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Working Paper

Features, Restrictions, and Policy Recommendations in the Service Sector of the People's Republic of China

ADB Economics Working Paper Series, No. 357

Provided in Cooperation with:

Asian Development Bank (ADB), Manila

Suggested Citation: Wei, Wang (2013) : Features, Restrictions, and Policy Recommendations in the Service Sector of the People's Republic of China, ADB Economics Working Paper Series, No. 357, Asian Development Bank (ADB), Manila, <https://hdl.handle.net/11540/2090>

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ADB Economics Working Paper Series



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Wang Wei

No. 357 | July 2013

Asian Development Bank



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Asian Development Bank

Asian Development Bank
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1550 Metro Manila, Philippines
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© 2013 by Asian Development Bank
July 2013
ISSN 1655-5252
Publication Stock No. WPS135834

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ABSTRACT

The development of the service sector in the People's Republic of China has not kept pace with the country's overall economic development. The share of employment in services is still lagging behind that of output and is also below the international norm. Moving from traditional services to modern business services has been the focus in recent decades, but the current structure is still dominated by low-end, traditional industries. In addition, due to the ongoing government strategy to make pilot reforms industry by industry, state-owned service providers still have a large market share, especially in some important service industries, and there are great disparities in development among non-state-owned service providers across various industries. Complicated institutional restrictions and a lack of effective institutional support and regulatory enforcement require in-depth reforms if the sector is to realize its potential. Strategic measures and policy options for promoting the sector in the next 10 years are suggested.

Keywords: services, People's Republic of China, growth, productivity

JEL classification: L8, O14, O40, O47

I. INTRODUCTION

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 in international trade. The service sector¹ has likewise witnessed rapid, sustained development and has made great contributions to the overall economy in terms of its share of gross domestic product (GDP) and employment. As the contributions of the service sector to GDP growth and employment have increased and have caught up with manufacturing, clearly the PRC is moving into a new stage of development with both sectors propelling economic growth.

The level of development of the service sector in terms of output and employment shares in the economy varies in different countries and is positively correlated with per capita income. As a developing country with a middle-income status, the development of the service sector in the PRC has been insufficient and has lagged behind its overall stage of development according to international norms. The gap in the development of the service sector between the PRC and the developed countries and also some selected developing countries is therefore still quite wide.

Major structural problems and systematic restrictions affect the sound development of the service sector in the PRC. The government should prioritize in developing the sector and adopt further reforms in the near future if it wishes to build a creative and modern society with higher income levels by 2030.

II. THE SIGNIFICANCE AND THE DEVELOPMENT OF THE SECTOR

A. An Engine of Economic Growth

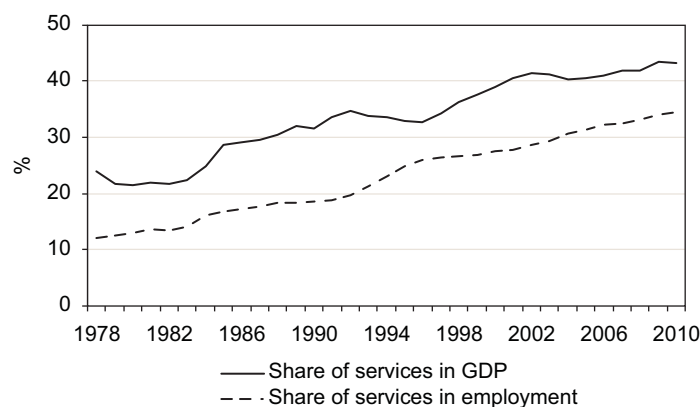
The service sector in the PRC has been growing rapidly in recent decades. From 1978 to 2010, its average annual growth rate was 11% which was higher than the average annual GDP growth rate of 9.9%. Similarly, the employment opportunities provided by the service sector stood at 263.3 million in 2010, 5.4 times that of 1978, which shows that the sector provided 7 million incremental jobs annually over the past 3 decades.

The contribution of the service sector to the economy has increased significantly. Since 1978, the manufacturing sector has been the major contributor to the national economy; however, the contribution of the service sector to GDP and to total employment has caught up in recent years. Figure 1 shows that the share of the service sector in total GDP increased from 23.9% in 1978 to 43.1% in 2010 and that the gap between output in manufacturing and services narrowed from 24 percentage points to 4.4 percentage points. The share of employment in the

¹ According to PRC Industrial Classification and Codes for National Economic Activities (GB/T 4754—2002), the service sector mainly includes communications and transportation, storage and postal services, information transmission, computer services and the software industry, wholesale and retail trade, accommodation and catering, financial services, 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, culture, sports and recreation, public administration, and social organizations. In the PRC, scholars and government statistical departments often identify tertiary industries with the service sector.

service sector in the overall economy grew from 12.2% in 1978 to 34.6% in 2010, close to that of agriculture.²

Figure 1: Contribution of the Service Sector to Gross Domestic Product and Employment in the People's Republic of China, 1978–2010



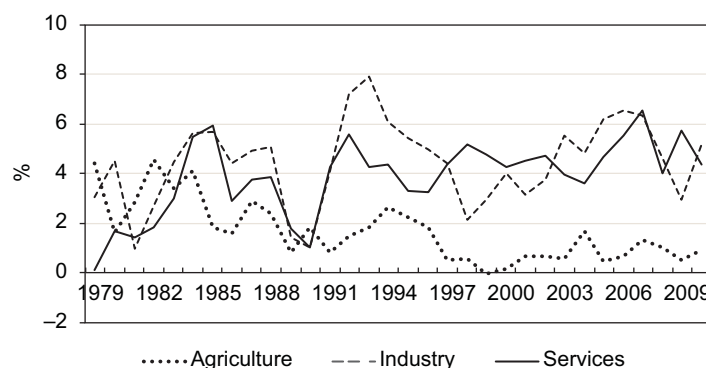
Source: [People's Republic of] *China Statistical Yearbook 2011*.

More importantly, the service sector has made great contributions to inclusive growth through job creation. From the late 1970s to 2010, total employment grew by 337 million, of which 208 million was generated by the service sector, especially by wholesale and retail trade, catering and hotels, transportation, and warehousing which are low market entry and labor intensive. In 2010, employment in wholesaling and retailing and in catering and hotels was about 81.28 million and accounted for 31% of employment in the service sector or 11% in the overall economy. From 2000 to 2010, the average annual incremental employment in such industries was 3.44 million which accounted for 52% of incremental employment in the service sector.

The service sector in the PRC has become an important engine for economic growth. Although its contribution to GDP growth has fluctuated, since 2000 it has remained at over 40% up from 20% in 1978. More importantly, the average contribution to GDP growth was almost equal to that of the industry sector from 2000 to 2010 (Figure 2).

² In 2011, the employment share of the service sector in the overall economy was 35.7%. By overtaking the agriculture sector, the service sector provides the most job opportunities in the PRC.

Figure 2: Contribution to Gross Domestic Product Growth by Sectors in the People's Republic of China, 1979–2009

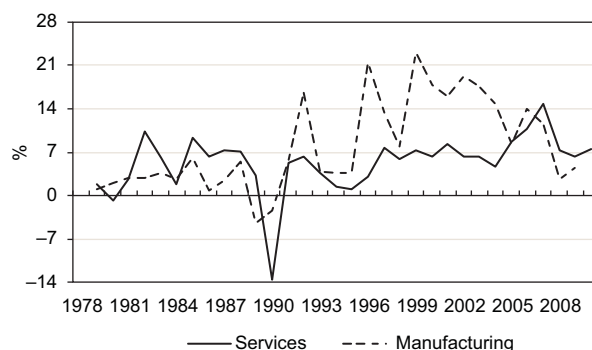


Source: [People's Republic of] *China Statistical Yearbook 2011*.

B. Significance in the Overall Economy

The service sector has helped in raising the efficiency of the economy of the PRC. Since 2000, labor productivity in the sector has increased at an average annual rate of 7.6%, 3.3 percentage points higher than from 1978 to 2010. More importantly, from 2005 to 2010, annual productivity growth in the manufacturing sector was 1.1 percentage points lower than that of services, whereas the rate had been twice that of the service sector from 1990 to 2005 (Figure 3). The total factor productivity (TFP) of the service sector has also registered a positive change and an upward trend since 1997. The average annual TFP growth rate of the service sector was 1.9% from 1997 to 2009 which was a sharp contrast to the 0.1% from 1981 to 1996. Compared with nearly all of the value added based on the input of capital and labor from 1981 to 1996, the contribution of TFP to the growth of the service sector was 16.6% from 1997 to 2009 (excluding outliers due to statistical adjustments in 1990).

Figure 3: Growth in Labor Productivity in the Service and Manufacturing Sectors in the People's Republic of China, 1978–2010



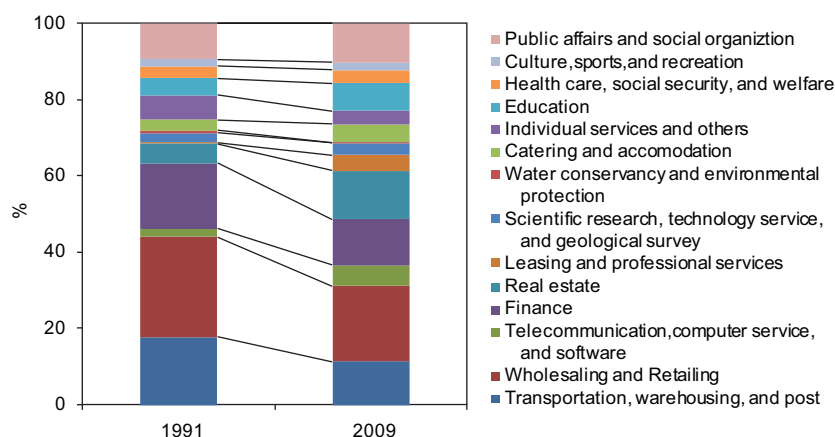
Source: [People's Republic of] *China Statistical Yearbook 2011*.

The service sector is becoming an important factor in the development of other sectors in the country. In 2007, the ratios of the intermediate input of services to the total value added of agriculture (including planting, forestry, animal husbandry, and fishing), mining, and construction were 6.3%, 10.9%, and 15.0%, respectively which were 2.7, 4.4, and 8.0 percentage points higher compared with 1990. Although the ratio of intermediate input of the service sector to the manufacturing sector remained at 8% and did not show a significant change, it has also enjoyed rapid development since the manufacturing sector has expanded so quickly and has become the major manufacturing base of the world in recent decades.

C. Structural Upgrade

Moving from traditional services to modern business services has been the focus of the service sector in recent decades. Previously, transportation, warehousing, wholesaling, and retailing were the major components of the sector in the PRC, but since the 1990s, their importance has gradually declined and by 2010, their share of output in the sector was 30.9%, down from 43.1% in 1991. Business services—telecommunications, computers, software, finance, real estate, leasing, scientific research, geological surveys, water conservation, and environmental protection which is of vital importance to the efficiency and competitiveness of firms in other sectors—have been a major part of the sector since 1990 as their share of total output increased from 27.3% in 1991 to 38.5% in 2009 (Figure 4). This change indicates that the service sector in the PRC is undergoing a structural upgrade similar to the one that the Organisation for Economic Co-operation and Development (OECD) members experienced in the 20th century.

Figure 4: Change in the Composition of the Service Sector in the People's Republic of China from 1991 to 2009



Notes: The Industrial Classification of the National Economy (GB/T 4754-2002) has been used in statistics since 2005. The 1991 figures were adjusted by the author.

Source: Author's calculations based on data from [People's Republic of] *China Statistical Yearbook* for 2009 and 2000.

The fast growth of business services in the PRC has been driven by the emergence of new service industries based on technological innovations and outsourcing. For instance, telecommunication, computer, and software industries grew at an average annual rate of 24.9% from 1991 to 2009 which was 13 percentage points higher than the growth rate of the sector as a whole. Other new service industries, e.g., scientific research driven by a great demand for outsourcing from various firms, have also grown rapidly. From 1991 to 2009, the output of research and technology services increased 24.5 times.

D. International Markets

After acceding to the World Trade Organization (WTO) in 2001, trade in services in the PRC expanded at an average annual rate of 17.4% until 2010, roughly twice the global rate in the same period. The PRC ranked fifth in the world in service exports in 2009 up from eighth in 2005 (MOC 2011). As an indicator of trade openness, the ratio of trade in services to GDP increased from 1.6% in 1982 to 6.2% in 2010.

Among the 12 general categories and 160 subcategories of trade in services outlined in the General Agreement on Trade in Services (GATS), the PRC opened 10 categories and 100 subcategories to foreign investors honoring its commitments to the WTO. As a result, foreign direct investment (FDI) in the service sector has enjoyed robust growth averaging 15.6% annually from 2001 to 2010. In 2010, total FDI in the service sector was \$38.5 billion, which was equivalent to 47.3% of total FDI; this was up from 25.7% in 2001.

Outsourcing services has also expanded rapidly. Taking advantage of the trend to shift the international service industry from developed countries to developing countries, the government has advanced outsourcing park projects in 20 pilot cities and has issued a series of supportive policies. With its large educated labor force and lower labor costs, the PRC is becoming one of the major destinations for outsourcing international services. The total volume of contracts in 2010 exceeded \$14.5 billion with an average annual growth rate of more than 20% from 2001 to 2010. The PRC now ranks second as a destination for international service outsourcing and accounts for 23% of the world market.³

E. Urbanization

Large cities have become the major areas for the development of the service sector in the PRC. With improvements in urbanization and the reallocation of economic resources among different regions, the sector has become concentrated in large cities, especially the 35 metropolises and central cities.⁴ In 2010, the output of the service sector in the 35 large cities was 8.28 trillion yuan, accounting for nearly 50% of the total. The concentration and the depth and breadth of development have been most noticeable in cities like Beijing and Shanghai where many emerging and flourishing high-end service industries have formed clusters like Central Business District, Financial Street, Logistics Park, Creative Industry Block, Software Industry Zone, and Service Outsourcing Base.

Services have in fact become the core of the economies in those large cities. In 2010, there were 287 cities with populations of 500,000 or more, and the average shares of their service sectors in GDP reached 47.8% which was higher than the national average of 43.4%. For the 35 large cities, however, the average share of the service sector in GDP was 52%. Beijing ranked first among all cities in the PRC with a service share of GDP of 75.5% in 2010.

While services tended to concentrate in large cities, manufacturing tended to move to medium-sized and small cities around the larger ones and even to new urban areas in the middle and western regions of the country. For example, while Beijing had a service share of 75%, neighboring cities like Tianjin and Tangshan gained more opportunities to promote manufacturing; shares of GDP in manufacturing in both cities are above 55%. This indicates that the development of the service sector promoted the reallocation of economic development among different cities and regions and improved the quality of urbanization in the country.

III. GAPS AND DISPARITIES

Compared with the improvements in the global economic structure and in light of the current requirements for economic development for the PRC, there are sizable development gaps in the service sector, not only in terms of its share in GDP and employment, but also in terms of its structure, productivity, and competitiveness.

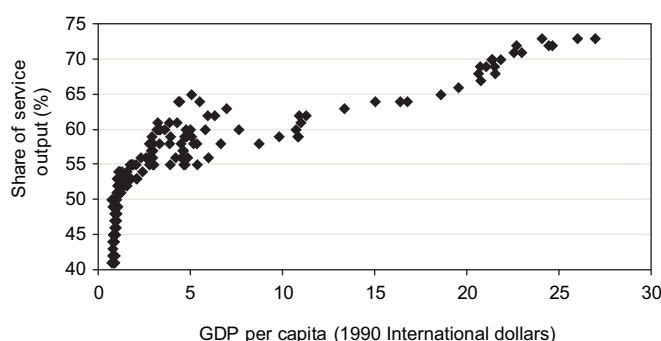
³ See Ministry of Commerce, People's Republic of China. <http://tradeinservices.mofcom.gov.cn/g/2012-03-29/96556.shtml>

⁴ The 35 big cities include the 4 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.

A. The Gap with International Norms

In the global context, the share of the service sector in GDP is positively correlated with GDP per capita (Figure 5), although the correlation is not strictly linear especially in the \$3,000–\$10,000 range (1990 International \$) (Xingzhou and Wang 2011). In 2009, GDP per capita in the PRC was \$7,359 (1990 International \$) and the share of services in GDP was 43.4%, which is about 15 percentage points lower than an economy would generally reach at this level of GDP per capita. This indicates that the development of the service sector has lagged behind economic development.

Figure 5: The Relationship between GDP per Capita and the Share of Service Sector Output in the People's Republic of China

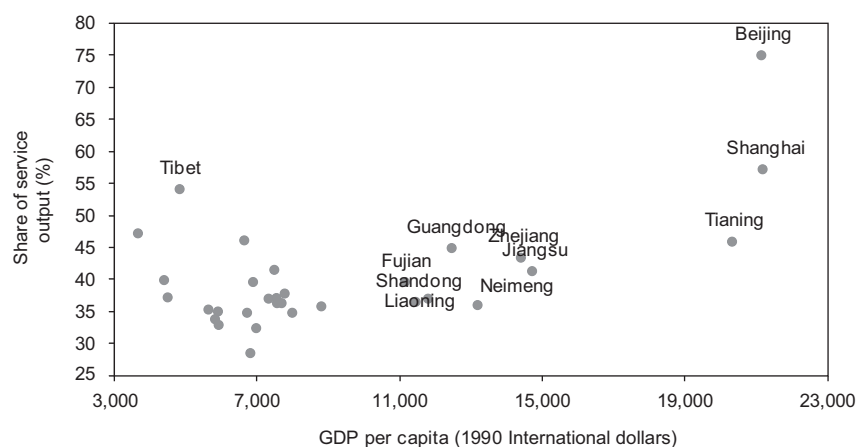


Notes: GDP = gross domestic product; G-K Dollar = International dollars

Sources: Author's calculations using World Bank World Development Indicators database (accessed December 2011) and Maddison (1995).

In the domestic context, the level of development of the service sector is still quite low in most provinces and cities. Per capita GDP in the provinces varies between \$4,000 and \$15,000 (1990 International \$). Except in Beijing, Shanghai, and Tibet, the average service share of GDP is about 40% or less (Figure 6). In terms of the 35 large cities, although the per capita GDP for most of them is basically more than \$11,000 (1990 International \$), there are only eight large cities with service sector shares of GDP above 50% (Figure 7).

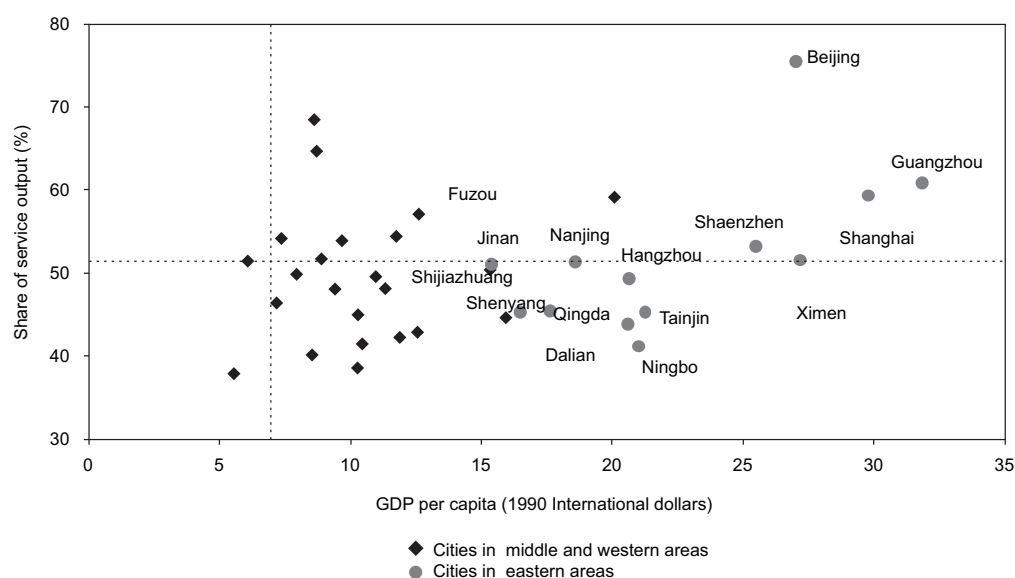
Figure 6: Development of the Service Sector in the Provinces in the People's Republic of China, 2010



Note: GDP = gross domestic product; G-K Dollar= Int\$; data for Tibet are from 2009.

Source: [People's Republic of] *China Statistical Yearbook 2011*.

Figure 7: Development of the Service Sector in the 35 Large Cities in the People's Republic of China, 2010



GDP = gross domestic product; G-K Dollar=Int\$.

Source: [People's Republic of] *China Statistical Yearbook 2011*.

Aside from an under-estimate of the service sector statistically (Xu 2000) , there are two plausible explanations why the share of service output is not as high as international norms. One is due to the country's current development stage at the middle-income level and to the ongoing, rapid, in-depth industrialization in the PRC. It is similar to the transition in developed countries when the manufacturing sector grew rapidly and the service sector moved from

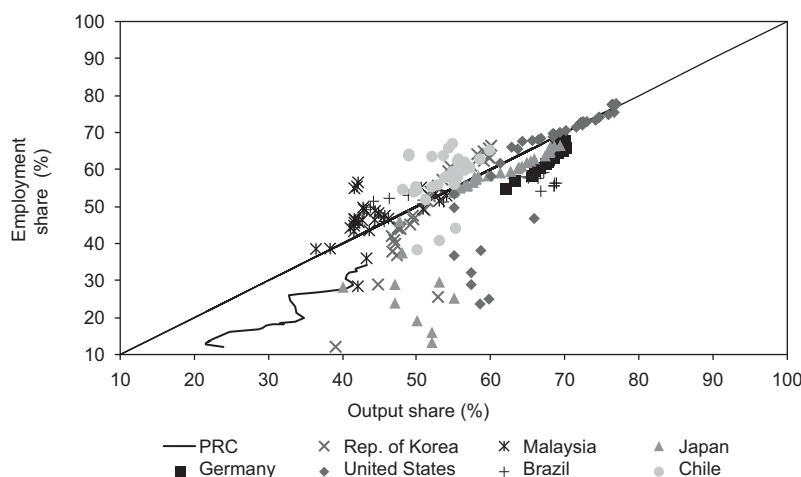
traditional services to business services. It is typical that the share of services in GDP increases comparatively slowly while per capita GDP rises from \$3,000 to \$11,000 (Figure 5). Thus, both the manufacturing and service sectors drive economic growth during the middle-income stage and the transformation to a higher level of industrialization (Xingzhou and Wang 2011).

The other explanation is due to globalization. The PRC has become one of the most important manufacturing bases in the world. Over the past few decades, manufacturing has enjoyed rapid growth; its share in total global manufacturing output went from 3.15% in the 1990s to 21.2% in 2009 and ranked the country among the top manufacturing nations in the world.⁵ Compared to the strengthening of the manufacturing sector globally, the service sector has lagged behind with a share in GDP that is lower than the international norm for its level of per capita income.

B. The Gap between Employment and Output

The share of employment in the service sector in an economy is an important indicator for understanding the level of service sector development. It correlates positively with per capita GDP and shows an increasing tendency to synchronize with the share of output of services (Figure 8). As the share of services in GDP increases, the share of employment will grow as well. When the share of service output is 50% or more, employment will grow quickly and will gradually tend to converge with the share of output (Xingzhou and Wang 2011).

Figure 8: Relation between Share of Employment and Share of Output of the Service Sector in Selected Economies



Notes: PRC = People's Republic of China. Data for Brazil are for 1981–2006, for Chile 1940–2007, for the PRC 1979–2009, for Germany 1991–2008, for Japan 1890–2007, for the Republic of Korea 1955–2008, for Malaysia 1957–2007, and for the United States 1870–2007.

Source: World Bank World Development Indicators database (accessed December 2011).

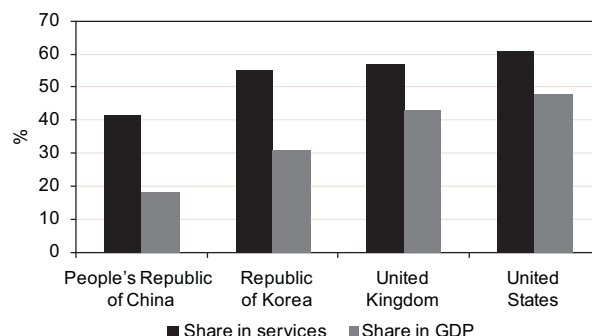
⁵ See United Nations Statistics Division: The National Accounts Main Aggregates Database <http://unstats.un.org/unsd/snaama/dnllist.asp>

Although the service sector in the PRC has been the main destination for labor in the past few decades, the share of employment in services is still lagging behind that of output in the overall economy and is also below the international norm. The average gap has been 10 percentage points during the past 30 years.⁶ Although employment in the sector has steadily expanded in recent years and has narrowed the gap to some extent, the situation has not appreciably changed. By 2010, the share of employment in the service sector was only 34.6%, 8.5 percentage points lower than the share of output (Figure 1). This indicates that the service sector has a limited ability to create jobs. The wholesaling and retailing industries, for example, have the largest employment in the sector at 70.25 million in 2010 which accounted for 9.1% of the total economy and 26% of the sector overall. Taking into account the huge population of the PRC, however, that translates into only 5.2 persons to provide services for every 100 people. In contrast, job opportunities in wholesaling and retailing for every 100 people in 2008 were 6.2 in the United States (US), 8.7 in Brazil, 9.2 in Japan, and 11 in Hong Kong, China.⁷

C. The Gap between Traditional and Modern Services

In terms of composition, the current structure of the service sector in the PRC is still dominated by traditional low-end and labor-intensive industries while structural upgrading to modern, knowledge-intensive services⁸ is at the initial stage. Rapid growth in knowledge-intensive service industries also represents the main direction of structural upgrading of the service sector worldwide; the aggregate share of such industries in GDP can reflect the level of development of the service sector in an economy. As shown in Figure 9, there is a huge gap in service composition between the PRC and some OECD members. In 2009, the share of modern service industries in GDP was about 18% in the PRC compared with 47.8% in the US and 31% in the Republic of Korea.

Figure 9: Modern Service Industries as a Share of the Service Sector and of Gross Domestic Product



Note: Modern service industries include information and communication technology, computer service and software, finance and insurance, scientific research and technical service, public administration and social organization, education, healthcare, social security and social welfare. For the United States, the United Kingdom and the Republic of Korea, the corresponding year is 2006; for the PRC it is 2009.

Source: [People's Republic of] China Statistical Year Book (2010).

⁶ That may be due to a lack of data. For example, in some low-end services such as catering, there are no complete statistics. Other countries may have similar problems.

⁷ The data for Brazil; Hong Kong, China; Japan; and the US in 2008 are based on [People's Republic of] *China Statistical Yearbook of the Tertiary Industry* (2011). Employment in Hong Kong, China includes retailing, wholesaling, catering, and hotels.

⁸ Knowledge-intensive services include information and communication technology, computers and software, finance and insurance, scientific research and technical services education, healthcare, social security and social welfare, and public service.

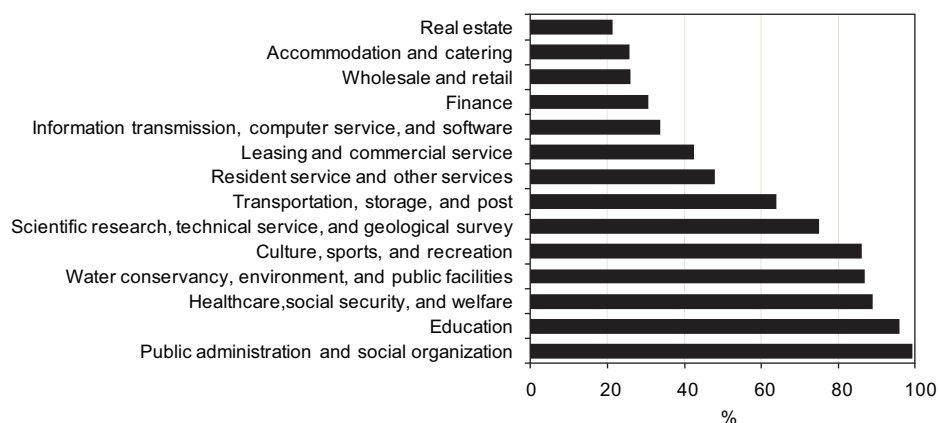
D. Disparities among Providers

With the change from central planning to a market economy, the monopolies of state-owned service providers have been gradually relaxed in many industries, and competition in the sector has increased as a result. However, due to the government strategy to make pilot industry by industry reforms, state-owned service providers still have a large market share, especially in some important industries, and there are great disparities among non-state-owned service providers across various industries.

In terms of ownership, state-owned enterprises accounted for 2.8% of all firms in the PRC in 2009, while state-owned service firms accounted for 29.2% of the service sector (NBS 2008). With regard to employment, state-owned service enterprises and units had an even greater concentration. In 2010, the employment share of urban state-owned units was 73.8% in the service sector which was much higher than the employment share of 12.5% in state-owned units in the manufacturing sector in the same period.

Second, there was great diversity in competition across various service industries. The share of employment in the state-owned education, healthcare, social security and social welfare, water conservation, environment and public administration, culture, sports, and recreation industries was all above 85% while in telecommunication, information, and finance services it was about 50% and in real estate, catering and accommodation, and wholesale and retail trade it was below 30% (Figure 10).

Figure 10: Share of Employment in State-Owned Service Units by Industry in the People's Republic of China, 2010



Source: [People's Republic of] China Statistical Yearbook 2011.

Third, there were great differences in consolidation and integration among various service industries. Although most service providers are small or medium-sized or even micro enterprises or self-employed businesses, there are still many large companies in the service sector in the PRC. In some services such as telecommunications and banking, the main participants are all very large companies, and the concentrations are great. For instance, the top five commercial banks are all state-owned and accounted for 51% of the total assets in the banking industry in 2011. In the highly competitive service industries like wholesaling and retailing, catering, road transportation, and individual services, however, the concentration is quite low, and millions of small and medium-sized enterprises and self-employed businesses hold a dominant position in the market. Taking retailing as an example, although consolidation and integration have been improved via the chain-store format since the turn of the century, the market share of the top 100 chain-store companies increased from 5.4% in 2001 to just 11% in 2010.

E. The Gap between Supply and Demand

The service sector is facing increased demand but a slowly growing supply, especially in personal services such as education, healthcare, and culture. As both the standard of living and consumption have risen, the focus of urban and rural households has shifted from basic needs to education, medical care, communication, tourism, and recreation, and the demand for these services is growing rapidly. For example, the average annual growth rate of per capita medical expenditures by urban households was 13% from 2005 to 2009, but the healthcare industry has not kept pace and has even declined to some extent. During the same period, the number of hospitals decreased from 60,397 to 59,918, and the number of medical professionals per 1,000 population, including doctors and nurses, decreased from 1.68 to 1.65. This implies that these service industries are not driven by market demand and that it is hard for them to meet the rising needs of urban and rural residents.

Second, there is a mismatch between service supply and demand, especially in producer services. As discussed earlier, the level of services as an intermediate input in the manufacturing industry is only 8.4%, which is far behind the 15% in OECD members and it has shown no signs of rising since 1990. Service imports, on the other hand have grown rapidly during the past decade resulting in a growing trade deficit generated by producer services like transportation, insurance, and patent and franchise fees. The average annual growth rate of imports in insurance services was 21% from 1997 to 2008, and the size of the trade deficit was 12 times larger than that in 1997 (SAFE 2008).⁹ This reflects the inability of the service sector to meet the requirements of the manufacturing sector completely and efficiently.

F. The Gap in Foreign Direct Investment

The country's lack of competitiveness is highlighted by the expanding deficit in trade in services since the latter half of the 1990s and by comparing the structure of service exports with developed countries or even with some other developing countries. Exports of tourism, transport, construction service, and other commercial services accounted for as much as 75.8% of total exports in services in 2009.¹⁰ Although the export of services in finance, insurance, patent rights and royalties, and films and audiovisual products has grown rapidly in recent years, their shares of total service exports in 2007 were only 0.3%, 1.2%, 0.3% and 0.1%

⁹ Source: [People's Republic of] China's Balance of Payments (2008), National Bureau of Foreign Currency of [People's Republic of] China.

¹⁰ Ministry of Commerce. [People's Republic of] China's Statistics of Trade in Services 2010.

respectively while in the US, the corresponding shares were 12.3%, 2.2%, 17.5%, and 3.3%, respectively. This sharp contrast shows that there is a relatively big gap between the PRC and the developed countries in knowledge-intensive services and that the PRC is not sufficiently competitive in the global service market.

In addition, the structure of FDI does not match the upgrading of the service sector. From 2005 to 2010, most FDI was in real estate which grew from 36.9% in 2005 to 43.6% in 2010. This was followed by leasing and professional services, wholesale and retail trade, and transportation with shares of 15.8%, 14.0%, and 6.6%, respectively. FDI in modern service industries accounted for only 11.4%. It is obvious that the current structure of FDI is not conducive for restructuring and upgrading the service sector.¹¹

IV. OBSTACLES AND CONSTRAINTS FACING THE SERVICE SECTOR

Given the ongoing transformation of the economic system from a centralized, and planned economy to a market economy, there are still various institutional impediments to business which makes it difficult for the PRC to make its service sector to be at par with its manufacturing sector. It is both urgent and necessary to explore in-depth reforms in order to provide a sound institutional and policy environment for the development of the service sector and for overall economic growth as well.

A. Complicated Institutional Restrictions

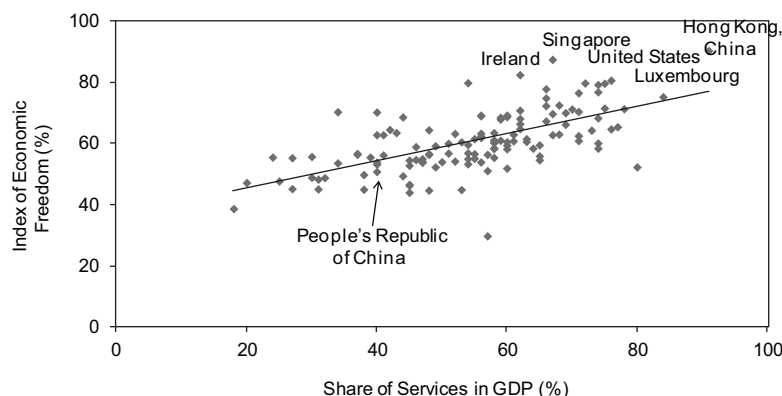
Based on a comparison of 135 countries and regions, the share of services in GDP correlates with the degree of economic freedom¹² (Figure 11). Developed countries and regions usually have a relatively high degree of economic freedom that enables them to enjoy a high level of service sector development. In contrast, most developing countries still have a low level of maturity in the service sector. In the PRC, the economic freedom score is about 50% out of a maximum 100% while the share of services in GDP is 40% which implies that the lag in service sector development can be explained by the imperfect market system to some extent.¹³

¹¹ Source: [The People's Republic of] China Statistical Yearbook for 2005 and 2011.

¹² The Heritage Foundation's 2008 Index of Economic Freedom. The index takes a broad and comprehensive view, measuring 130 countries' performances in 10 separate areas of economic freedom that have been grouped into four broad categories or pillars: rule of law (property rights, freedom from corruption); limited government (fiscal freedom, government spending); regulatory efficiency (business freedom, labor freedom, monetary freedom); and open markets (trade freedom, investment freedom, and financial freedom).

¹³ Although the indicator of economic freedom is not welcomed by most Chinese officials and academics, there is no replacement for it when evaluating the degree of marketization across countries. The indicators for restrictions of the World Bank would be a good choice if the number of countries were greater.

Figure 11: Relationship between Degree of Market Perfection and Service Sector Development in the People's Republic of China and Selected Economies

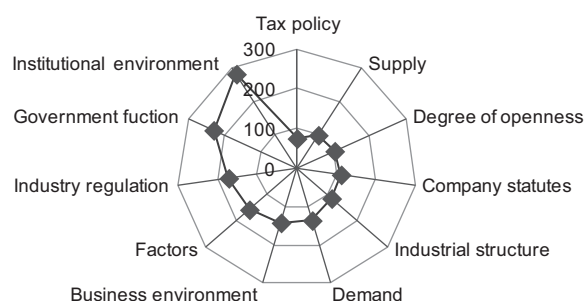


GDP = gross domestic product.

Source: World Bank World Development Indicators database (accessed December 2011) and The Heritage Foundation (2008).

Based on a survey conducted by the Development Research Center of the PRC (DRC)¹⁴ in 2010, the development of the service sector is restricted by complex institutional arrangements and mechanisms. As is shown in Figure 12, of the 11 categories of indicators that affect the development of the service sector, the top 3 are institutional environment (including the legal system and property protection), government functions, and industrial regulations (Xingzhou and Wang 2011).

Figure 12: Indicators of Restrictions on the Service Sector in the People's Republic of China by Category



Source: Xingzhou and Wang (2011).

¹⁴ The survey uses 11 categories of influence indicators and 75 influence terms for factors that affect the development of services in banking, education, wholesale and retail trade, research and design, professional positions, computers and information services, logistics, and individual services.

B. Lack of Effective Institutional Support

In general, there are various forms of service providers in a modern society, e.g., corporate enterprises, partnerships, cooperatives, non-profit institutions, and individual practitioners. Only corporate enterprises and self-employed businesses are protected by relevant laws and regulations in the PRC while the other forms are subject to unfair or even discriminatory treatment. One example of this is income tax payment. According to the Individual Income Tax Law, the highest rate for an individual proprietorship, a partnership, or a self-employed business stands at 35%; however the basic tax rate for corporations is 25% and the preferential tax rate is 20% for micro and small businesses. Clearly, this puts individual firms and partnerships at a disadvantage.

Also, some business formats still suffer from a lack of recognition in terms of specific laws and regulations. For instance, a chain-store company with a series of outlets or commercial establishments in different locations is a common commercial format in many service industries. Although the State Council issued a document promoting chain stores in 1997, there have been no further specific legal provisions or regulations concerning their establishment and supervision since. That is why all the outlets or commercial establishments of chain stores in different locations are treated as separate corporate enterprises. These companies cannot enjoy the benefits of scale in operations, unified business licensing and qualifications, or consolidated tax payments and have to bear heavier operational costs and lower profit margins. The average margin of the top 100 retail chain stores was 3% or less in the PRC from 2005 to 2010, but it was 8%–9% for the big retail chain stores in Japan in the same period (AEON 2010).

Non-profit organizations face another set of problems. While non-profit organizations are recognized around the world as important providers in service industries such as medicine, education, culture, and social welfare, there is no clear, unified, legal definition and standard to regulate non-profit organizations in the PRC. There are many public, non-profit organizations in the service sector that could enjoy tax-free treatment according to the Corporate Income Tax Law,¹⁵ but it is difficult for non-state-owned service providers to register as non-profit organizations since they need approval from both the relevant administrative department and from the business registration agency.

Finally, the reform of state-owned service institutions has not been pushed forward comprehensively but is instead at the design stage for trials in selected provinces. Traditionally, state-owned service institutions have provided services to society as affiliated units or branches of relevant government departments and have not had the freedom or the right to make business decisions or to allocate their human resources, revenue, or assets. In short, they are not self-motivated entities in the service market. This is the fundamental reason why the heavily state-dominated medical and healthcare, education, and culture and entertainment industries have developed so slowly in terms of supply and capacity and are unable to sufficiently meet the demand for services generated by the growing economy.

¹⁵ Clause 4 of Article 26 in the Corporate Income Tax Law 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 restrictions on the service scope, content, and expenses of the non-profit organization.

C. Lack of Regulatory Enforcement

The PRC has made great efforts to promote regulatory reform in the service sector to increase the degree of openness and competition. However, reforms have not been continuously promoted due to the lack of enforcement mechanisms. State-owned monopolies could not be broken up as quickly as expected and therefore continue to dominate in some service industries. For instance, in railroad transportation, education, healthcare, news and publishing, broadcasting, and television, the state still maintains a relatively high degree of ownership. In industries like telecommunications, even after splitting up and restructuring, a few very large state-owned enterprises still hold monopolies in various market segments.

Access for non-state-owned service providers in some markets has also been blocked. Since 2000, the State Council has issued many policy documents to encourage and support the development of the non-state economy including the private sector and small and medium-sized enterprises. The best examples are the two versions of the 36 Articles for the Non-State-Owned Economy.¹⁶ Most of the policy measures in the 36 articles have yet to be implemented because all the relevant regulatory agencies issued similar documents instead of revising the current laws and regulations and putting them into effect. As a result, it is hard for non-state-owned service providers to overcome discriminatory and unfair treatment and gain access in the service market. This significantly restricts the development and overall competitiveness of the service sector in the PRC.

D. Inadequate Administrative and Regulatory Reforms

To build a market economy and cultivate the service sector, both the government and its administrative system need reforms including transforming government functions, updating regulatory measures and tools, and restructuring supervisory systems. In fact, inadequate administrative and regulatory reform has been one of the main restrictions on service sector development in the PRC.

Changing the way government functions has been comparatively slow, and government intervention is still quite strong in the service sector. In fact, currently the government is not only the regulator and supervisor in the service sector but also a key provider and referee. The government not only takes the responsibility on making policies and guidelines but also exercises the power to allocate land, capital, and human resources and set the price for services including rates of interests, transportation fees, tuition, and charges for medical treatment. As a key provider, the government sets up state-owned enterprises in the service sector. As a referee, although there has been some progress, it is hard for government agencies to be fair and objective while they assume the other two roles simultaneously. This state of affairs provides the government wide opportunities to intervene in the service sector and block the formation of a market mechanism that allocates resources effectively and efficiently.

Currently, the administration of the service sector is fragmented because it involves a number of departments at different levels of government for any particular service industry. The logistics industry is an example. It involves 12 departments in the central government and all

¹⁶ There were two documents issued by the State Council simply called “36 Articles for the Non-State-Owned Economy.” The earlier one is the Guiding Opinions on Promoting and Supporting the Non-State-Owned Economy by the State Council, issued in 2005. The newer one is the Guiding Opinions on Promoting and Leading the Healthy Development of Private Investment by the State Council issued in 2010. Both of these documents contained 36 policy measures aimed at developing the private sector and small and medium-sized enterprises.

their corresponding agencies locally from provincial capitals to the grassroots.¹⁷ Each of the 12 departments is in charge of regulations and administrative responsibility for one or more aspects of the industry, and all have their own codes and standards. Therefore, logistics providers in the PRC face a complicated administrative set-up. Even within the government there is some confusion on how to push regulatory reform to promote the service sector. For example, opening up the sector under the framework of the Closer Economic Partnership Arrangement between Hong Kong, China and Guangdong Province required not only the support of the provincial and the Hong Kong, China authorities but also that of the local government which had to seek support and approval from relevant central government departments. Since it costs time to negotiate and coordinate with different local governments and with the local and the central governments, such a fragmented administrative system is a constraint to regulatory reform in the service sector.

In addition, the government lacks the capacity for adequate supervision, and a comprehensive supervisory framework has yet to be formulated. The government lacks legal and regulatory measures, an adept workforce, and specific tools and knowledge to oversee the service sector, especially emerging services, as well as the capacity to introduce modern regulatory measures and tools such as conditions for transparency and listing on market entry, benchmarking and industry codes on enterprise behavior, and credit reporting evaluation systems on performance. There is a great deal of room for improvement in supervision in the service sector.

Finally, the PRC does not have industry associations or legal and accounting firms to act as supervisors. Take the role of industry associations as an example. Although there are quite a number of industrial associations in the service sector, most of them are not independent since they basically grew out of government departments and still have close ties to them to get financial support, supervisory authority, and other resources. For example, the authority to grant professional qualifications and to formulate and implement industry codes and standards that is usually the function of associations in developed countries is still in the hands of the government in the PRC. Industry associations thus lack the will, ability, and means to provide services for the sector and therefore do not enjoy the recognition of service enterprises.

E. Policy Motivation Toward Manufacturing

The way government performance is currently evaluated is not favorable for the development of the service sector as most indicators are based on economic achievement in terms of GDP growth, tax revenues, and capital investment. This explains why authorities at all levels are more inclined to pursue growth in manufacturing and capital investment. As a result, most preferential industrial policies at all levels are concentrated on manufacturing. There have been few substantial policy measures and public resources to support the development of the service sector in recent decades.

The taxation system and preferential tax policies are not favorable for the development of the service sector either. There is an obviously heavier tax burden on the sector than on

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.

manufacturing due to different tax structures and corresponding collection measures. In 2008, the top five taxable service industries were wholesaling and retailing, finance, real estate, leasing and business services, and individual services in all sectors. The share of taxes paid to the total output of the industry were 29.6%, 38.8%, 26.6%, 25.1%, and 28.5%, respectively while the share in manufacturing was only 21%.¹⁸ The reason is that the tax categories and collection policies for service providers are quite different from the ones for manufacturing firms. For example, the business tax is one of the main taxes and is collected at 5% based on the total revenue of the service providers without any deductions for procurement or depreciation of fixed assets. The value-added tax, in contrast, is the major tax in the manufacturing sector, and its actual burden¹⁹ was approximately 3.1%. Clearly, the heavy tax burden and its unfair calculations have discouraged service providers, blocked the outsourcing services of manufacturers, and hindered the creation of new service industries.

F. Imbalance between International and Domestic Markets

All in all, the PRC has not achieved a balance between catering to the world market and to its domestic market. Many foreign companies still enjoy preferential treatment compared with their domestic competitors. In order to promote economic development, some local governments provided foreign companies more favorable policies in terms of land use, fast-track permits, and subsidies on office rent and taxes. To some extent, this has widened the gap in competitiveness between domestic and foreign service providers.

More importantly, while emphasizing opening up to the outside world, it was unusual for governments at various levels to consider opening domestic markets to non-state-owned enterprises or to non-local service providers. The motivation was further open the service sector to the outside world as part of the country's commitment to the World Trade Organization (WTO). The problem is that the effect of opening up is quite different across various types of service industries. For industries already open to non-state owned enterprises and non-local service providers before the PRC's accession to the WTO, e.g., wholesaling and retailing, road transportation, catering and accommodation, the policy contributed to promoting development and competition. For service industries not open before accession, the policy contributed little to increasing competition or to regulatory reform. Opening up to both world and domestic markets calls for institutional arrangements and intrinsic motivation to push forward in-depth reforms.

V. STRATEGIC MEASURES AND POLICY OPTIONS FOR PROMOTING THE SERVICE SECTOR OVER THE NEXT 10 YEARS

The slow pace of service sector development in the PRC is not only related to the country's economic development stage but is also closely connected with the current imperfect market system. Complicated institutional impediments, misleading incentive mechanisms, and an unclear policy orientation have become the major obstacles to the accelerated development of the sector.

During the 10th and 11th five-year plans (2000 to 2010), as part of the national development strategy the Central Committee and the State Council issued a series of policy

¹⁸ Calculated by the author based on data from [the People's Republic of] China Statistical Yearbook (2009) and [the People's Republic of] China Taxation Yearbook (2009).

¹⁹ Value-added tax burden = value-added tax payment/sales revenue.

documents on promoting service sector development.²⁰ Despite these measures, the service sector continues to suffer from deeply rooted, institutional obstacles, so its capacity to develop has not substantially improved. As a result, the development targets for the sector were not fully met in terms of share in GDP and total employment²¹ during the 11th Five-Year Plan from 2005 to 2010.

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

A. Development Orientation and Strategies

The PRC should promote service sector development not just to maintain its high rate of economic growth but also to benefit from contributions by the sector to structural upgrading, improving economic efficiency, increasing innovative capacity, and creating employment. It is necessary to promote the so-called harmonious development strategy and the following measures:

- the parallel development of new service industries with traditional services, through structural upgrading and business innovations, information technology applications, and professional training in the latter;
- the parallel development of business services with personal and community services such as healthcare and education, which could contribute to increasing living standards and enhancing the quality of labor;
- the parallel development of the state-owned economy with the non-state-owned economy in all service sectors through in-depth reforms and by providing the proper policy environment and promoting fair competition;
- the parallel development of the service sector in large cities and in medium-sized and small cities and towns with relatively large populations and significant manufacturing, and the development of specific service activities in towns and rural regions to meet the demands of modern agriculture;
- the parallel opening up of the service sector to both the local and international markets to encourage service providers to compete with their counterparts both domestically and globally, offering more support to domestic service providers so they can enter the global market.

²⁰ The State Council had issued documents on service development including Measures of the State Council on Accelerating the Development of the Service Sector (2005), Measures of the General Office of the State Council on Implementing Relevant Policies for Accelerating the Development of the Service Sector (2010). The 12th Five-Year Plan for the Development of the Service Sector is yet to be approved by the State Council.

²¹ The target to increase the service share in total GDP and employment set in the 11th Five-Year Development Plan has not been accomplished.

B. Reform Priorities and Policy Options

The service sector in the PRC will have various development opportunities in the next 10 years, but they will be accompanied by critical challenges. The government should put substantial efforts into reforms, in addition to providing stimulating and supportive policies for the sector. The specific tasks and priorities are the following.

- Reform regulations on market entry and thus expand development opportunities for all service providers.
- Reform the regulatory and supervisory systems to clarify the position of the government in the service sector and to advance its transformation, promote the reform of the administrative framework, and increase efficiency and transparency with new supervisory measures and tools.
- Reform institutional arrangements for various diverse service entities including in-depth reforms of state-owned enterprises and comprehensive reforms of state-owned service institutions from human resource management and the pension system to ownership, corporate governance, and wage and salary systems, and update legislation and regulations to safeguard various types of service industries.
- Reform support systems such as the government performance evaluation, taxation, and procurement.
- Strengthen the capacity of government and other intermediaries to regulate and supervise the sector through data collection and updated statistical systems, credit reporting systems, knowledge sharing, and staff training.
- Accelerate the drafting of the overall design and timetable for reform and promote pilot testing of comprehensive reforms in selected industries and regions. Service industries that are largely state-owned monopolies such as banking, telecommunications, education, broadcasting, social security, healthcare, sports, and other areas should pilot test regulatory reforms according to their different features and reform requirements. As for the regions and big cities with high concentrations of service industries, the government should explore comprehensive reform measures to test and ascertain the policy effects.

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Features, Restrictions, and Policy Recommendations in the Service Sector of the People's Republic of China

This study examines the development of the service sector in the People's Republic of China. It finds that the share of employment in services is still lagging behind that of output and is also below the international norm. Moving toward modern business services has been the focus in recent decades, but the sector remains dominated by low-end, traditional industries. In-depth reforms are needed if the sector is to realize its potential.

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