

How Deregulation Would Benefit China's Services Economy

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About the Author

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Introduction

One of the central goals of China's current round of economic restructuring is to foster a transition away from a deeply industrial economy to a more services-driven one. China's services sector now comprises more than 50 percent of GDP, and there has been remarkably fast growth in "modern" services such as information technology.

But the bad news is that finance and real estate account for a large portion of these gains, making the ostensible shift to a services economy less sustainable. Indeed, China's modern services sector, including finance, actually looks over-developed in comparison to other Asian economies. What is more, the Chinese household services sector by contrast

looks somewhat under-developed, and many service sectors in China are still heavily regulated.

Further deregulation of many service sectors, including the use of public and quantitative targets, will be needed if China is to successfully shift the pattern of services development in a healthier direction.

This memorandum offers a few ideas about why such deregulation is needed. It begins with an economic analysis of the sources of recent growth in China's services sector. It then outlines a three-part prescription for a potentially effective program of service-sector liberalization.

The Economics of Services Growth in China

With once-booming heavy industrial sectors like steel and coal now experiencing a deep slowdown and plagued by overcapacity, hopes for the future growth of the Chinese economy are increasingly focused on services. Policymakers aim to “identify and cultivate” new sources of growth. And so senior Chinese politicians and policymakers are touting services to provide many of the new growth drivers.

Recognizing that excess capacity in traditional heavy industry is deterring new investment, China’s government has, for example, called for “strategic

emerging industries and the services sector” to play a greater role in the economy.¹ With the share of services in the Chinese economy rising rapidly in recent years—and exceeding 50 percent for the first time in 2015—this transition seems to be making some progress. But the drivers behind the rise of services are not well understood. Nor is it necessarily clear what is the proper role for government policy.

How, then, should we evaluate the rise of China’s service sector so far? What could or should China do to help further develop services?

To help answer these questions, it is necessary to look at the sources of recent growth in China’s service sector, and to compare its development to that in other Asian economies.

The first step to a better understanding China’s service sector is to recognize that there is not just one, unitary service sector. Services are a diverse group of businesses with very different economic characteristics, and it is not always meaningful to lump together activities

as diverse as educating children, delivering packages, and making loans.

This memorandum adapts a classification of services from

the economics literature by grouping services into three broad categories of sectors: traditional, household, and modern services.² In doing so, it aims to steer a middle course between making excessively vague generalizations about services as a whole, and conducting overly tedious investigations of multiple and distinctive sectors.

“Traditional” service sectors are those for which demand is usually proportional to the size of the economy. This means that their share of GDP tends to stay flat or fall somewhat over time. Traditional services are mainly

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those that move goods around the economy (transportation, wholesaling, or retailing, for example), but public administration is also included.

“Modern” services tend to grow faster than the overall economy, in part because they can make better use of new technologies, and thus their share of GDP tends to rise sharply over time. These include finance, real estate, communications, and other business services.

“Household” services—for instance, healthcare, education, and entertainment—lie somewhere in between. They have both modern and traditional characteristics but share the common trait of being consumed directly by households. Their share of GDP also tends to rise over time.

Service Sector Performance in China

To investigate the performance of these three broad categories of services over time requires fairly detailed data on the composition of GDP by sector. For China itself, official data with a sufficiently detailed breakdown of the service sector is available only for the years 2004-2012.

This memo is based on the construction of a longer time series back to 1981 that merged the official data with the historical estimates published in the China Industrial Productivity Database (CIP), a project of the Research Institute of Economy, Trade and Industry (RIETI) in Tokyo.³ It also extends the data up to 2015 by combining partial official data and the author’s own estimates.⁴

Table: Classification of Service Sector

	Description	Chinese national accounts categories
Traditional services	Transportation; wholesaling and retailing; public administration	Wholesale and retail trade; Transport, storage and post; Public administration and social organization
Household services	Hotels and restaurants; education; health; community and personal services	Accommodation and catering trade; Education; Healthcare, social security and welfare; Culture, sport and entertainment
Modern services	Telecommunications; computer services; finance; real estate; legal, technical and other business services	Information transmission, computer services and software; Financial intermediation; Real estate; Leasing and commercial service; Scientific research, polytechnic service and geological prospecting; Water conservancy, environment and utility management

Source: KLEMS database; author.



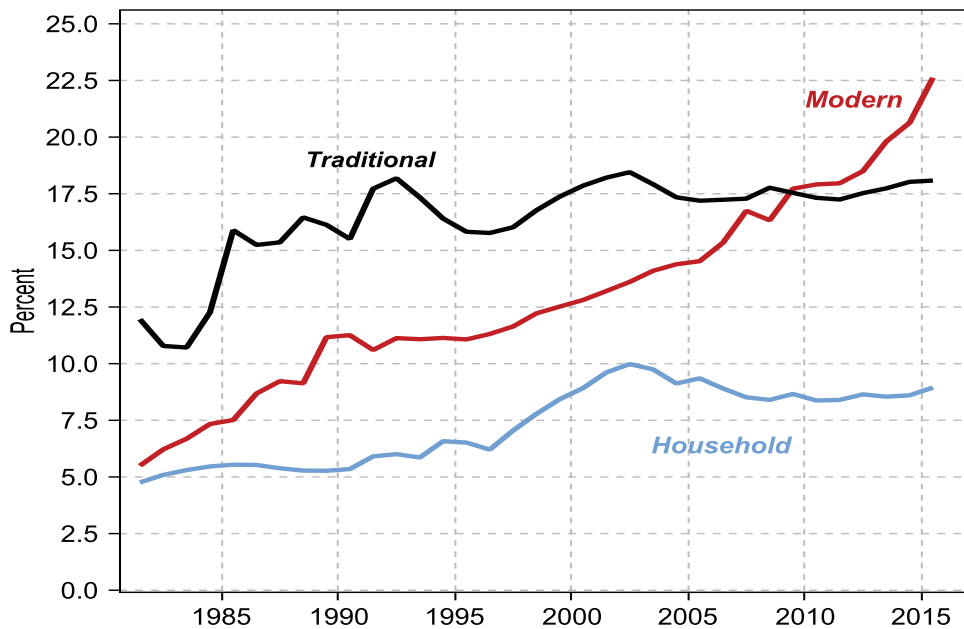
The author then created time series data on traditional, household, and modern services in Japan, South Korea, and Taiwan, using the detailed data on value-added by sector published by the World KLEMS and Asia KLEMS projects.⁵ These data sources use slightly different sector classifications; the table below shows the definition used for traditional, modern, and household services in terms of each system (see Table).

With this data in hand, we can establish some basic facts about the development of the service sector in China, and how it compares to other Asian countries at similar levels of income.

The size of China's traditional service sector has stayed steady at around 17.5 to 18 percent of GDP for more than a decade, after rising from a low base in the 1990s (see Figure 1). The size of the household services sector has also been relatively stable around 8.5 percent in recent years, after increasing sharply from 5-6 percent in the 1980s and early 1990s.

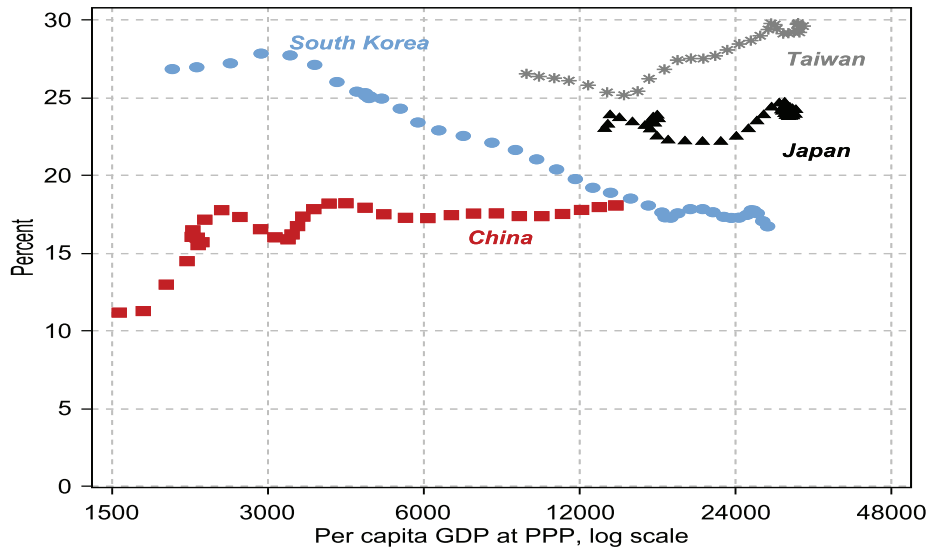
In contrast, the size of the modern services sector has not been at all stable: it has steadily risen over time, from about 13 percent of GDP in 2000 to an estimated 22.6 percent of GDP in 2015. Thus we can immediately see that

Figure 1. Share of Service Sector Groups in China's GDP



Source: CEIC; RIETI; author estimates.

Figure 2. Traditional Services Share of Value Added



Note: 3-year centered moving average
 Source: CEIC; RIETI; World KLEMS; Gavokal; author estimates.

virtually all of the recent increase in the total size of all service sectors, from 40 percent of GDP in 2000 to 50 percent in 2015, has been due to modern services.

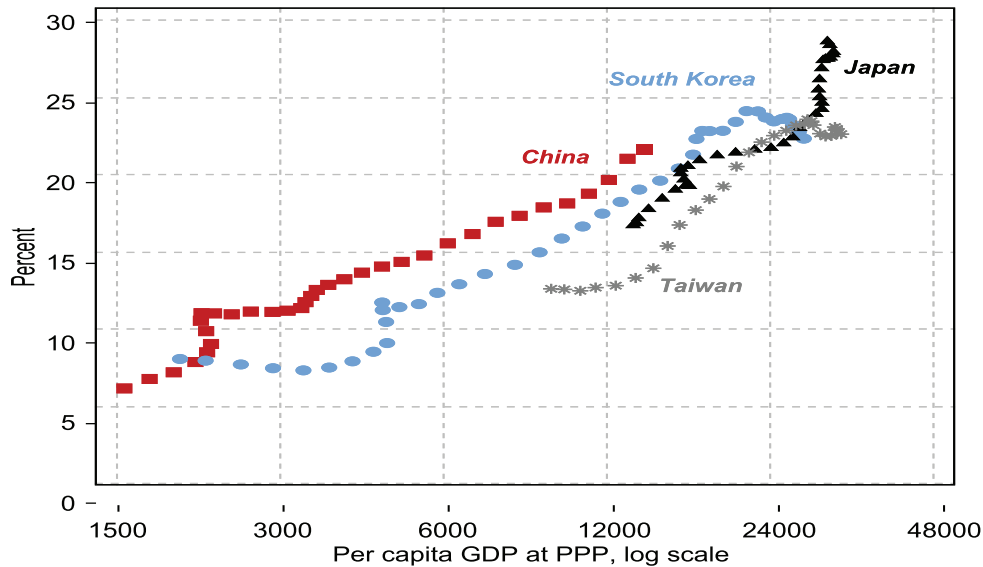
How does China’s experience compare with other Asian economies? In traditional services, there is no consistent cross-country pattern: their share of GDP was stable in China, declined in South Korea, and rose in Taiwan and Japan (see Figure 2). In modern services, on the other hand, the cross-country pattern is very consistent (see Figure 3). All four Asian economies have experienced a sharp and sustained increase over time. The rise in the share of China’s GDP comprised of modern services has been quite similar to that experienced by its neighbors. In fact,

if anything, China has performed even better.

China currently has a per-capita GDP of around US\$14,000 at purchasing-power parity and a modern services sector of about 22.6 percent of GDP. This is a somewhat larger share than South Korea (19 percent) or Japan (17.6 percent) had at similar income levels, and significantly larger than what Taiwan (12.9 percent) had.

Given that the data sources used for this comparison may still differ in how individual sectors are defined, small differences in the level are probably less informative than the trend over time. But the fact that China’s economy has a large share of modern services at a

Figure 3. Modern Services Share of Value Added in Asia



Source: CEIC, RIETI, World KLEMS, Gavekal Data, author estimates.

lower income level is indeed striking in an Asian comparative context.

The pattern of the development of household services in different Asian economies also varies quite a bit. China's household services sector made up about 9 percent of 2015 GDP in these estimates (see Figure 4).

At comparable levels of income, the size of the household services sector was very similar in Taiwan (8.9 percent), but much higher in South Korea (12.7 percent) and Japan (17.7 percent). Perhaps more significantly, all three Asian economies experienced very rapid increases in household services as a share of GDP when their incomes were similar to China's today.

So in contrast to the very rapid growth it has seen in modern services, China does not appear to be experiencing similar rapid growth in household services. (Of course, some of the most recent figures for this sector in China are partially estimated by the author and therefore could have some errors; official data when or if it becomes available may show a slightly different trend.)

To summarize: relative to countries with similar historical development trajectories, China appears to have an over-performing modern services sector but an under-performing household services sector.

What explains this unusual pattern? Taking the modern services sector first,

there are two main factors behind its recent rapid rise, one fairly positive and the other less so.

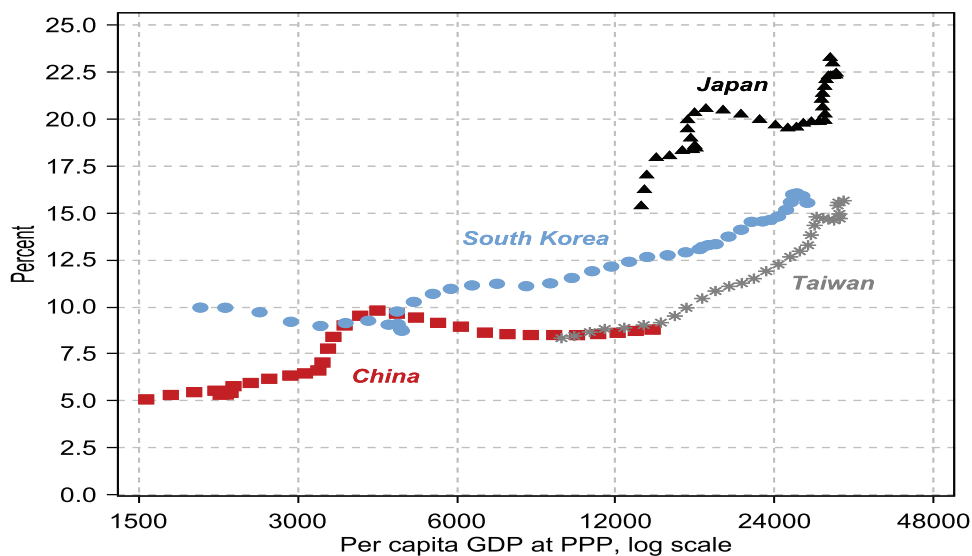
The positive story is the steady increase in the share of GDP from business services and technology-related services (see Figure 5). The author's own estimate, based on the correlation with other indicators of activity, shows a sharp spike in the share of GDP from technology-related services in recent years.

Official data, when it becomes available, could show a less volatile trend, yet the surge in activity does match up with recent reports of huge new venture capital investments in many high tech businesses and the rapid expansion

evident in sectors such as online retailing. China has seen much more rapid growth in the penetration of online retailing than almost any other large economy, whether developed or developing.⁶ China's enormous domestic market and relatively well-developed infrastructure seem to have made it fertile ground for Internet businesses that benefit from economies of scale. Nonetheless, the share of technology-related services in the economy, around 3-4 percent, is much smaller than the popular attention to them might suggest.

A more worrying factor behind the rapid rise of modern services is the enormous expansion in China's financial sector, which has enabled the stock of

Figure 4. Household Services Share of Value Added



Note: 3-year centered moving average

Source: CEIC; RIETI; World KLEMS; Gavekal; author estimates.

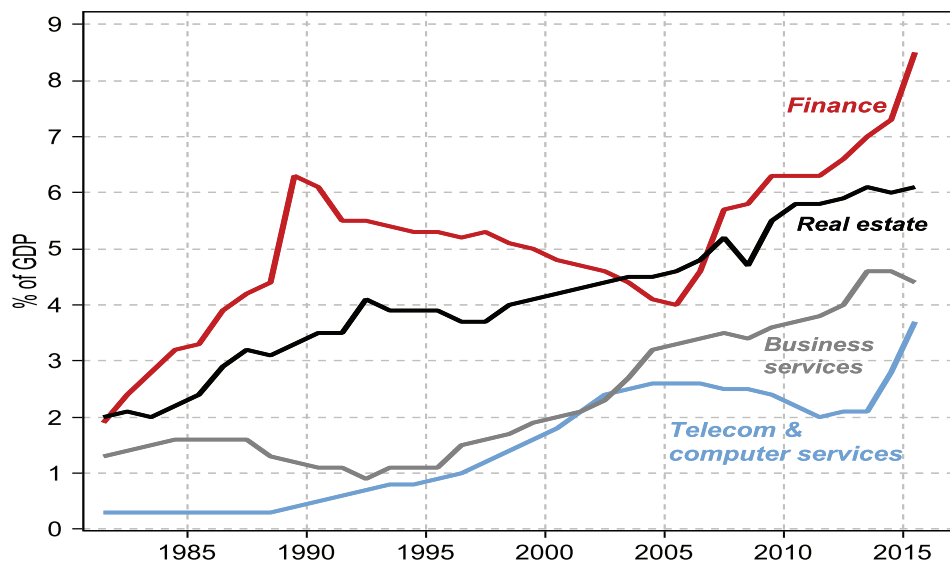
outstanding credit to the real economy to rise from a low of 120 percent of GDP in 2007 to over 200 percent in 2015 (see Figure 6). This trend is the result of the extremely loose monetary policies and aggressive stimulus measures employed in China since the global financial crisis of 2008, as well as associated policies of financial deregulation.

The expansion of China's financial sector is mainly responsible for the concomitant rise of the share of modern services in GDP. A simple breakdown illustrates this: The share of modern services in GDP increased by 7.3 percentage points in the decade to 2015. And of this increase, more than half (3.9 percentage points) was due to the financial sector alone.

The combination of business services and technology-related services together contributed just 2.0 percentage points. The rapid expansion of the financial and real estate sectors has, in other economies, been associated with boom-bust cycles and financial crises. So it is hard to interpret this pattern of service-sector development in China as evidence that the underlying structure of the economy is shifting in a more sustainable direction.

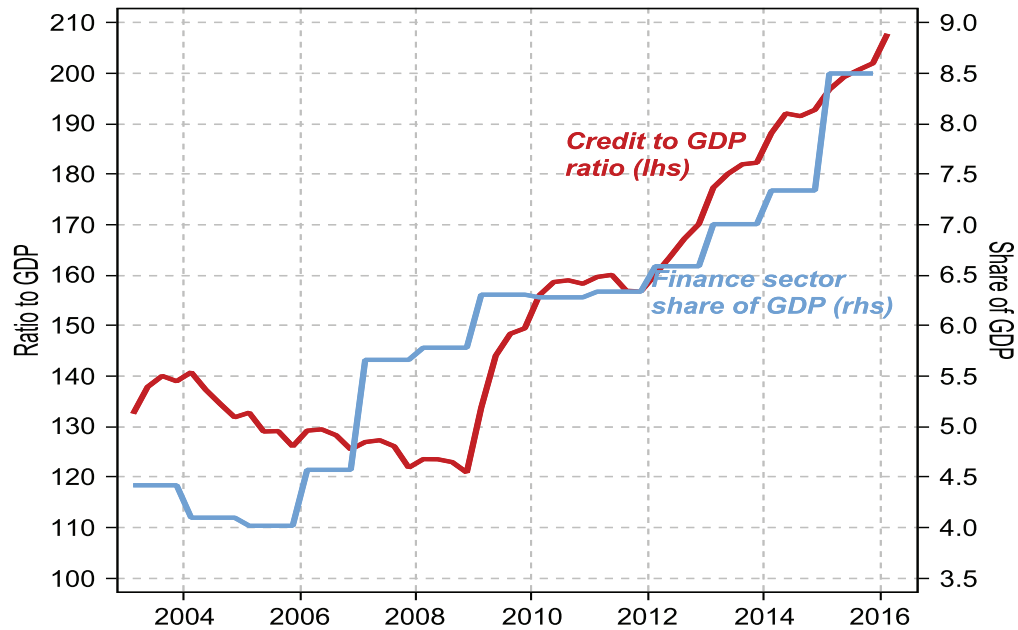
For household services, however, the explanation is less clear-cut. The share of household services in China's GDP has crept steadily upward in recent years and the trajectory is so far quite similar to Taiwan's. But household services also had a much higher share of GDP in South Korea and Japan, and rose

Figure 5. Modern Services as a Share of China's GDP



Source: CEIC; RIETI; author estimates.

Figure 6. The Growth of China's Financial Sector



Source: CEIC; author estimates.

much more rapidly. Even after taking into consideration the price controls imposed on many service sectors, including healthcare, this pattern suggests that the provision of these services may be inadequate in China given its level of income.

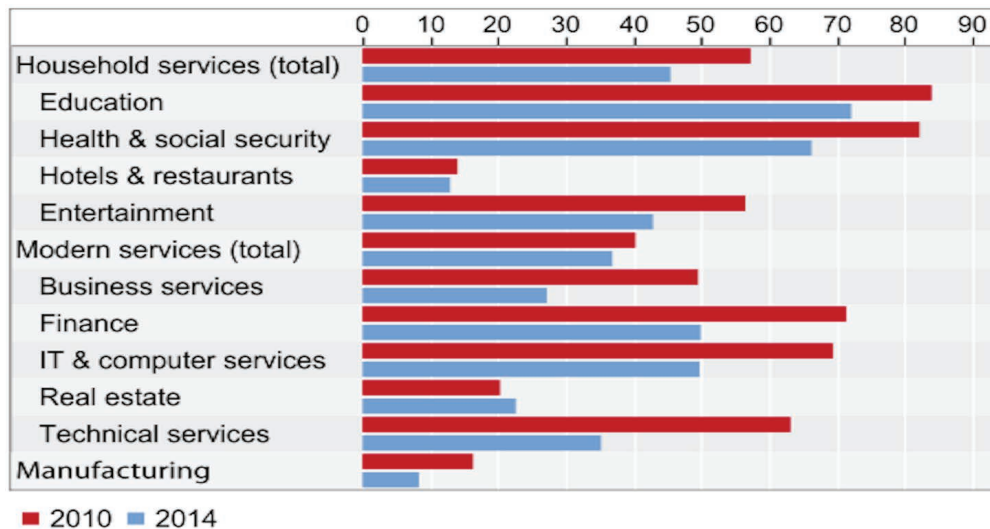
The economic cycle does not provide an obvious explanation: growth in China's household consumption has in fact outpaced GDP growth since 2011, so the share of consumption in GDP is actually rising. A structural explanation may therefore be more plausible—the most obvious being the combination of high levels of state ownership and regulation in household services.

Services in China in general are tightly regulated compared to developed economies. The Organization

for Economic Cooperation and Development's (OECD) Services Trade Restrictiveness Index measures restrictions on cross-border trade in 18 service sectors; China's average score of 0.451 makes it significantly more restrictive than the OECD average of 0.195, although this is comparable to India and Indonesia.⁷ Most of the services ranked in the OECD's index fall in the traditional and modern categories, but some of the household services that are ranked—notably broadcasting and motion pictures—are among the most restricted services in any country.

It is harder to measure how restrictive Chinese regulations are for domestic investors, but one possible proxy is the role of state-owned enterprises (SOEs). China's detailed data on fixed-asset

Figure 7. SOE Investment by Sector



Source: NBS.

investment make it possible to quantify the role of SOEs in different sectors, since the figures are broken down according to whether firms undertaking the investment are state-controlled or not (see Figure 7). SOEs account for about 45 percent of investment in household services overall, and in two large and important household service sectors, healthcare and education, SOEs account for 72-74 percent of investment.

By comparison, SOEs account for just 35 percent of investment in modern services, about the average for the Chinese economy as a whole. The level of SOE involvement in many service sectors has clearly declined in recent years, but it also remains high relative to sectors that were opened to private investment earlier, such as manufacturing or restaurants.⁸

Higher levels of regulation and SOE involvement (which may be versions of the same phenomenon) could restrict the growth of China’s service sectors in two ways.

First, firms in these sectors may act (or be forced to act through regulation) like monopolies that provide a lower quantity of goods at a higher price, and therefore leave some of the potential market unserved.

In this situation, allowing more private-sector firms to enter the market would increase investment and output as the new entrants target opportunities not served by incumbents. Second, because state-owned firms in China have a systematically lower return on investment than private-sector firms, their investments in service sectors may not generate as much future growth as

those by private firms. Boosting higher return investments by private firms in service sectors should therefore lead to faster growth in output of services.

From this discussion, we can draw two simple conclusions. The first is that the rise in the share of services in China's economy is, to a large extent, the result of economic policy decisions taken in response to slowing growth. Finance and real estate have been the main channels through which government stimulus policies have operated, and these have also been the main contributors to the increase in the service sector's share of GDP.

The high level of debt that has resulted has drawn a great deal of concern both domestically and internationally, and it is far from clear that the rapid expansion of the financial sector is an unalloyed good for China. Therefore it would be premature to take the recent rise in the service sector's share of GDP as evidence that the structure of the

Chinese economy is shifting to a more sustainable pattern. Indeed, there is a risk that rapid growth in the financial sector will end up making growth less sustainable, as has turned out to be the case in other economies.

The second conclusion is that it would also be premature to take the rising share of services in GDP as a sign that China's regulatory system is well adapted to the needs of a growing middle-income country. China does have expanding service sectors outside of finance and real estate, notably in technology and other business services.

But services in general are still very tightly regulated and some of them, particularly household services, could be under supplied given China's level of income. As the gains in China's financial sector are unlikely to be sustainable, there is a good case for further liberalizing other service sector to encourage a transition to new sources of growth.

A Roadmap for Liberalizing Services

The overview in the last section suggests a need to liberalize a number of service-related sectors. But China will face a particular challenge because it lacks an effective government policy framework for driving such liberalization. This is because of three interrelated issues.

First, overall industrial policy is now dominated by the “Made in China 2025” initiative, which assigns to manufacturing a central and strategic role and a subordinate one to services.⁹

Second, specific policies on services are dominated by attempts to encourage the growth of fashionable high-technology services rather than other, more mundane services. Third, while official documents do endorse the liberalization of service sectors in principle, they do not propose any concrete or quantifiable targets for such liberalization. This makes it difficult to ensure compliance with the broad aim of liberalization—and to measure whether or not progress is being made.

To be sure, the Chinese government has not ignored the service sector. Over the course of 2015, the State

Council published a number of policy documents on services, including one on trade in services and another on consumer services.

But these documents were primarily focused on technology-related services. Indeed, the State Council published no less than three separate documents

on encouraging e-commerce in 2015 alone, as well as two on “Big Data”—and that does not even include the high-profile “Internet Plus Action Plan.”¹⁰

This focus on high technology risks turning into a misallocation of a scarce and valuable

resource—the government’s time and attention. Technology-related services such as e-commerce (and related fields, such as express delivery) are indeed among the fastest-growing parts of the Chinese economy. But this rapid growth has been going on for years, before any government documents named the sector as a source of “new dynamism” for the economy.

There is no obvious need for substantial government intervention to further drive their growth, in part because high-tech sectors are already relatively lightly



Photo: Flickr/Wolfgang Staudt

regulated. The government’s resources could, then, be better directed to encouraging growth in sectors where growth is not as strong and regulation is more of a burden.¹¹ Many—but certainly not all—of the best candidates for such government action are in household services.

This memo suggests a three-part strategy for accelerating the liberalization of the service sector:

- A plan for liberalizing service sectors should be promulgated by the highest levels of government, thus putting this economic reform on a par with “Made In China 2025” and other major policy priorities.

- This plan should focus primarily on those service sectors that are highly regulated, heavily dominated by SOEs, or both. In many cases these will be slower growing household service sectors rather than recently fashionable or high-growth sectors. However, there are sectors such as media, express delivery, and telecommunications that are both relatively high growth and heavily regulated.

- Perhaps most controversially, this plan should include specific quantitative targets for liberalization. The simplest way to do this would be to simply announce a target for the private sector’s overall market share in a given sector.

Such a strategy would be consistent with broad goals already outlined by China’s government. The 13th Five-Year Plan (FYP, 2016-2020) calls for promoting the development of business services, such as industrial design, legal and accounting services, and business consulting, as well as household services including education, elder care, entertainment, and tourism. It also calls for opening up numerous service sectors to private capital, although it does not propose any quantitative indicators for measuring progress.¹²

Perhaps most controversially, this plan should include specific quantitative targets for liberalization.

Indeed, quantitative targets are often seen as an undesirable legacy from China’s planned economy era. But most of the

criticism directed at quantitative targets in China is because they are used inappropriately, for indicators that the government cannot actually control. For indicators that are actually within the government’s control, such as regulation and the delivery of public services, quantitative targets are not in principle undesirable.

After all, no one thinks it strange for central banks to have a quantitative target for inflation. And in China’s vast, decentralized bureaucracy, quantitative targets can play a very useful role: they are very transparent, communicate policy intentions effectively to large numbers of people, and make accountability possible by monitoring progress toward the target.

In fact, the Chinese government has already used this approach in one important service sector. The 12th FYP (2011-2015) for the healthcare sector set a target for private hospitals to account for 20 percent of total hospital beds and service volume by 2015.¹³ And the share of private hospitals has notably risen since the FYP's promulgation. While final figures for 2015 are not available, by 2014 private hospitals accounted for 17 percent of beds, up from 12 percent in 2011.¹⁴

The increase came mostly from the creation of new hospitals rather than the privatization of existing public hospitals. So this top-down initiative seems to have successfully catalyzed greater provision of healthcare services.

The change in this sector has, of course, been controversial, with some private hospitals accused of providing shoddy

services.¹⁵ Regulation often struggles to keep up as a sector evolves from a few state-controlled players into a more diverse marketplace with multiple providers. So complementary reforms to improve regulation of both state and private entities are a necessary part of any liberalization. But the healthcare sector does provide one example of how government action can promote the expansion of private-sector firms in services.

Announcing quantitative, industry-specific targets for increasing private companies' role in multiple service sectors, along with credible commitments for the creation of a neutral regulatory regime for companies of all ownership types, would send a very clear signal that China's leadership is serious about liberalizing what is now the largest part of the nation's economy.

Endnotes

¹ Central Economic Work Conference Communique, December 11, 2014, available at http://www.gov.cn/xinwen/2014-12/11/content_2789754.htm.

² The classification is adapted from Barry Eichengreen and Poonam Gupta, “The Two Waves of Service-Sector Growth,” *Oxford Economic Papers* 65 (2013): 96-123 (available at <http://dx.doi.org/10.1093/oeq/gpr059>). What I have called “household services” Eichengreen and Gupta refer to as “hybrid” or Group II services, but I prefer the simpler designation.

³ The CIP data is available at <http://www.rieti.go.jp/en/database/CIP2015/index.html>.

⁴ Official data are available through 2015 for transportation, wholesaling and retailing, finance, real estate, as well as the service sector as a whole. I used these official data, and then estimated the share of GDP from 2013-2015 for other service sectors as follows: healthcare value-added is estimated using the correlation with total expenditure on public health; education value-added is estimated using the correlation with government spending on education; public administration value-added is estimated using the correlation with fixed-asset investment in the sector; post and telecommunications value-added is also estimated using the correlation with fixed-asset investment in the sector. The remaining services all fall in the “modern” category of business services and were estimated as the residual implied by the difference between the total service sector share of GDP and the sum of the other individual service sectors.

⁵ Data for South Korea and Japan can be downloaded directly from the World KLEMS Data page: <http://www.worldklems.net/data.htm>; data for Taiwan is available at Asia KLEMS: <http://www.asiaklems.net/>.

⁶ Bronnenberg, Bart J., and Paul B. Ellickson, “Adolescence and the Path to Maturity in Global Retail,” *Journal of Economic Perspectives*, 29(4): 113-34. <http://dx.doi.org/10.1257/jep.29.4.113>.

⁷ OECD Services Trade Restrictiveness Index is available at <http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm>.

⁸ For more on the pattern of investment by state-owned and private companies, see Nicholas Lardy, “The Changing Role of the Private Sector in China,” a paper prepared for the Reserve Bank of Australia Annual Conference in March 2016, available at <http://www.rba.gov.au/publications/confs/2016/pdf/rba-conference-2016-lardy.pdf>.

⁹ The “Made in China 2025” industrial policy is available at http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm.

¹⁰ See “State Council Directive on Rural E-Commerce Development,” http://www.gov.cn/zhengce/content/2015-11/09/content_10279.htm; “State Council Directive on Cross Border E-Commerce Development,” http://www.gov.cn/zhengce/content/2015-06/20/content_9955.htm; “State Council Directive on E-Commerce Development.” http://www.gov.cn/zhengce/content/2015-05/07/content_9707.htm.

¹¹ For a summary of some of the regulatory issues facing service sectors and some proposed solutions, see Wei Wang et al., “Beyond Manufacturing: Developing the Service Sector to Drive Growth in the PRC,” *East-West Center Asia Pacific Issues*, No. 124, May 2016, <http://www.eastwestcenter.org/node/35640>.

¹² The service sector is discussed in Section 5, Chapter 24 of the 13th Five Year Plan summary, published on March 17, 2016, the document is available at http://news.xinhuanet.com/politics/2016h/2016-03/17/c_1118366322.htm.

¹³ See “12th FYP for Helath Care,” http://www.gov.cn/zwqk/2012-10/19/content_2246908.htm.

¹⁴ *China Public Health Statistical Yearbook*, table 3-1-2, various years. The statistics divide hospitals into two categories, public and non-public (公立, 非公立); for simplicity, I refer to “non-public” hospitals as private.

¹⁵ For an example of the critical coverage sparked by the death of a young man, see <http://www.ejinsight.com/20160506-student-death-reveals-china-s-chaotic-private-hospital-sector/>.

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Paulson Policy Memorandum

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