Interview with Donghyun Park, Principal Economist in the Economic Research Department at the Asian Development Bank

Competition Will Enhance Service Sector Growth Potential in Developing Asia

By *Japan SPOTLIGHT*

Asia is a center of global growth today, but what sector will be the major source of Asian growth? Economic theory says that as economic development progresses, the service sector enlarges its share in the economy. In this regard, as most Asian nations are developing, their service sectors must play a key role in their growth. It is also pointed out by economists that the service sector's employment absorption capacity would be far greater than the manufacturing sector, and so expansion of the service sector would contribute significantly to job creation, in particular jobs for professionals in services, such as IT software engineers with high salaries. Expanded employment will encourage a nation's personal consumption. Some developing Asian nations are today occasionally referred to as suffering from the "middle income trap", meaning in their economic development they face the challenge of an underdeveloped "middle class" due to the widening income inequality between the rich and the poor. The service sector's expansion could mitigate this challenge as well by expanded employment.

Dr. Donghyun Park, a distinguished economist with the Asian Development Bank and one of the authors of an important review on the service sector in Asia titled *"Developing the Service Sector as an Engine of Growth for Asia"* (2012), kindly responded to our questions as below on the basis of his analysis in his book, still relevant today.

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Service Economy in Asia

JS: What is the present situation of the service sector in Asian countries? How great is the share of the service sector in GDP and employment in Asian countries? Is it significant? Do you think that the service sector is making a major contribution to inclusive growth as well as job creation?

Donghyun Park, Principal Economist in the Economic Research Department at the Asian Development Bank

Park: 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 China from 2000 to 2010.

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 two 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.

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.

JS: How do you predict growth of services in the coming years in Asia? Would "connected industries" — a concept of service economization of the manufacturing sector — be a driving force for service sector growth in Asia?

Park: 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.

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.

JS: What are the characteristics of service sector productivity in Asia?

Park: 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 China. In the worst cases, it may take up to 30 years to reach 20%.

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.

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.

JS: What do you think would be a driving force to lift labor productivity in developing Asia's service sector?

Park: Growing per capita GDP will help to lift labor productivity in developing Asia's service sector. According to our econometric analysis, the lower the initial per capita 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.

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.

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, China'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.

Policy Recommendation

JS: What do you think would be key themes for policies to raise labor productivity and the growth potential of the service sector in developing Asian countries?

Park: 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 policy makers depend on to formulate effective measures to fill these gaps.

JS: How can they deal with regulatory gaps?

Park: 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 China, India, and Indonesia is about twice as high as it is in the 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 to competition and innovation in service markets.

The guiding principle for regulatory reform should be to tackle entrenched vested interests to create more competitive service markets, however politically difficult disarming them can be. Where public monopolies exist, restrictions on the entry of private firms should be eased to promote greater competition. SOEs themselves must be reformed to run along more commercial lines.

Political will is needed to tackle the entrenched vested interests that hinder competition in the service sectors of many Asian countries. Often what is needed is better regulation rather than less regulation. A sound, transparent, responsive regulatory framework that creates certainty is key to creating a sound business environment that attracts investment.

Developing Asia should promote trade and foreign direct investment (FDI) in services. Despite the prospects of large gains from opening up — gains associated with both exports and imports — the region still maintains high trade barriers. The increasing tradability of services and the region's recent history of benefiting hugely from liberalized merchandise trade strengthen the argument for more trade. Countries in developing Asia need to prioritize services when negotiating regional agreements and to expand the coverage of services in those pacts. Liberalizing FDI regimes would boost already large FDI inflows into the region. Because trade and FDI barriers protect vested interests and restrict competition as much as domestic regulations do, dismantling them requires strong political will.

An important caveat is that regulatory reform may dislocate previously protected firms in the short run. Service sector regulations designed to protect a particular group of firms from competition inevitably relieve competitive pressure and thus abet poor productivity. To minimize short-term dislocations caused by deregulation, however, gradual, well-sequenced deregulation coupled with adequate safety nets is the best approach.

JS: How can they respond to infrastructure gaps?

Park: Basic infrastructure for electricity, transportation, and communication affects the productivity of the entire economy, including the service sector. While countries in East and Southeast Asia have invested heavily to build relatively good infrastructure, other countries in the region have poor infrastructure that hinders both manufacturing and services. It is especially important to address infrastructure gaps in industries such as ICT that have the potential to catalyze large gains across the economy. By reducing the cost of information and enabling new economic activities, ICT offers the promise of advancement onto higher growth paths.

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. There is a need to build more schools to deliver more and better education as well as more facilities for healthcare and other basic services. The need for large infrastructure investments is not confined to countries with infrastructure deficits such as India but extends to China and other countries perceived to have relatively good infrastructure.

JS: How can they tackle human capital gaps?

Park: 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 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.

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.

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. Fostering competition among public educational institutions is also important.

JS: How can they respond to data gaps?

Park: 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.

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.

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 roadmaps for sustainably improving statistics on services.

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.

Conclusion

JS: What is a key guiding principle for Asian service sector development policy?

Park: 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.

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. 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. JS

Formatted by Naoyuki Haraoka, executive managing director and editor-in-chief of *Japan SPOTLIGHT*.