of both growth and employment.[2] The share of services in total GDP (gross domestic product) increased from 23.9 percent in 1978 to above 40 percent since 2000. In 2013, services accounted for 46.1 percent of GDP in current prices, exceeding the manufacturing industry's share for the first time. Clearly, the PRC is moving to a new stage of development, with services being the main engine of growth.

At the same time, the share of service sector employment in overall employment rapidly grew from 12.2 percent in 1978 to 38.5 percent in 2013, generating most of the country's new jobs. The employment provided by the service sector stood at 296.4 million in 2013, 6.1 times that of 1978. In other words, services provided 7.3 million new jobs annually over the past three decades.

Contrary to popular perceptions that manufacturing is more efficient, the service sector has actually helped raise the efficiency of the PRC's economy. Since 2000, labor productivity—the amount of real GDP produced per worker—in the sector has increased at an average annual rate of 7.6 percent. This was 1.1 percentage points higher than the increase in labor productivity of manufacturing over the same period. In the service sector, the average annual total factor productivity (TFP) growth rate—a rate that measures the portion of GDP not explained by labor and capital inputs—was 1.9 percent from 1997 to 2009, a sharp increase from the 0.1 percent reported for 1981 to 1996.

Development Gaps and Structural Problems

Despite these achievements, the development of the service sector in the PRC has lagged behind that of other countries at similar stages of development, not only in terms of the sector's relative contribution to GDP and employment, but also in terms of the kind of industries that make up the sector and its overall productivity and competitiveness.

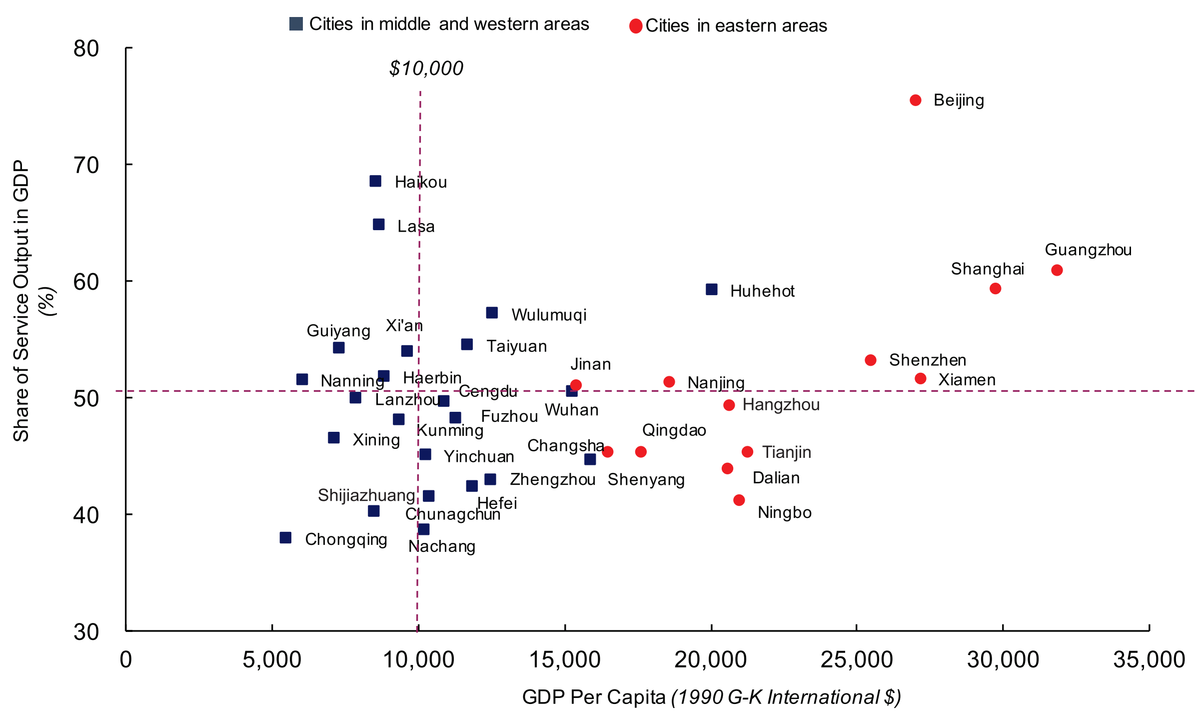
First, the percentage of GDP generated by services is still low. In 2013, the PRC's GDP per capita was $9,828 (in 1990 international dollars) and the share that services contributed was 46.1 percent, which is about 13 percentage points lower than an economy would typically reach at this level of GDP per capita.[3]

Second, the number of jobs generated by services (known as "share of services in total employment") still lags behind the sector's contribution to GDP ("share of services in total output or GDP"), and is also below international benchmarks. The average gap between the service sector's employment and output figures has been 10 percentage points over the past 30 years, with employment scoring lower.[4] In contrast, in middle-income countries such as Brazil and Malaysia, service employment shares have not lagged far behind service output shares. This indicates that the service sector in the PRC has not yet realized its full potential for job creation. Helping workers move from low-productivity agriculture into the service sector can help raise overall productivity levels.

Third, the structural upgrading of the service sector—the move from low-end services such as wholesale and retail trade, as well as transport and storage, to high-end services such as financial intermediation, computer services, business services, communications, and legal and technical services—is still at an early stage. The sector is dominated by traditional low-end and labor-intensive services, although their importance has declined since 1990. The structural upgrading to modern, knowledge-intensive services[5] has gained traction, and their share in total service sector output increased from 27.3 percent in 1991 to 39.9 percent in 2011. However, compared with the corresponding share of about 45 percent in Malaysia and Thailand, for instance, there is still a gap in service composition between the PRC and other upper middle-income countries. Further, the structural upgrading of urban areas for services also lags behind, although services have developed better in larger cities. In 2011, 288 cities with populations of 500,000 or more accounted for 67.8 percent of the service sector output, but 35 mega-cities out of the 288 accounted for nearly 50 percent of the output.[6] While less than half of the mega-cities had a service sector share above 50 percent of their GDP (Figure 1), the GDP per capita of most was above $11,000 (in 1990 international dollars), which implies a service sector share of 60 percent when compared with international GDP/service sector ratios.[7]

The sector is still dominated by low-end and labor-intensive services

Fourth, there are great differences in consolidation and integration among various service industries. In highly concentrated industries such as banking, the main participants are a few large companies. The top five commercial banks are all state-owned and accounted for 44.3 percent of the total banking assets in 2013. In highly competitive industries such as retailing, on the other hand, the concentration is



GDP = gross domestic product; 1990 G-K International $ = Geary-Khamis International dollar

Figure 1. Development of the Service Sector in Selected Large Cities in the People's Republic of China, 2011.
Source: National Bureau of Statistics of China.

quite low, with millions of small and medium-sized enterprises and self-employed businesses dominating the industry. Although consolidation and integration have increased via the chain-store format since the beginning of the century, the market share of the top 100 chain-store companies increased to merely 11 percent in 2011 from 5.4 percent in 2001. This relatively small jump is the result of restrictions that prevent consolidation and thwart the competitiveness of large retail companies.

Fifth, the international competitiveness of the PRC's service sector needs strengthening. The country's lack of competitiveness is highlighted by the expanding deficit in trade in services since the latter half of the 1990s. In addition, when comparing the structure or makeup of service exports with that of developed countries, the sector's disadvantages become evident. Exports of knowledge-intensive services are a good example. In the PRC, the share of total exports of high-end services is still small compared to advanced countries. Exports in finance accounted for only 0.5 percent of total service exports in 2011, which compares to 12.7 percent for the United States in 2011. Similarly, insurance accounted for 1.7 percent (US: 2.6 percent), and patent rights and royalties accounted for 0.4 percent (US: 20.8 percent).[8]

To understand these low figures, it's useful to compare the service sector to the manufacturing sector. In the PRC's export-oriented manufacturing sector, a key factor behind its dramatic increase in international competitiveness was an inflow of foreign direct investment (FDI). In contrast, due to entry barriers, most FDI in the PRC's service sector goes to real estate services, which in 2010 accounted for 43.6 percent of total FDI in the service sector. Knowledge-intensive service industries accounted for only 11.4 percent of total FDI.[9] The current barriers to FDI inflows work against the restructuring and upgrading of the country's service sector.

Government policy encouraged investment in manufacturing at the expense of services

Sixth, productivity in the PRC's service sector is relatively low and unbalanced. It has lagged behind other countries with similar income levels, in part because of the dominance of traditional labor-intensive services over high-end, modern services. In 2012, the country's labor productivity in services was only equivalent to about 34 percent to 66 percent of labor productivity in Brazil, Mexico, and Peru. Within Asia, there is a similar gap between the PRC's labor productivity and that of other upper middle-income countries. For example, labor productivity was about 49 percent that of Malaysia and 82 percent that of Thailand.[10] On the other hand, there are obvious differences among various ownership structures in the service sector that affect productivity. One study found that state-owned enterprises controlled by the central government are the most productive. In contrast, collectively owned firms are the least productive, followed by state-owned enterprises belonging to local governments. Private firms fall in the middle.[11]

Obstacles and Constraints Facing the Service Sector

Given the ongoing transformation of the PRC's economic system from a centrally planned economy to a market economy, the market system is still imperfect and institutional impediments to conducting business remain. This largely explains why the PRC's service sector is still not on a par with other economies.

First, policymaking has traditionally not favored the service sector. The bias toward a capital-intensive growth model explains, in large part, the underdevelopment of the service sector. Government policy allowing price distortions encouraged investment in manufacturing at the expense of services.[12] Over the past decades, most preferential industrial policies at all levels were concentrated on manufacturing to increase GDP growth, tax revenues, and capital investment. In 2011, the top five taxable service industries were wholesaling and retailing, finance, real estate, leasing and business services, and individual services in all sectors. The total tax burden was equivalent to 32.7 percent, 31.8 percent, 32.3 percent, 30.5 percent, and 24.2 percent of total output, respectively. The ratio levied on manufacturing, by contrast, was only 20.5 percent.[13] However, since July 2012, the PRC has been replacing its steep turnover tax with a value-added tax that allows for deductions in selected service industries. This should help to reduce the tax burden on services and level the playing field with manufacturing, although the rollout has yet to be completed and it is too early to assess its impact. At this stage, the tax burden is still heavier for services than for manufacturing due to the taxation system and preferential tax policy that favor the manufacturing sector.

Second, the PRC's service sector still faces serious challenges to market access. Before companies are allowed market entry, they must adhere to a system of administrative examination and approval. Access standards are unclear, examination and approval procedures are complex, and transparency is low, thereby increasing costs and hindering diversification and competition. According to the OECD Service Trade Restrictiveness Index (STRI),[14] the PRC scores are above average in almost all service industries, indicating how poorly the country fares in terms of market access (Figure 2).

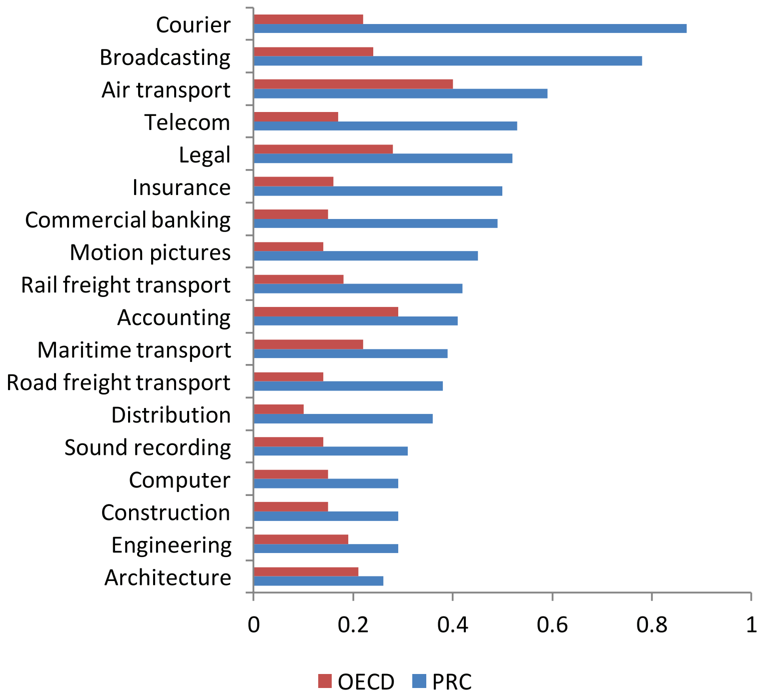


Figure 2. Service Trade Restrictiveness Index: PRC and OECD Comparison.
Source: OECD.

The PRC's service sector still faces serious challenges to market access

Third, while the PRC has made great efforts to promote openness and introduce competition in some service industries, other important industries such as railroad transportation, education, healthcare, news and publishing, broadcasting, and television are still dominated by state-owned enterprises. As affiliated units or branches of relevant government departments, state-owned service institutions traditionally have not had the freedom or the right to make business decisions, including those related to resource allocation. As a result, the development of those state-owned service providers is not driven by market demand. For example, average per capita medical expenditures in urban households grew by 13.4 percent from 2000 to 2012. However, the number of medical institutions decreased from 1.03 million to 0.95 million. As state institutions dominated certain markets, private service providers have seen access blocked—a consequence of favorable private sector policies going unenforced. The State Council released two documents in 2005 and 2010

It remains difficult for non-state service providers to overcome discriminatory treatment

that contained 36 policy measures aimed at developing the private sector and small and medium-sized enterprises.[15] Most of these measures have yet to be implemented because there is no mechanism for revising relevant laws and regulations to put them into effect. As a result, it remains difficult for non-state service providers to overcome discriminatory and unfair treatment in order to enter or expand in the service industry.

Fourth, service sector providers lack effective and fair legal protection. Among various forms of service businesses, only corporate enterprises and self-employed businesses are protected by relevant laws and regulations, while other forms are subject to unfair or even discriminatory treatment, or suffer from a lack of recognition in terms of specific laws and regulations. For example, there is no clear, unified, legal definition and standard to regulate nonprofit organizations in the PRC, which are important service providers worldwide in medicine, education, culture, and social welfare. Only the Law on Corporate Income Tax[16] includes a definition of those nonprofit organizations that are designated as tax exempt. The lack of clarity overall makes it difficult for non-state-owned service providers to register as nonprofit organizations.

Fifth, government intervention with regard to prices and resource allocation is still strong in the service sector. The government retains significant power to allocate land, capital, and human resources, and to set the price for services—for instance, interest rates, transportation fees, tuition, and medical treatment fees. Further, a number of departments at different levels of government are often involved in regulating a particular service industry. The logistics industry is a good example. It involves 12 departments in the central government and all their corresponding agencies at the local level of government, from provincial capitals down to counties.[17] Each of the 12 departments is in charge of regulations and holds administrative responsibility for one or more aspects of logistics, and all have their own codes and standards. As such, logistics providers face a very complicated regulatory environment. Even within the government, it takes considerable time to negotiate and coordinate policy changes with different agencies across central and local government offices.

Strategic Measures and Policy Options for Promoting Services in the Next Five to Ten Years

In light of ongoing industrialization, urbanization, globalization, and economic reforms, there is great potential for the PRC to grow rapidly, driven by two engines: namely, manufacturing and services. In order to realize its potential and take advantage of the opportunity to enhance its service sector, the PRC should promote the sector's development through in-depth, market-oriented reforms.

Particularly in the coming 13th Five-Year Plan period, the PRC should develop a comprehensive national strategy to enhance the service sector. The goal should be not only maintaining the sector's high rate of economic growth, but also increasing its economic efficiency, innovative capacity, and employment contribution. To promote the country's "harmonious development" strategy, a concept similar to synergy, the following approaches to service sector development should be considered:

(1) Develop new service industries, in parallel with traditional services, through structural upgrading and business innovation, information technology applications, and professional training in traditional services.

(2) Develop business services along with personal and community services such as healthcare and education, which could contribute to improved living standards and enhanced quality of labor.

(3) Develop the service sector in large cities, as well as medium-sized and small cities and towns with relatively large populations and

significant manufacturing. In addition, develop specific service activities in towns and rural regions to meet the demands of modern agriculture. Cities should be allowed to pursue their own paths of specialization.

(4) Open up the service sector to both local and international markets, thus encouraging service providers to compete with their counterparts both domestically and globally. Also, offer more support to domestic service providers to facilitate their entry into global markets.

In the next 10 years, many development opportunities will arise for the PRC's service sector, but also many critical challenges. The government should put substantial efforts into reforms, in addition to providing stimulating and supportive policies for the sector. Specific tasks and priorities include the following:

(1) Reform regulations on market entry by reducing the length of the negative list, which defines areas or economic activities with market-entry limitations. Following the success of pilot reforms in Shenzhen, develop a national negative list. In addition, update regulations on market entry to make them fair, equal, and standard for all service industries, thereby encouraging the investment of private capital in the service sector.

(2) Reform the regulatory and supervisory systems to clarify the role of government in the service sector and advance its transformation. Promote reform of the administrative framework, increase efficiency and transparency with new supervisory measures and tools, and strengthen government capacity to regulate through data collection and updated statistical systems, credit reporting systems, knowledge sharing, and staff training.

The central problem is low productivity, which is caused by lack of competition

(3) Reform institutional arrangements for diverse service entities, including in-depth reforms of state-owned enterprises—from human resource management and the pension system to ownership, corporate governance, and wage and salary systems. In addition, promote the reforms across the country, and update legislation and regulations to safeguard various types of service industries.

(4) Improve support systems such as government performance evaluation, taxation, and procurement. Specifically, extend value-added tax reforms to all industries in the service sector during the 13th Five-Year Plan and provide tax preferences for innovation to service firms, such as corporate tax deductions for research and development expenditures.

(5) Accelerate reform for the service sector by drafting an overall design and timetable in the 13th Five-Year Plan period or beyond. Promote pilot testing of regulatory reforms in selected state-dominated industries, such as banking, telecommunications, education, broadcasting, social security, healthcare, sports, and other areas, according to their different features and reform requirements. Explore comprehensive reform measures by testing and assessing the policy effects in regions and big cities with high concentrations of service industries.

The PRC's service sector faces serious constraints to development, yet it is vital for rebalancing the economy, sustaining economic growth, and creating millions of jobs for the workforce. The central problem of the PRC's service sector is its low productivity, which is caused by lack of competition in many service industries. Therefore, the cornerstone of reform must be opening up such industries to competition. Doing so would raise productivity. The specific reforms outlined in this paper will unlock the potential of the service sector to become an engine of growth and job creation for the PRC, which is especially important in the challenging post–global financial crisis era.

References

[1] According to the PRC's Industrial Classification and Codes for National Economic Activities (GB/T 4754—2002), the service sector mainly includes transportation and communications; storage and postal services; information transmission, computer services, and the software industry; wholesale and retail trade; accommodation and catering; financial services and real estate; leasing and commercial services; scientific research, technical services, and geological surveys; water conservation; managing the environment and public facilities; residential and other services; education, healthcare, social security, and social welfare; and culture, sports and recreation, public administration, and social organizations. In the PRC, scholars and government statistical departments often identify the service sector with the tertiary industry.

[2] Asian Development Bank, *Developing the Service Sector as an Engine of Growth for Asia* (Manila: ADB, 2013).

[3] Tao Liu and Wei Wang, "Prospect and Strategy of China's Service Sector in 13th FYP," Working Paper of the Development Research Center (DRC), 2015.

[4] That may be partly due to a lack of data. For example, in some low-end services such as catering, there are no complete statistics. However, statistics of other countries face similar problems.

[5] Modern knowledge-intensive services include information and communications technology, computers and software, finance and insurance, scientific research and technical services, education, healthcare, social security and social welfare, and public services.

[6] The 35 mega-cities include the four municipalities of Beijing, Shanghai, Tianjin, and Chongqing that are under the direct administration of the central government; the 26 provincial capitals (excluding Tibet); and the five large cities specially designated in the State Plan, i.e., Dalian, Ningbo, Xiamen, Qingdao, and Shenzhen.

[7] Asian Development Bank, *Developing the Service Sector as an Engine of Growth for Asia* (Manila: ADB, 2013).

[8] World Trade Organization, International Trade Statistics, Geneva, 2013. http://www.wto.org/english/res_e/statis_e/its2013_e/its13_trade_category_e.htm.

[9] National Bureau of Statistics, *China Statistical Yearbook 2005, 2011* (Beijing: China Statistics Press).

[10] Estimated using data on services value-added from the World Bank's World Development Indicators and employment data from the International Labour Organization's Key Indicators of the Labour Market and CEIC Data Company (accessed February 9, 2016).

[11] Margit Molnar and Wei Wang, *A Snapshot of China's Service Sector*, OECD Economics Department Working Papers No. 1217 (Paris: OECD Publishing, 2015). http://dx.doi.org/10.1787/5js1j19lhbkl-en.

[12] N. Lardy and N. Borst, *A Blueprint for Rebalancing the Chinese Economy*, Peterson Institute for International Economics Policy Brief PB13-02 (Washington, DC: Peterson Institute, 2013).

[13] Calculated by the authors based on data from the *China Statistical Yearbook 2012* and *China Taxation Yearbook 2012*.

[14] The Service Trade Restrictions Index (STRI) helps identify which policy measures restrict trade. It compares the trade restrictiveness of services across 18 sectors in 34 OECD (Organisation for Economic Co-operation and Development) members and 6 key partner economies, including the PRC, Brazil, Indonesia, India, Russia, and South Africa. The STRI indices take values from 0 to 1, where 0 is completely open and 1 is completely closed.

[15] The two documents issued by the State Council are mostly called the "36 Articles for the Non-State-Owned Economy." The earlier version is the "Guiding Opinions on Promoting and Supporting the Non-State-Owned Economy" by the State Council, issued in 2005. The more recent version is the "Guiding Opinions on Promoting and Leading the Healthy Development of Private Investment" by the State Council issued in 2010.

[16] Clause 4 of Article 26 in the Law on Corporate Income Tax of the PRC and the Notice on Tax-Free Income for Nonprofit Organization Enterprises (No. 122 of Finance and Revenue, 2009) issued by the Ministry of Finance and the State Administration of Taxation have clarified the condition of tax-free income by restricting the scope of services and expenses of nonprofit organizations.

[17] The members of the National Committee on Logistics Industry Development include 12 departments and 3 industry associations: National Development and Reform Commission, Ministry of Commerce, Ministry of Railroads, Ministry of Transportation, Ministry of Industry and Information, National Civil Aviation Authority, Ministry of Public Security, Ministry of Finance, China's Customs Head Office, National Administration Bureau for Industry and Commerce, National Administration of Taxation, General Administration of Quality Inspection, National Standardization Committee, China Federation of Logistics and Purchasing, and China Communications and Transportation Association.

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1601 East-West Road
Honolulu, Hawai'i 96848-1601

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About the Authors

***Wei Wang** is director general of the Institute of Market Economy, Development Research Center of the State Council in the People's Republic of China.*

***Gemma Estrada** is senior economics officer at the Economic Research and Regional Cooperation Department, Asian Development Bank.*

***Jurgen Conrad** is principal economist at the People's Republic of China Resident Mission, Asian Development Bank.*

***Sang-Hyop Lee** is professor in the department of economics, University of Hawaii at Manoa, and adjunct senior fellow, East-West Center.*

***Donghyun Park** is principal economist at the Economic Research and Regional Cooperation Department, Asian Development Bank.*

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