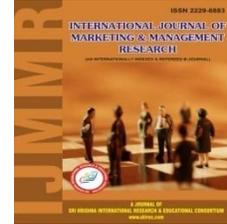




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## COMPREHENSIVE STUDY OF CRITICAL ISSUES IN SERVICE SECTOR GROWTH IN INDIAN MARKET

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### ABSTRACT

*Most of the developing economies, in the last decade, have undergone a significant structural shift. The share of agriculture in total value added has significantly declined, correspondingly the share of manufacturing and services sector has increased with the share of manufacturing sector growing at a faster pace than that of services Sector. However, India is a unique case in this respect. Most of decline in the agricultural Sector in India has been picked up by the services sector and it now accounts for more Than 50 per cent of the gross domestic product .Given the growing significance of the services sector, the paper identifies some of the critical issues in India's service-led growth and provides policy insights with respect to them. The critical issues identified are: what explains growth of service sector in India; what are the reasons for lack of corresponding growth in employment in the service Sector; can service sector sustain its growth*

**KEYWORDS:** *Structural shift, agriculture, service sector, service-led growth, critical issues.*

### INTRODUCTION

A service is the action of doing something for someone or something. It is largely intangible (i.e. not material). A product is tangible (i.e. material) since you can touch it and own it. A service tends to be an experience that is consumed at the point where it is purchased, and cannot be owned since it quickly perishes. A person could go to a café one day and have excellent service, and then return the next day and have a poor experience. So often marketers talk about the nature of a service as: 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<sup>1</sup>. In line with the global trend, service sector in India has also grown rapidly in the last decade

### **OBJECTIVE OF THE STUDY**

Following are the main objectives of this paper

- 1) To identify and discuss critical issues with respect to Growth of India's service sector.
- 2) To provide policy insights thereof.
- 3) An assessment of Performance of services at the aggregated as well as the disaggregated level.
- 4) To identify crucial constraints on their growth.

The Critical issues that have been identified are:

- I. What is the pattern of growth in India's service-sector, i.e., how do different services Compare in terms of their growth rates and shares in GDP, employment, trade and FDI?
- II. What explains growth in India's service sector?
- III. What explains the lack of employment growth in the services sector?
- IV. Can India's service sector sustain its growth?

### **SOME PATTERN IN GROWTH OF SERVICES**

#### **1 CONCEPTUALIZATION 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 conceptualisation there have been many studies<sup>2</sup> 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 assign 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 donate essentially require this though it may be useful. Services that require essential physical proximity have been further categorized 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.

## **2 GROWTHS IN SERVICES**

The emergence of India as one of the fastest growing economies in the world in the 1990s can be attributed, to a large extent, on the rapid growth of its service sector. The growth of output in the service sector in the 1990s has been much higher than the growth of output in agriculture or industry. Consequently, contribution of services to GDP in the period 2001-2004, has been more than 60 per cent per annum. However, this growth in the service sector has not been uniform. In order to arrive at some policy direction it is imperative to examine the performance of different services and assess the economy's potentials and constraints in these services. We examine the performance of aggregate as well as disaggregated services in terms of their growth rates; share in GDP, employment, trade and FDI.

## **3 SHARE IN GDP**

A striking feature of India's growth performance is that in the four decade period, 1950 to 1990, agriculture's share in GDP has declined by about 25 percentage points, while industry and services have gained equally. The share of industry has stabiles since 1990 and consequently the entire subsequent decline in agriculture has been picked up by the services sector During the 1990s, the contribution of service sector to the growth rate of GDP was nearly 60 per Cent in contrast to 54 per cent in middle income countries, 43 per cent in least developed Countries and 34 per cent in China. High share of services in GDP is a unique feature of the Indian economy as in other developing countries decline in agricultural sector's share has been

## **4 SHARE IN INTERNATIONAL TRANSACTIONS**

The growth in services sector worldwide has also been accompanied by the rising share of services in world transactions. With respect to the Indian economy, we find that similar to the world trend, growth in the services sector has also been accompanied by a substantial growth in international transactions in services. In fact, India's exports of services displayed one of the fastest growth rates in the world, i.e., over 17 % per annum in the 1990s (the world average being 5.6 per cent). Correspondingly, both inward and outward foreign direct investment (FDI) in India's services sector has also grown substantially in the same period.

## **REASONS FOR GROWTH IN INDIAN 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 LIBERALIZATION AND REFORMS**

- a) Increased trade
- b) Higher foreign direct investments in services and
- c) Improved technology

#### **A) DEMAND-SIDE FACTORS**

##### **A) HIGH-INCOME ELASTICITY OF DEMAND FOR FINAL PRODUCT SERVICES**

High-income elasticity of demand for final product services implies that at any relative price of services the quantity absorbed rises more than the quantity of commodities as real income per capita increases. This explanation for increasing share of services in output and employment in the growth process has been tested by many studies<sup>4</sup>. But the results are ambiguous. We find that this hypothesis, i.e., 'demand for services is income-elastic' tended to find support in early empirical work in the 1980s but in the 1990s studies with better Methodologies and better international data found results contrary to this. For example, Falvey and Gemmell (1996) used dis-aggregated data set covering sixty countries in 1980

For example, Kravis et al 1983 estimated income elasticity of demand for services. They rejected the above hypothesis for overall services though confirmed it for different types of services.

##### **B) SLOWER PRODUCTIVITY GROWTH IN SERVICES**

It has been long argued that productivity growth in services is slower than that in Manufacturing sector. Different explanations have been put forward for it. Following Vernon's Law<sup>5</sup>, Caldor (1966) argued that there will be a negative relationship between labour productivity growth in the economy as a whole and the productivity growth in the non-manufacturing sector most activity outside the manufacturing sector particularly land-based activities such as and many service activities are subject to diminishing returns. Further, the unbalanced growth models by Baumol (1967) helped in popularizing the notion that because of their labor-intensive nature, service-sector activities cannot be made more efficient through capital accumulation, innovation, or economies of scale.

It has also been argued that in the creation of new ways of satisfying wants, technological changes are as important in service sectors (such as health care) as in commodity sectors, but when it comes to cost reduction for existing products or services, technological change is more frequent and more powerful in its effects in the commodity sector. Therefore, productivity of service sector relative to productivity of commodity sector may vary inversely with income level of the country<sup>6</sup>. In other words, between poor and rich countries the productivity differential in services is found to be lower than that in commodities.

However, more recently, two alternative arguments for lower productivity in services have been put forward. These are (a) greater investment has been done in new technology (especially IT) in services sector and this may take time to lead to productivity enhancement and (b) low Productivity of services is a product of mis-measurement of output in services since an increasing portion of output is not captured in the basic statistics. A key problem in measuring productivity elates to obtaining a suitable measure of output of services over time. The problems pointed out in the literature that leads to mis-measurement of productivity in services are:

5 the growth of productivity in manufacturing is an endogenous result of the growth of output

6 For example, Kuznets (1950), Bhagwati (1984), Kravis et al (1983)

a) Market prices are not available for publicly provided services;

(b) It is difficult to identify precisely what constitutes the service activity in a particular industry and to account correctly for the quality changes in services and this is further complicated due to inappropriate deflators that are not able to distinguish quality improvements;

(c) The “quantity” of services is difficult to capture, as it often represents a process by which a user (consumer) or the user’s good is changed (Hill 1977);

(d) Compared to goods many services are characterized by a greater degree of heterogeneity (even uniqueness) so it is difficult to aggregate them;

(e) Poor qualities of data on services further complicate the problems.

## **2. STRUCTURAL CHANGES**

Along with the notion of services being generally unprogressive there are arguments about structural changes that take place with growth in the economy<sup>7</sup>. Greenfield (1966) and Francois (1990) argue that demand for producer services in total intermediate demand by manufacturing firms grow with development because higher specialization is now more profitable. This expansion is linked to growth in more roundabout process of production and the associated conversion of local markets into national markets. With technological progress and development, services also become more crucial to co-ordinate production processes; to create and absorb new innovations and to increase the benefit-extracting capacity in production and Consumption. All these lead to higher use of services in the growth process.

**B) SUPPLY SIDE FACTORS**

## Trade Liberalization and Reforms

Along with demand side factors, there are also some supply side factors that lead to Higher use of services as growth takes place in an economy. Three supply side factors that leads to higher supply of services are increased trade, higher FDI and improved technology. But there 7 See Fisher (1935), Kuznets (1957) and Fuchs (1980)are two distinguishing features of trade liberalization of services: a) “imports” of services must be locally produced and b) liberalization of services leads to enhanced competition, which is both domestic and foreign. Greater foreign factor and increased competition together imply a large-scale of activity, and hence greater scope for generating the special-growth enhancing effects.

Fact if in foreign participation merely substitutes for domestic factors and the sector do not expand, i.e., the degree of competition remains the same, then there cannot be a positive growth impact on account of scale effect. On the other hand, even without scale effects and even if service sector does not possess endogenous growth attributes, import of foreign factors that Characterize services sector liberalization can still have positive effects because they are likely to bring with them the source of endogenous growth, namely, 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 to1993-94.

**REASONS FOR SLOW GROWTH OF EMPLOYMENT IN INDIA’S SERVICE SECTOR**

Growth in the share of service sector in GDP is often followed by a corresponding growth in the share of service sector in total employment in the economy. However, in India we find that though there has been a phenomenal growth in the service sector, this growth has not been followed by a corresponding high growth in employment in the 1990s. And this rise in the share of services in employment has been much slower than the decline in the share of agriculture and manufacturing in total employment (as seen in Table 1). This shows that while output generation has shifted to services,

**TABLE 1 INDUSTRIAL DISTRIBUTION OF TOTAL WORKFORCE IN INDIA**

	<b>1971</b>	<b>1977-78</b>	<b>1983</b>	<b>1987</b>	<b>1993</b>	<b>2000</b>	<b>2010</b>
Agriculture	76.2	73.9	71	68.6	65	64.7	59.9
Mining & quarrying	0.5	0.4	0.4	0.6	0.7	0.7	0.6
Manufacturing	8.6	8.8	10.2	10.7	11.1	10.5	11
<b>Services</b>	<b>14.7</b>	<b>16.9</b>	<b>18.4</b>	<b>20.1</b>	<b>23.3</b>	<b>38.4</b>	<b>47.5</b>
Elect. Gas. water	0.3	0.2	0.3	0.3	0.3	0.4	0.3
other	14	12	16	17	19	24	29.2

Source: virmani (2010) obtained from the author

## 7. CONCLUSION

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 policy dilemma and doubts have been cast on the sustainability of service-led growth.

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.

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