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GROWING IMPORTANCE OF SERVICES SECTOR FOR INDIA

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ABSTRACT

The 1st stage when the primary sector is the dominant sector in GDP, the second stage in which manufacturing is dominant and the third stage in which the tertiary sector is dominant and is identified with countries in an advanced stage of development. India's growth experience does not seem to follow this theory of stages as the high growth and high share of services sector which is a feature of a developed economy has been attained by India even before reaching a developed stage. Rather than debating on which growth strategy is ideal, it is important to realise that the constraints in the industrial and agricultural sectors and the natural advantage of India in services sector has led to a services led growth of the economy. While the constraints in the other two sectors need to be removed as is being attempted now, there is no need to expect the hare to sleep for the tortoise to overtake it. There is infact a need to tap our full potential in the services sector.

EVOLUTION OF AN ECONOMY FROM PRIMARY SECTOR BASED TO TERTIARY SECTOR BASED

During early civilization all economic activity was in primary sector. When the food production became surplus people's need for other products increased. This led to the development of secondary sector. The growth of secondary sector spread its influence during industrial revolution in nineteenth century. After growth of economic activity a support system was the need to facilitate the industrial activity. Certain sectors like transport and finance play an important role in supporting the industrial activity. Moreover, more shops were needed to provide goods in people's neighbourhood. Ultimately, other services like tuition, administrative support developed.

INTERDEPENDENCY OF SECTORS

To understand this interdependency, let us take an example of a cold drink. A cold drink contains water, sugar and artificial flavour. Suppose if there is no sugarcane production then procuring sugar will become difficult and costly for the cold drink manufacturer. Now to transport sugarcane to sugar mills and sugar to the cold drink plant needs the services of a transporter. A person or system of persons is required to maintain and monitor all these movements of goods from farm to factory to shop in different locations. That is where role of administrative staffs comes. Let us go back to the farmer. He also needs feritlisers and seeds which is processed in some factory and which will be delivered to his doorstep by some means of transportation. To top it all at every step of these activities we require the proper monetary and banking system. So, in a nutshell this describes how interrelated all sectors of an economy are.

PRIMARY SECTOR

When the economic activity depends mainly on exploitation of natural resources then that activity comes under the primary sector. Agriculture and agriculture related activities are the primary sectors of economy.

SECONDARY SECTOR

When the main activity involves manufacturing then it is the secondary sector. All industrial production where physical goods are produced come under the secondary sector.

TERTIARY SECTOR

When the activity involves providing intangible goods like services then this is part of the tertiary sector. Financial services, management consultancy, telephony and ITare good examples of service sector.

CONCEPTUALISATION OF SERVICES

The earliest attempt to define services was made by **Hill (1977 pp336**) who argues that “goods and services belong in different logical categories.” He focused on the fact that producers cannot accumulate stock or inventory of services, stressing that services must be consumed as they are produced unlike the goods that can be produced and then stored. This makes it essential for the user and the provider of the service to interact. But subsequent to this conceptualization there have been many studies2 that point out that **Hill’s definition** simply relates to **contact services** and that there exists a range of services which do permit a separation (in space as well as in time) of the location of production and consumption, so that service trade may take place either at the factor or at the product level.

Bhagwati (1984) argues that services can be divided into **two** categories; first, those that necessarily require the **physical proximity** of the user and the provider; and second, those that do not essentially require this though it may be useful. Services that require essential physical proximity have been further categorised into three groups that are:

a) Mobile provider and immobile user, e.g., shifting labour to the construction site in other country.

b) Mobile user and immobile provider, e.g., hospital services

c) Mobile user and mobile provider, e.g., lectures, haircuts, etc.

Further, **Bhagwati (1985**) argues that services for which physical proximity is inessential, i.e., the long distance services, are on a rise due to technical progress, e.g., banking and insurance. However, unlike in the case of goods where factor mobility and trade are distinct phenomena, in the case of services the distinction vanishes as factor mobility and trade in services are two integral aspects of service transaction but, **Stern and Hoekman** (1988) point out that services can be: (1) complementary to trade in goods; (2) substitute for trade in goods; (3) unrelated to goods.

All these characteristics have implications for how trade can occur. For the purpose of classifying international transaction in services the most commonly used classification is provided by **Sampson and Snape** (1985) and modified by **Sapir and winter (1994**). This classification, which is based on the constraints on the physical location of producer and consumer in realising the transaction, has been adopted by World Trade Organisation (WTO) under the General agreement on Trade in Services (GATS). The Agreement applies to four “modes of supply”

Mode 1: cross-border supply of service (i.e., not requiring the physical movement of supplier or customer)

Mode 2: Provision implying movement of the consumer to the location of the supplier;

Mode 3: services sold in the territory of a Member by (legal) entities that have established a presence there but originate in the territory of another Member; and

Mode 4: provision of services requiring the temporary movement of natural persons.

Alternatively, many studies adopt a broader and simpler definition of services that help indistinguishing services from goods. One such broad definition of services is: ‘services form a diverse group of economic activities not directly associated with the manufacture of goods, mining or agriculture’. Thus, studies have put forward alternative definitions and classification schemes depending on the purpose of their study. However, the basic characteristics of services on which most of the classifications are based are: non-transferability and non-storability. Other associated characteristics of services that need to be noted are services are heterogeneous and flexible in production and imperfect competition is highly relevant for services.

For the purpose of our study we broadly use the United Nations' International Standard Industrial Classification (ISIC). The broad categories of services in this classification include electricity, gas and water; construction; wholesale and retail trade; hotels and restaurants; transport, storage and warehousing; post and telecommunication; financial institutions; insurance; real estate; business services; machinery and equipment rental and leasing; public administration and defense; sanitary and social services; social and related community services (including education, research and scientific institutions, medical, professional and labour associations, radio and television broadcasting, entertainment services); and personal and household services.

IN INDIA SERVICES INCLUDE FOLLOWING SUB-SECTORS

1. **Trade** (Wholesale trade and retail trade in commodities both produced at home (including exports) an imported, purchase and selling agents, brokers and auctioneers)
2. **Hotels and Restaurants** (services rendered by hotels and other lodging places, restaurants, cafes and other eating and drinking places)
3. **Railways**
4. **Transport by other means** (roads, water, air transport, services incidental to transport)
5. **Storage**
6. **Communications**
7. **Banking** (banks, banking departments of RBI, post office4 saving bank, non-bank financial institution, cooperative credit societies, employees provident fund)
8. **Insurance** (life, postal life, non-life)
9. **Dwellings, real estate**
10. **Business services**
11. **Legal services**
12. **Public administration, defense**
13. **Personal services** (domestic, laundry, barber, beauty shops, tailoring, others)
14. **Community services** (education, research, scientific, medical, health, religious and other community)
15. **Other services** (recreation, entertainment, radio, TV broadcast, sanitary services

Development theory usually identifies three stages of development, the 1st stage when the primary sector is the dominant sector in GDP, the second stage in which manufacturing is dominant and the third stage in which the tertiary sector is dominant and is identified with countries in an advanced stage of development. India's growth experience does not seem to follow this theory of stages as the high growth and high share of services sector which is a feature of a developed economy has been attained by India even before reaching a developed stage. Rather than debating on which growth strategy is ideal, it is important to realise that the constraints in the industrial and agricultural sectors and the natural advantage of India in services sector has led to a services led growth of the economy. While the constraints in the other two sectors need to be removed as is being attempted now, there is no need to expect the hare to sleep for the tortoise to overtake it. There is infact a need to tap our full potential in the services sector.

The Share of the Services Sector

	Percent of GDP			
	1960	1980	1995	2004
UK	53	54	66	72
Australia	51	58	70	71
France	52	62	71	73
Japan	42	54	60	68
USA	58	64	72	75
Singapore	78	61	64	65
Hong Kong	62	67	83	88
China	20	21	31	35
India	30	36	41	52
Sri Lanka	48	43	52	58

Service sector has emerged as the largest and fastest-growing sector in the global economy in the last two decades, providing more than 60 per cent of global output and, in many countries, an even larger share of employment. The growth in services has also been accompanied by the rising share of services in world transactions. Testimony to the rise in international supply of services is the fact that trade in services has grown as fast as trade in goods in the period 1990-2003 (i.e., 6% per annum). Along with this, worldwide there has been a marked shift of FDI away from manufacturing sector towards services sector. The share of services in total FDI stock has now increased to around 60% since 2002 as compared to less than half in 1990 and only one quarter in 1970s. In line with the global trend, service sector in India has also grown rapidly in the last decade. Its growth has in fact been higher than the growth in agriculture and manufacturing sector. It now contributes around 51 percent of GDP. In the trade mode, services trade has also grown at the same rate as goods trade over the 1990s (i.e., about 6.5 per cent) and its share in total trade has reached around 24 per cent. Growth of trade in services has also been accompanied by growth in the share of services in total inward FDI. FDI (approvals) into service sector constituted around 30 percent of total FDI approvals in 2003. Interestingly, outward FDI from India has also grown rapidly and in 2003 outward FDI stock in services constituted around 25% of total outbound FDI stock.

However, though the growth of service sector in India is in line with the global trends, there are two unique characteristics of India's service sector growth. First, the entire decline in the share of agriculture sector in GDP, i.e., from 32 % in 1990 to 22 % in 2003, has been picked up by the service sector while manufacturing sector's share has remained more or less the same. In general, such a trend is mainly experienced by high-income countries and not by developing countries. And second, in spite of the rising share of services in GDP and trade, there has not been a corresponding rise in the share of services in total employment. This jobless growth of India's service sector, with no corresponding growth in the share of manufacturing sector, has raised doubts about its sustainability in the long run. If we exclude the services sector, and take only the agricultural and industrial sectors (commodity sector GDP), we find that value added there is now growing at a crawl — between 1996-97 and 2002-03, at the annual rate of just 0.7 per cent per capita. (Without the benefit of the new series of GDP, which systematically overestimates agricultural GDP, we would probably find the per capita commodity sector GDP actually falling in that period.)

Share of Different Sectors in GDP

(GDP at factor cost, 1993-94 Prices)

	Agri.	**Industry**	**Services**	**Total**	**Services%**
1970-71	137320	46151	113438	296278	38%
1980-81	159293	70687	171148	401128	43%
1990-91	223114	150383	319374	692871	46%
2000-01	285877	263797	649011	1198685	54%
2001-02	302054	272359	691016	1265429	55%
2002-03	292625	288266	739842	1320733	56%

-- RBI, Handbook of Statistics on the Indian Economy

India's bloated growth of the services sector and the shrinking share of the industrial sector is in contrast to certain other Asian countries. The share of industry in GDP in 2001 was 51.1 per cent in China, 49.6 per cent in Malaysia, 46.5 per cent in Indonesia, 41.4 per cent in Korea, and 42.4 per cent in

Thailand. However, in the case of India it was just 26.4 per cent in 2001, down from 29.3 per cent in 1990. (See **Table)**

Table: Shifting Shares of Different Sectors in GDP in China, Malaysia, and India

(GDP at current market prices)

Country	**Agriculture**				**Industry**				**Services**		
	1980	1990	2001		1980	1990	2001		1980	1990	2001
China	30.1	27	15.2		48.5	41.6	51.1		21.4	31.3	33.6
Malaysia		15.2	8.4			42.2	49.6			42.6	41.9
India	38.1	31	24.7		25.9	29.3	26.4		36	39.7	48.8

Economic Survey, 2002-03

Nor does industry account for a growing share of employment. The share of industry (including construction) in employment in 1999-2000 was just 17.5 per cent, the same as in 1987-88. Most of the labour which cannot find a livelihood in agriculture is unable to find jobs in industry either, and has become part of the lower end of the 'services' sector, working as petty vendors and such types of disguised unemployment.[23] Between 1987-88 and 1999-2000, the share of agriculture in employment fell from 60.1 to 56.7 per cent. The difference — 3.4 per cent — landed up in the services sector.

Table 17: Shares of Agriculture, Industry and Services in Employment

(Casual Daily Status basis)

	1983-84	**1987-88**	**1993-94**	**1999-00**
Agri.	63.2	60.1	60.4	56.7
Industry	15.6	17.6	15.8	17.6
Services	21.2	22.3	23.8	25.7

Economic Survey, 2002-03

Studies show that the employment elasticity in the service sector as a whole in the post-reform period (1993-2000) has been 50 per cent higher than in manufacturing sector. India's share of employment growth in the service has been higher than in manufacturing sector on Usual Principal Status (UPS) basis (see Table 1). In the decades of eighties and nineties, the fall in the share in employment in agriculture sector has been increasingly absorbed by the service sector. However, in 2004-05 compared to 1999-2000, there is a change with the fall in employment share of the agriculture sector being absorbed both by the manufacturing and service sectors with a higher share for the former. Like other countries of

South East Asia, like Malaysia, Thailand and Indonesia, in India also a larger share of employment has been created in the service sectors, in the eighties and nineties.

Table 1

Shares and change in sectoral shares of employment in India(UPS basis)

	1983			1993-94			1999-2000			2004-05		
Shares (percentage)	Agri 66.2	Man 14.6	Serv 19.8	Agri 61.7	Man 15.7	Serv 22.6	Agri 58.5	Man 16.7	Serv 24.7	Agri. 54.2	Man 19.4	Ser. 26.4
Change in shares				83 to 93-94			93-94 to 99-00			99-2000 to 2004-05		
				Agri -4.5	Man 1.1	Serv 2.8	Agri -3.2	Man 1.0	Serv 2.1	Agri -4.3	Man 2.7	Ser. 1.7

Source: Planning Commission

While the recent rise in share in employment growth in manufacturing sector is a positive development, the importance of services in employment creation needs to be noted, particularly when India is competitive in many labor-intensive and skill-intensive services and there is a huge market (both domestic & external) including outsourcing to India, which needs to be tapped further.

PATTERN OF GROWTH OF INDIA'S SERVICE SECTOR

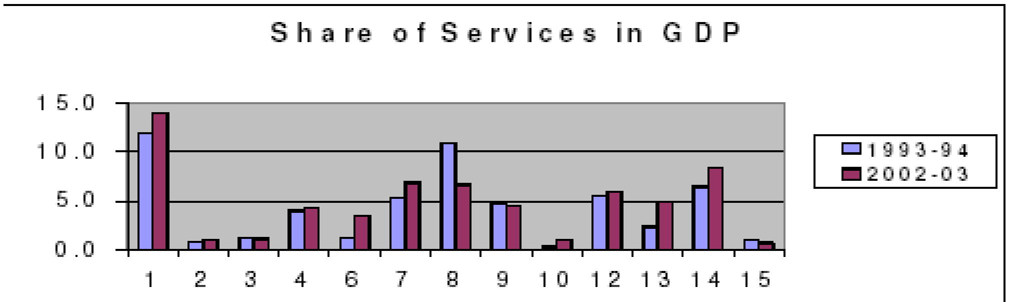
A closer scrutiny of India's service sector reveals that amongst services, business services has been one of the fastest growing services in the 1980s closely followed by banking and insurance (as seen in Table 1). In the 1990s, we find that a similar trend continues for business services, which grows by almost 20 percent, but while the growth in banking has increased growth in insurance sector has slowed down in the 1990s. The prime drivers of growth in services, apart from business services in the 1990s, are found to be communication services (with average growth of around 13.6 %) and hotels and restaurants (with average growth of around 9%). However, there is a fall in the growth rates of railways, dwellings and real estate, legal services and public administration and defense in the 1990s.

Table

	1980s	1990s
Trade (Wholesale trade and retail trade)	5.9	7.3
Hotels and Restaurants	6.5	9.3
Railways	4.5	3.6
transport	6.3	6.9
storage	2.7	2
communications	6.1	13.6
banking	11.9	12.7
Insurance	10.9	6.7
Dwellings, real estate	7.7	5
Business services	13.5	19.8
legal services	8.6	5.8
public administration, defense	7	6
personal services	2.4	5
Community services	6.5	8.4
other services	5.3	7.1

Source: CSO

Further we find that increase in the share of services in GDP has not been the same across the board for different services in India [as seen in Figure 3]. Figure 3 compares share of different sectors in GDP in the last ten years, i.e., 1993-94 and 2002-03. The most important services in terms of their share in GDP in early 1990s were trade (12%), insurance (11%), community services (6.5%), but in 2002-03 we find that the sectoral contributions have changed. Share of trade has increased to 14% and community services to 8.4%. But share of insurance has declined to 7%. Other services that have witnessed a fall in their shares in 2002-03 are railways, real estate and dwellings.



Source: Author's estimates based on Economic Survey and CSO.

Note: Services with share less than one percent has not been shown.

1. **Trade** (Wholesale trade and retail trade in commodities both produced at home (including exports) an imported, purchase and selling agents, brokers and auctioneers)
2. **Hotels and Restaurants** (services rendered by hotels and other lodging places, restaurants, cafes and other eating and drinking places)
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14. **Community services** (education, research, scientific, medical, health, religious and other community)
15. **Other services** (recreation, entertainment, radio, TV broadcast, sanitary services.

What emerges from the above trends is that, services sector has grown in importance as compared to other sectors in terms of its contribution to GDP and also its growth rates since 1990s. But this growth in share of GDP differs for different services. The most important service in terms of its share in GDP in the last decade has been wholesale and retail trade. But in terms of growth, we find that business services and communications have experienced the maximum growth in the 1990s, but their share in GDP is still quite low. Community services (which include education and health) on the other hand, have improved their share in GDP and also their growth rates in the 1990s.

The growth rate of services in 2004-05, 2005-06 and 2006-07 were 9.6 percent, 9.8 per cent and 11.0 per cent, respectively and is expected to grow at 9.9% in the 11th Plan. The GDP growth performance of the Indian economy during 2003-04 and 2004-05 indicated a possible ratcheting up of the trend rate of GDP growth of the economy from 6% to about 7% per year. The sectoral break-up of India's growth shows the ratcheting up of the trend growth rate in the services sector from 6.7% in 1983-93 to 8.2% in 1993-03. Since 2004-05 the growth rate of services sector is at 10 per cent, while the general growth of the economy has moved up to 9.0% in 2005-06 and 9.4% in 2006-07. The manufacturing sector growth was more or less the same at 6% in 1993-03 compared to 6.1% in 1983-93, though it has risen to 9.1 per cent in 2005-06 and 12.3% in 2006-07 with the aim of 12% (10.5% projection for Industries) in the 11th Plan period. Agriculture sector growth was low at 2.3% in 1993-03 and fluctuated from one extreme of 10 per cent in 2003-04 to another extreme of 0.0 per cent in 2004-05. In 2005-06, agricultural growth rate was 6.0 per cent, but in 2006-07 it again fell to 2.7% and is expected to continue at 4.1% for the eleventh plan period. As a result, the share of services in India's GDP has increased from 37.6% in 1993 to 54.1% in 2005-06 and 54.9% in 2006-07. If Construction is considered as services as done by RBI, this share will increase by another 6.9% totaling to 61.8 per cent. Thus, India is nearing the shares of countries like the US, where the share of services in GDP is 73% (2003).

III. WHICH SERVICES HAVE GROWN RAPIDLY?

In this section we identify the drivers of the acceleration of growth in the services. The data on annual growth rate over the past fifty years (Figure 4) suggest a structural break in growth in services starting in 1980. Through the 1970s, the growth path was more or less flat, but the trend shifted upwards in the

1980s and then perhaps again in the 1990s. By contrast, the growth path for industry, which exhibited a declining trend between 1954–80, has been flat over the past two decades.

The acceleration in services growth in the 1980s and 1990s was not uniform across different activities. Some sub-sectors grew at a much faster rate than in the past, while for other subsectors; growth rates were similar to the past trend (Table 5). To identify the growth-drivers within the services sector, we compare the growth rates of various activities in the 1990s with their previous trend growth rates (Figure 5). The trend growth rates are estimated using the three year moving average of the growth rate, with the period 1954-90 used in estimating the trend (except for banking for which the trend is estimated using the data to1980). A comparison of the actual and the trend growth rates shows that growth in several service sub-sectors accelerated sharply in the 1990s (and for banking in the 1980s); indicating some sort of a structural break in their growth series. We call these activities fast growers. The remaining activities grew more or less at a trend rate; these we call trend growers.

A .FAST GROWERS

Based on the above criterion, fast growers were as follows:

• **Business services** (including IT) was the fastest growing sector in the 1990s, with growth averaging nearly 20 percent a year. Though disaggregated data for this category are not available, export and software industry data indicate that the growth was mainly on account of the IT sector. Despite being the fastest growing sector, business services, particularly IT activity, was growing off a low base and its contribution to the services sector and GDP growth was quite modest in the 1990s. As we discuss later, this segment is expected to continue growing at a very high rate and is likely to contribute more significantly to services growth in the future.

• **Communication services**, which registered growth of 14 percent a year during the 1990s, made a significant contribution to services growth. The growth in communication was mostly due to telecom, which accounts for 80 percent of output.

• In the **banking sector**, growth jumped from about 7 percent over the period 1950–80, to 12 percent in the 1980s, and 13 percent in the 1990s. Growth was most rapid in the NBFIs (which grew by 24 percent in the 1980s and 19 percent in the 1990s), followed by growth in the banks (by10 percent and 9 percent, respectively, in the 1980s and 1990s). Overall, the contribution of banking to services sector growth was larger than that of the communications sector.

• **Community services and hotels and restaurant**s increased at the trend growth rate through the early 1990s, but experienced a pick-up in growth in the latter part of the decade. In community services, this was due to both education and health services (70 percent and 23 percent of value added, respectively) growing at an average rate of 8 percent in 1990s.

B. TREND GROWERS

Among the trend growers, the growth rate of distribution services (the largest service subsector in India), averaged about 6 percent in the 1980s, higher than in previous decades, and accelerated further to about 7 percent in the 1990s—just below the threshold for fast growers. The rate of growth of public administration and defense in the 1990s averaged 6 percent, which was similar to the growth experienced in previous decades. Growth spiked in response to the Fifth Pay Commission awards to government employees in the late 1990s, but this did not substantially increase average sector growth for the decade as a whole. The growth rate of personal services jumped to 5 percent in the 1990s, but remained below the growth in most other services activities. The other sub-sectors such as transport, dwellings, and storage grew more or less at the same rate in the 1980s and 1990s as in previous decades.

C. CONTRIBUTION OF FAST AND TREND GROWERS TO SERVICES GROWTH

The fast growing activities accounted for about a quarter of services output in the 1980s, but because of their relatively fast growth, these activities represented one-third of services output by 2000. We show the estimation of the average contribution of the fast growers and trend growers to services growth in the 1950s–1970s, the 1980s, and the 1990s in Figure 6. Based on our estimates, the high services growth in the 1980s was primarily due to the trend growing sub-sectors. These activities added about 1 percentage point of additional services growth in the 1980s, while fast growing activities made a contribution only about half as large. In the 1990s, by contrast, fast growing sectors made about the same contribution to services growth as the trend growing sectors. In fact, since the growth of trend growing sectors was about the same in both decades, the fast growers collectively accounted for almost all of the higher services growth in the 1990s. This is consistent with new activities and industries having sprung up in the fast growth sub-sectors, but not in the trend growth ones.

SHARE IN TRADE

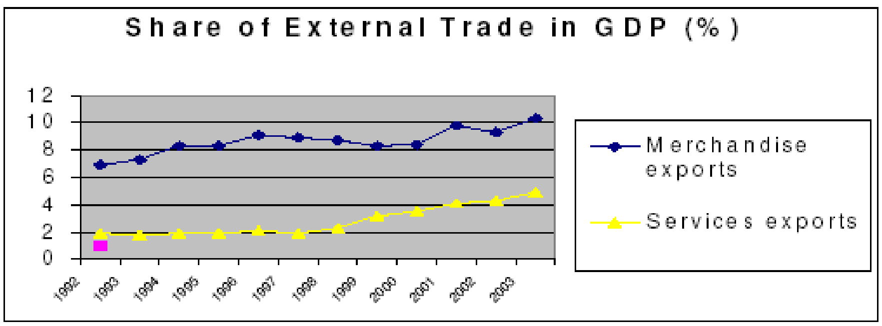
While there is a services dominated growth, India is also moving to a services dominated export growth. Due to the phenomenal rise in India’s export of services in the 1990s, India’ shares in total world an export of services has increased overtime (see **Table 2**). We find that services exports have always been higher than services imports in India.

India's Share in World Services Exports

Year	Exports of India's Services in (USD bn)	Imports of India's Services in (USD bn)	India's Share in World Exports of Services
1998-99	13.20	11.02	0.99
1999-2000	17.60	11.64	1.20
2000-01	20.40	16.39	1.40
2001-02	20.70	16.08	1.30

Source: WTO, Reserve Bank of India (2003)

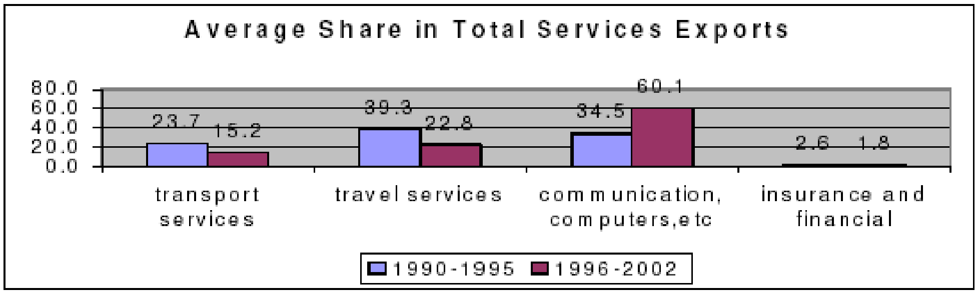
Compared to merchandise exports, we find that the percentage share of exports of services in GDP has steadily risen since 1998 (see figure 4). The share of services in total trade increased to from 19.3 % in 1995 to 24.9% in 1998.



Source: RBI

While merchandise export growth was 21% in 2006-07 on the top of a 23%, growth in 2005-06, services export growth rate in 2006-07 was 32.5% on top of a 31.7% growth in 2005-06. While the $ 31.3 billion software services grew by 32.6% in 2006-07 on top of a 37.2% growth in 2005-06, the $31.1 billion non-software miscellaneous services (mainly including business services) neared the value of exports of software services with growth of 39.3% in 2006-07 on top of a 67.0% growth in 2005-06 and 150.3% growth in 2004-05. Services Exports at $ 81.3 billion in 2006-07 is nearing merchandise exports at $124.6 billion. If labour services (reflected in private transfers) are taken, then the contribution of services will be still higher. India's share in world merchandise exports is at the 1% level in 2006 with the rank at 28, while its share in world commercial services exports is 2.7% with a rank of 10.

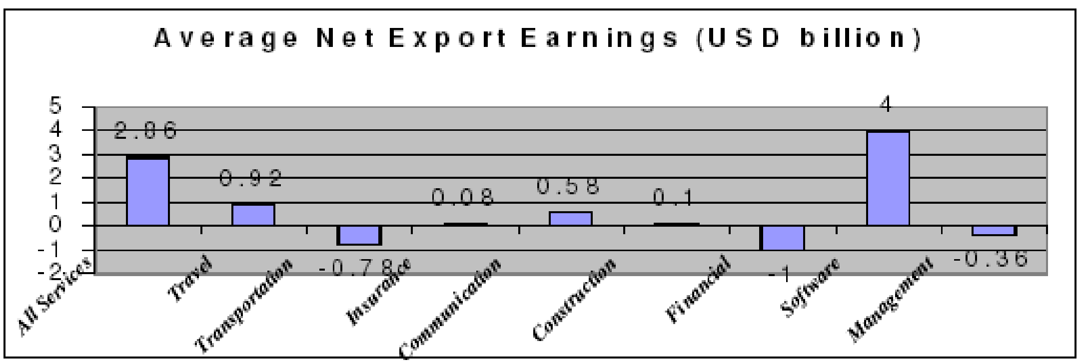
Figure 5



Source: World Development indicators (2004)

However, the **composition of India's exports of services has changed** over the years [as seen in Figure 5]. In the period 1990-95 to 1996-2002, we find that the relative shares in total exports of travel has fallen from 39 % to 23 %, while that of transportation services has fallen from 24 % to 15 %. On the other hand, there has been a substantial rise in the share of software services from 34 % to 60 %. In fact, India has become a net foreign exchange earner in total services after 1997-98. Services that are net foreign exchange earners are mainly travel, communication and software services while India is a net importer in services like transport, management and financial services (as seen in Figure 6).

Figure 6



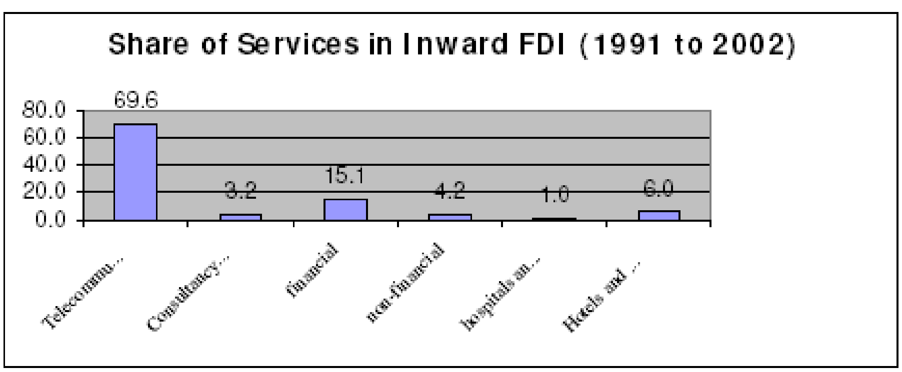
Source: Reserve Bank of India.
Average for the period (1998-99 to 2002-03)

According to World Bank (2004), India exhibits a strong revealed comparative advantage (RCA) in services as compared to goods. Between 1996 and 2000, the RCA index for services increased by 74 percent while that for goods declined by 15 percent. This increase in RCA of services was mainly on account of "other business services" which include software exports (IT and BPO), finance, communication, management, and consultancy and telecommunication sectors.

SHARE IN FDI

Along with trade, there has been a large inflow of FDI into India since 1990s onwards. India has been ranked in top ten FDI destinations in the World Investment Report (2004). However, this Increase in FDI inflows has been accompanied by a change in the structure of FDI. Following the international trend, FDI inflows into India are also shifting increasingly away from manufacturing sector, towards services sector. The average share of services in total FDI in the period 1990-94 increased from 10.5 per cent to 28.3 per cent in the period 1995-1999 (World Investment Report 2004). But, the inflow of FDI into services sector has been biased towards few of the services sectors (see figure 7). Sectors that have received largest approvals are telecommunications and financial services. Within telecommunication, the largest recipient is cellular mobiles. One of the striking features of India's FDI flows is the growing proportion of outward FDI from the services sector. The share of services in total FDI outflow increased to around 45 percent in the period 1999-2003, in which non-financial services constitute around 36%, trade is around 5% and the rest was from financial and other services. It is interesting to note that the sectors that received higher FDI in services, i.e., telecommunications, financial and consultancy services are also the fastest growing services sectors in the economy. Though the above analysis of performance of different services sectors does point out that trade and FDI in services sectors are also accompanied by growth in the sector, the impact of trade and FDI on the growth of services sectors has not yet been empirically examined. One of the main reasons for this is the lack of data on disaggregated services, both with respect to actual FDI and output of services. However, an important impact of FDI on services that has been studied is the impact on India's exports of back office services (McKinsey &Co. 2003). According to NASSCOM estimates foreign affiliates accounted for around 58% of exports in 2002-2003 of offshore using operations in India.

Figure 7



Source: SIA Newsletter 06/2002. Based on FDI Approvals

OPENNESS OF THE ECONOMY

India's trade in merchandise as a percentage of GDP which is usually used to measure the openness of an economy shows an increase from 14.7% in 1990-91 to 37% in 2006-07. If services trade which has been increasing steadily for India is also considered, total trade as a percentage of GDP shows a remarkable increase from 17.5% in 1990-91 to 52.7% in 2006-07.

INFLATION & SERVICES AND DOMESTIC TERMS OF TRADE INCLUDING SERVICES

The Wholesale Price Index (WPI) which is the main indicator of inflation, in India does not include services. The consumer price index for industrial workers (CPI-IW), Consumer Price Index for Urban Non-Manual Employees (CPI-UNME) and Consumer Price Index for Agricultural Labourers and Rural Labourers (CPI-AL&RL) include some services but their weightage is only about 10-15 per cent, though services form 54 percent of the GDP. While, in USA, where the contribution of services to GDP is around 73 percent, the consumer price index for all urban consumers (CPI-U) gives 59.9% weightage for services and consumer Price Index for urban wage earners and clerical workers (CPI-W) gives 55.4% weightage for services. In India, the services included in CPI-IW and CPI-UNME are Medical Care, Education, Recreation & Amusement, and Transport & Communication, while in the GDP of India the major services are trade, hotels, transport and communication and financing, insurance, real estate and business services. Even these indices are based on some sample surveys and are sometimes just approximations. A look at some services items included in CPI-IW for the latest available month shows that in May 2007, point to point inflation of Education & Recreation is only 2.0% compared to general CPI-IW inflation of 6.6%. Another item, Medical care (including both services and commodities) has inflation of only 5.9%. Transport and communication has a inflation of only 1.6% which is also a reflection of the low inflation of fuel. But none of these services have the high inflation of 9.1% of food group. While the services taken here are very limited, with the fall in prices of services like telecommunications, air transport (with no frills flights) and metro services, there is an indication that inflation could have a moderating effect, if services are included in inflation calculations. Besides, prices of services do not fluctuate at short intervals like commodity and manufacturing prices.

WHAT EXPLAINS GROWTH IN INDIA'S SERVICE SECTOR?

The literature on growth in service sector primarily argues that when an economy grows, both demand side and supply side factors operate that lead to higher growth in the service sector as compared to the other sectors and also lead to a larger share of service sector in total employment. These factors are:

A. Demand-Side Factors

a) High-income elasticity of demand for final product services,

b) Slower productivity growth in services that leads to higher employment potential and

c) Structural changes within the manufacturing sector, which make contracting out services more efficient than producing them in the firm or household.

B. Supply-Side Factors: Trade Liberalisation and Reforms

a) Increased trade

b) Higher foreign direct investments in services and

c) Improved technology

With respect to the Indian economy there exist two studies that empirically estimate the reasons for growth of India's service sector. These are by Gordon and Gupta (2004) and Banga and Goldar (2004). Gordon and Gupta show that on the demand side high growth of services output in the 1990s was mostly due to factors such as, increasing input usage of services by other sectors i.e., higher domestic demand, higher foreign demand for services and higher income elasticity for final demand for services. They measure the increasing usage of services in other sectors through changes in the input-output coefficients. The matrices for different years show that the use of services sector input to industry increased by about 40 percent between 1979-80 to 1993-94. But the role of elastic final demand for services was found to be 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 is a sharp growth in the final demand services in the 1990s.

Alternatively, the increased usage of services by manufacturing sector has been estimated by Banga and Goldar (2004) for 1980s and 1990s. For this purpose, they empirically estimate the contribution of services as an input to manufacturing (organized) output growth and productivity in Indian manufacturing using the KLEMS (capital-labor-energy-materials-services) production function. They use panel data for 148 three-digit level industries for 18 years, 1980-81 to 1997- 98, and estimate the production function, which has services used by the industry as one of the inputs8. The results of the analysis bring out that the growing use of services has a significant favorable effect on growth of output in Indian manufacturing in the 1990s, The coefficient of services is found to be positive and statistically significant. The contribution of service input to output growth in manufacturing was about one per cent in the 1980s, and it increased to about 25 per cent in the 1990s. Apart from growing demand for producer services, another important reason for growth of service sector, as highlighted by these studies, is the impact of trade liberalisation and reforms on growth of services. Gordon and Gupta use panel data regression for trade, hotels, rail transport, and transport by other means, storage, communications, insurance and other services for the period 1970-2000. Using sector-specific liberalisation dummies they find that sectors that were open for FDI, external trade, or private ownership, etc. were the ones which experienced faster growth. Alternatively, Banga and Goldar use multiple regression analysis and show that trade reforms carried out in the 1990s explain to a large extent the rapid growth of use of services in manufacturing. Lower tariff (adjusted for changes in real effective exchange rate) and lower nontariff barriers (in terms of import coverage ratio) were also found to have led to an increase in the usage of services in manufacturing sector. The process appears to have been aided by other reforms undertaken in this decade. Thus, the studies show that growth of India's services sector can be attributed to:

7. CONCLUSION AND SPECIFIC POLICY DIRECTIONS

India's services sector has witnessed tremendous growth in the last ten years. But this growth has not been accompanied by a corresponding growth in employment in the service sector. The share of manufacturing sector in GDP has also declined in the 1990s. This has led to a policy dilemma and doubts have been cast on the sustainability of service-led growth. The paper attempts to resolve some of these issues. It is found that growth in service sector has been lopsided and jobless. Some sectors have witnessed a double digit growth rate in the last decade, e.g., communication and business services, while some have experienced a fall in their growth rates, e.g., railways, real estate and dwellings. The sectors that have witnessed negative growth rates and those that have experienced slow growth rates are also the sectors that have large potential for generating employment, e.g., construction, transport and professional services. Rising labour productivity in the faster growing sectors has further reduced the scope for increasing employment in these sectors.

It is also argued that in terms of its service-led growth India is not an outlier. Growth in services has led to higher use of services in manufacturing sector. This has in turn led to higher output and productivity growth in the manufacturing sector, which implies that the service sector will be able to generate its own demand in the future. Studies also show that the growing dynamism of India's service sector is, to a large extent, due to growing external markets for services and the gradual, though partial liberalisation of domestic economy. Most of the studies on the Indian economy support the view that domestic reforms and higher liberalisation, in terms of lowering of barriers to trade and allowing FDI, have improved growth in the corresponding services. This increased external demand may also play an important role in sustaining the dynamism of services.

To resolve the problem of lack of employment growth in services, there is a need to achieve uniformity in the growth of different services. This becomes even more important if we consider the interdependency of different services. An important aspect of services is the ability to generate sizable external economies or diseconomies that are not reflected in the price signals. Also, closely linked is the problem of linkages, both backward and forward, with the rest of the economy and with its growth rate. Inefficiencies in services therefore can exert a multiplying effect on the economy as a whole and efficiency in providing services can make a considerable difference to the sectoral growth rates (e.g., for achieving higher efficiency in financial services like banking and insurance, we need efficient IT-related services).

One of the probable reasons for lopsided growth in services is the fact that reforms in India at the sectoral level have evolved in an ad-hoc way. There has been no coherent overall policy for services in line with the industrial policy and agricultural policy. Consequently, the depth and pace of reforms lack uniformity across sectors. Along with the national and international efforts to liberalise trade, India also needs to undertake some domestic reforms, e.g., institutional and regulatory reforms, so as to maximise the benefits of higher trade and FDI in services. In particular, the paper points to the following directions in the policy with respect to services:

I. Given the large externalities of services, it is important for an economy to provide services as efficiently as possible. Hansda (2001) estimates the Rasmussen index of backward and forward linkage for 115 activities in different sectors and find that the services that have maximum forward as well as backward linkages are trade, transport and construction. These sectors are found to have high domestic constraints and therefore require immediate policy reforms. Adequate infrastructure facilities will not only enhance the country’s attractiveness to foreign investment but will also improve competitiveness of domestic investment. Since these sectors have large potential for generating employment, growth in these sectors will also help in resolving the dilemma of jobless growth in the services sector. Most of these services still have considerable restrictions on FDI limits and Mode 4. Emphasis should be now laid in improving growth of these services by reducing external as well as domestic constraints, which have been identified by the specialised studies.

II. Assessment of performance of India’s different services shows that there exists some services which have low external barriers and high growth rate but these services have not been able to enjoy a suitable share in India's exports of services. In particular, we find that health and education sectors have high potential for trade since they have low external barriers and high growth rates. This indicates substantial domestic constraints in these services. Given the large potential to trade in these services, there is a need to undertake the following policy directions, as outlined by the specialised studies:

_ given the low cost quality treatment available in India, there is a large scope for health tourism in India. India also has a competitive advantage in the practice of alternative medicine. These areas should be developed and exploited for trade opportunities.

_ an important domestic constraint identified in the health sector is that since 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. 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. Thus, even though there is no cap on FDI in health services, we still find low share of health services in total trade and FDI (only 0.4 percent of total FDI approvals in health). There is therefore a need to have a clear-cut demarcation of responsibilities of Center and the State in this respect. Regarding 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. To compete successfully with the existing reputed educational testing services such as GRE, GMAT and TOFEL, our reputed testing services such as CAT, GATE, JEE and others must upgrade and modernise. There is also a need to improve on educational database regarding number of educational institutions, their enrolments (domestic and foreign), faculty strength, financial sources and quality and accreditations.

III. With respect to slow growing services, which have low share in exports, e.g., professional services, like legal, postal, accountancy, etc. we find that these services have restricted liberalisation. Both external and domestic constraints restrict growth in these services. Some of the important external and domestic constraints that have been identified by specialised studies and which need to be removed are:

_ With respect to legal services, many of the domestic policies need to be altered. For example, the Indian law which prohibits formation of partnership with enrolled professionals of foreign countries in legal services limits the scope for an Indian firm to build its capacity to advice on foreign law or international law or in a newly developed area. This needs to be suitably altered.

_ Prohibition on partnership with multi-disciplinary knowledge prevents capacity building in areas where technology progresses beyond comprehension of lawyer. Restrictions on joint ventures or establishment of firms in India by foreigners should therefore be relaxed, but since this would be a major reform strategically it would be better to delay it by few years.

_ in accountancy services, India does not yet have large firms with international visibility. There is a need to embrace international accounting standards and reporting requirements. The process of adoption should be treated as urgent and concomitant changes should be undertaken in domestic statutory legislation.

IV. Though there exists a strong case for trade liberalisation of services, one should not forget that growth is not the sole objective of an economy. Therefore social costs of trade liberalisation of services should also be considered. For the Indian economy this issue becomes even more relevant given the employment dimension of services sector. Services sector in 1999-2000 employed almost 68 percent of urban employment. One of the arguments that is put forward against trade liberalisation is displacement of labour towards sectors where an economy has competitive advantage.

However, some of the services sectors that have traditionally been under public sector, e.g., railways, postal services, etc. are saddled with excessive labour and higher trade liberalisation in these sectors might result in large displacements of labour. Similar concerns are also found in sectors like retail distribution sector that employs large number of unskilled labour. Displacement of labour in these sectors might cause lot of social unrest. Trade liberalisation in these sectors therefore must be undertaken in a phased manner accompanied by appropriate policies to curb unemployment. Thus trade liberalisation policies have to be supported by complementary social policies so as to avoid substantial social costs that might undermine the support for reforms.

V. Limited empirical research exists in the area of services in India. What remains the biggest hurdle in future research on trade and investment in services is the lack of reliable, timely and easily interpretable data. The data that is more widely available do not currently encompass all forms of trade in services, in particular intra-firm trade in services is not recorded. What is required is trade data on services at a more disaggregated level which is consistent with value-added and employment data and is comparable across time. Efforts should therefore be made to develop a suitable database for furthering empirical research in this field.

VI. There is a dire need to formulate an Index of Services in order to have a coherent policy on services. Appropriate measures to estimate output in services need to be identified and by attaching suitable weights to disaggregated services, index for services can be formulated. Given the heterogeneity of services, formulation of separate indices can also be considered.

Along with the above policy insights it must be kept in mind that full gains of trade liberalisation in services can be acquired by an economy only if certain economy-wide efforts are made to make general environment more conducive to trade and investments in services. Macroeconomic policies like high tariff rates, large fiscal deficits and rigid labour laws may have as adverse effect on competitiveness of services as on goods. Excessive regulations, discretion in the allocation of licenses and permits, corruption and poor quality of infrastructure could adversely affect the growth of services sector. But, studies have shown that business environment in India is not very competitive as compared to other developing countries. The regulatory and administrative burdens are considerably high and so are the labour market restrictions. These points to the need for regulation in services, which arises primarily from market failures attributable to natural monopoly and inadequate consumer information. However, it is beyond the scope of this paper to analyse the ways to overcome these weaknesses. But a strong and financially independent regulators and economy-wide efforts to improve business environment can go a long way to sustain the dynamism of India's services sector.

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