Services Sector in India: Trends, Issues and Way Forward

Arpita Mukherjee

Abstract

This paper provides an overview of the Indian services sector. It shows that services is the fastest growing sector in India, contributing significantly to GDP, GDP growth, employment, trade and investment. Labour productivity in services is the highest and it has increased overtime. India is a major proponent of liberalizing services both in the WTO and in its bilateral trade agreements. However, there are some concerns. Economic growth has slowed down. Growth in employment in services has not been commensurate with the share of the sector in GDP. A large part of the employment is in the non-corporate or unorganised sector, with limited job security. Although India is portrayed as a major exporter of services, its rank among WTO member countries in services exports is lower than that of China’s and its export competitiveness concentrate in few sectors and a few markets. The paper identifies a number of barriers faced by the services sectors and suggests policy measures, which, if implemented, will lead to inclusive growth, increased productivity, generate quality employment, increase trade and investment, and enhance India’s global competitiveness in services.

Keywords
Services, Employment, Productivity, Trade, Investment, Trade Agreements and India

JEL Codes
L80, O40, J21, L88, F13,

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India is among the fastest-growing economies in the world. According to the International Monetary Fund (IMF), in 2010, India’s gross domestic product (GDP) grew at 10.6% compared to 10.4% for China, an average growth rate of 9.7% in developing countries within Asia and 7.5% average growth rate in emerging and developing economies. Although growth rate slowdown substantially in 2011 to 7.2%, it was still higher than the average growth rate of emerging economies (6.2%). Services sector has been a major contributor to India’s GDP and growth (Bhattacharya and Mitra 1990). It is the second largest employer after agriculture. India’s trade in services has increased overtime and services accounts for the largest share in India’s foreign direct investment (FDI) inflows and outflows.

The growth of India’s services sector, its contribution to GDP, and its increasing share in trade and investment has drawn global attention. Unlike other countries, where economic growth has led to a shift from agriculture to industries, in India, there has been a shift from agriculture to the services sector. In this respect, some economists (Ansari 1995) consider India as an outlier among South Asian countries and other emerging markets. Contending this view, Gordan and Gupta 2003, Banga 2005 and Jain and Ninan 2010 have pointed out that India is not an outlier as the share of services sector in GDP has increased with rise in per capita income. Kochhar et. al. 2006 argued that India was a negative outlier in 1981 compared to other emerging markets as the share of services in value added and employment was below that of other countries. After the economic reforms of the 1990s, services sector grew and in 2000 India became a positive outlier in terms of the share of services in value added but continued to be a negative outlier in terms of its share in employment.

In India, growth in services sector has been linked to the liberalisation and reforms of the 1990s. In the first three decades (1950s to 1970s) after India’s independence in 1947, GDP grew at an average decadal growth rate of less than four per cent. India was largely an agrarian economy. The share of services sector was small and a large number of services were government monopolies. Services sector started to grow in the mid-1980s but growth accelerated in the 1990s when India initiated a series of economic reforms after the country faced a severe balance of payment crisis. Reforms in the services sector were a part of the overall reform process, which led to privatization, removal of FDI restrictions and streamlining of the approval procedures, among others.

Existing studies show that liberalisation and reforms is one of the important factors contributing to the growth of services sector in India (Chanda 2002, Gordan and Gupta 2003, Banga and Goldar 2004 and Jain and Ninan 2010). With economic growth and rise in per capita income,

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4 World Economic Outlook: August 2012
5 World Economic Outlook: August 2012
there is a change in demand pattern from necessary to discretionary consumptions like education and personal and health care services (McKinsey & Company 2007). High income elasticity of demand for services has contributed to the high growth of this sector (Bhattacharya and Mitra 1990 and Gordan and Gupta 2003). Technological progress and availability of high skilled manpower has led to growth of services like information technology (IT) and IT enabled services (ITeS) (Chanda 2002). Developed countries outsource its services to developing countries like India leading to a rise in demand for services from the developing market (Bhagwati 1984, Gordan and Gupta 2003 and Hansda 2001). High government expenditure on certain services like community, social and personal services has also led to high growth of services (Ansari 1995).

The objective of this paper is to provide an overview of the Indian services sector. It identifies major barriers faced by the sector and provides policy recommendations which if implemented will lead to inclusive growth, increase productivity, generate quality employment and increase trade and investment. Section I provides an overview of the services sector in India, focusing on its contribution to GDP, GDP growth and employment. It also presents future growth projections. Section II examines India’s trade and investment in services. Section III discusses India’s negotiating position in services in the WTO and bilateral trade agreements. Section IV presents the barriers faced by the services sector in India and provides policy recommendations. The last section draws the main conclusions.

I. Overview of Services in India

This section analyses how services sector is classified, its governance structure, the contribution to GDP, employment and labour productivity. It also presents future growth projections.

A. Classification of the Services Sector and Governance Structure

Services sector can be classified either by using the country’s own definition or by using the United Nations Central Product Classification (UNCPC). The UNCPC is used as a basis for international negotiations like the WTO. In India, the National Industrial Classification (NIC) provides classifications for services. Since the services sector has evolved over the years and the modes of services delivery have undergone changes, the UNCPC and the NIC have also undergone changes. At present, the NIC 2008 classification is used (see Box 1).
There are differences between NIC 2008 and UNCPC classification. For instance, in NIC 2008, construction is not a part of services sector while in the UNCPC construction is included in the services sector.

Disaggregated data for many services is not available in India. Different government departments such as the Central Statistical Organisation (CSO) and the National Sample Survey Organisation (NSSO) under the Ministry of Statistics and Programme Implementation (MOSPI) and the Reserve Bank of India (RBI) have been trying to collect and collate data at the disaggregated level. However, since services such as retail and construction are largely in the non-corporate (informal or unorganised) sector, there is misreporting and underreporting of data.

India has a quasi-federal governance structure and according to the Constitution of India some services are under the jurisdiction of the central government (Union List), some are under the state governments (State List) and the remaining are under the joint administration of central and state governments (Concurrent List) (see Box 2.) At the central level, multiple ministries and government department regulate services such as energy and transport while others like construction and retail do not have a nodal ministry. Some services such as telecommunications has one independent regulator while others like electricity have state level regulators. Professional bodies regulate professions such as doctors, architects and accountants.
B. Contribution of the Services Sector to India’s GDP

After India’s independence, for more than a decade share of services in the GDP was less than 30%. Table 1 shows that overtime the share of services in GDP has increased while that of agriculture has declined. In the last decade, the share of services has surpassed the combined share of agriculture and industry, making it the most important contributor to the country’s output. In 2009-10, services, industries and agriculture respectively accounted for 57.3%, 25.7% and 16.9% of India’s GDP. Nevertheless, the share of services is lower than that of developed countries (the United Kingdom (UK, 78.4%) and the United States (US, 78.2%)), but higher than that of China (41.8%).

Table 1: Decadal Average of the Year on Year Share of the Different Sectors in India’s GDP for the Period 1950-2010

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Primary/Agriculture</td>
<td>55.3</td>
<td>47.6</td>
<td>42.8</td>
<td>37.3</td>
<td>30.9</td>
<td>21.8</td>
</tr>
<tr>
<td>Secondary/Industries</td>
<td>14.8</td>
<td>19.6</td>
<td>21.3</td>
<td>22.3</td>
<td>23.3</td>
<td>24.5</td>
</tr>
<tr>
<td>Tertiary/Services</td>
<td>29.8</td>
<td>32.8</td>
<td>35.9</td>
<td>40.3</td>
<td>45.7</td>
<td>53.7</td>
</tr>
</tbody>
</table>

Author’s own calculations from National Income Accounts, CSO, MOSPI. The calculations are made on GDP at constant prices, constant at 1999-00 and 2004-05.

Source: Author’s compilation from the Constitution of India, 1950.

Source: Author’s own calculations from National Income Accounts, CSO, MOSPI.
Note: The calculations are made on GDP at constant prices, constant at 1999-00 and 2004-05.

The growth of services sector accelerated in the late eighties. In the late nineties; the sector surpassed the growth of industries to become the fastest growing sector of the Indian economy (see Figure 1). Even during the global slowdown the services sector remained resilient to external shocks. In 2009-10, the services sector grew at 9.96% compared to 8.81% growth in industries and 1.57% in agriculture.\(^8\) The compound annual growth rates (CAGR) of services in China and India during 2001-2010 was respectively 11.3% and 9.4%.\(^9\) This implies that even though the present share of services in GDP for China is lower than India, since it is growing at a faster rate, in future the share of services will be higher and can even surpass that of India.

\(^8\) Author’s own calculations from National Income Accounts, CSO, MOSPI.
\(^9\) Economic Survey of India 2011-12.
Over the years, the share of services in gross domestic product (GSDP) of different Indian states has increased but there are variations across states in terms of share of services sector in the GSDP and its growth. In 2009-10, share of services in GSDP of states such as Bihar, Delhi, Kerala, Maharashtra, Mizoram, Nagaland, Tamil Nadu, Tripura and West Bengal was higher than the all-India average while that of Chhattisgarh and Himachal Pradesh was lower. The growth rate of services for states such as Arunachal Pradesh and Sikkim is higher than the all-India average while that of Andhra Pradesh, Karnataka, Rajasthan, Nagaland and Tripura is lower. Even though the share of services sector in GSDP is high for states like Nagaland and Tripura, share of services sector is expected to fall in future because growth of services sector is low. Kochhar et. al. 2006 found that the share of public sector services including administration is growing in laggard states while the share of private sector services is growing in fast-growing

Figure 1: Percentage Growth Rate of Different Sectors in India for the Period 1951-2010

Source: Compiled by authors from National Income Accounts, Central Statistical Organisation (CSO), Ministry of Statistics and Programme Implementation (MOSPI). Note: The calculations are made on GDP at constant prices, constant as 1999-00 and 2004-05.

10 Economic Survey of India 2011-12.
states. A number of fast-growing states have shown a decline in growth in manufacturing and rise in services.

**Contribution of Services Sub-Sectors to India’s GDP**

There are variations in growth and performance of different sub-sectors of services. Business services (including IT), communications and trade have grown faster than the overall services sector growth in India. Others such as real estate, legal services, transport, storage and personal administration and defence services have grown at the same rate as the overall services sector growth (see Gordon and Gupta 2003). Existing literature shows that services such as IT, telecommunications and financing services have contributed to the high growth of the services sector. Hansda (2001) and Joshi (2008) has pointed out that the rise in the export demand of IT has led to high services growth in India.

Table 2 shows that the share of different subsectors of services in the GDP and services sector has changed overtime. After the economic reforms of the 1990s, the share of all the services subsectors in GDP has increased. The share of financing, trade and transport sectors in total services sector has increased while that of community, social and personal services has declined.
Table 2: Decadal Average of the Year on Year Share of Services Sub-sectors in Total Services Sector and GDP (in %)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Community, social &amp; personal services</td>
<td>35.0</td>
<td>10.4</td>
<td>35.0</td>
<td>11.4</td>
<td>35.1</td>
<td>12.6</td>
</tr>
<tr>
<td>Public administration &amp; defence</td>
<td>9.5</td>
<td>2.8</td>
<td>12.3</td>
<td>3.9</td>
<td>14.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Other services</td>
<td>26.3</td>
<td>7.8</td>
<td>23.2</td>
<td>7.6</td>
<td>21.0</td>
<td>7.5</td>
</tr>
<tr>
<td>Financing, insurance, real estate &amp; business services</td>
<td>25.2</td>
<td>7.5</td>
<td>21.2</td>
<td>7.0</td>
<td>20.3</td>
<td>7.3</td>
</tr>
<tr>
<td>Banking &amp; insurance</td>
<td>4.0</td>
<td>1.2</td>
<td>4.8</td>
<td>1.5</td>
<td>5.9</td>
<td>2.1</td>
</tr>
<tr>
<td>Real estate, ownership of dwellings &amp; business services</td>
<td>20.5</td>
<td>6.1</td>
<td>16.2</td>
<td>5.4</td>
<td>14.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Trade, hotels &amp; restaurant</td>
<td>28.5</td>
<td>8.5</td>
<td>30.7</td>
<td>10.0</td>
<td>30.2</td>
<td>10.8</td>
</tr>
<tr>
<td>Trade</td>
<td>26.5</td>
<td>7.9</td>
<td>28.4</td>
<td>9.3</td>
<td>28.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Hotels &amp; restaurants</td>
<td>2.0</td>
<td>0.6</td>
<td>2.2</td>
<td>0.7</td>
<td>2.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Transport, storage &amp; communication</td>
<td>11.3</td>
<td>3.4</td>
<td>13.1</td>
<td>4.3</td>
<td>14.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Railways</td>
<td>4.7</td>
<td>1.4</td>
<td>4.9</td>
<td>1.6</td>
<td>4.5</td>
<td>1.6</td>
</tr>
<tr>
<td>Transport by other means</td>
<td>5.9</td>
<td>1.7</td>
<td>7.1</td>
<td>2.3</td>
<td>8.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Storage</td>
<td>0.3</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Communication</td>
<td>1.0</td>
<td>0.3</td>
<td>1.3</td>
<td>0.4</td>
<td>1.6</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: Author’s own calculations from National Income Accounts, CSO, MOSPI.
Note: The calculations are made on GDP at constant prices, constant at 1999-00 and 2004-05.
In the 1950s and 1960s, transport, storage and communication services and trade, hotels and restaurant services grew faster than the overall services sector growth in India. In the 1970s and 1980s, financing and business services started growing at a faster rate. In fact, in the 1980s, financing and business services surpassed the growth of services such as transport, storage and communication and trade, hotels and restaurant. In the decade of 2000-2010, transport, storage and communication services are the fastest growing services sub-sector, followed by financing and business services. Both the sub-sectors have grown faster than the overall services sector growth (see Figure 2).

**Figure 2: Decadal Average of the Year-on-Year Growth in the Services Sub-sectors for the Period 1950-2010**

<table>
<thead>
<tr>
<th>Decade</th>
<th>Trade, hotels &amp; restaurant</th>
<th>Transport, storage &amp; communication</th>
<th>Financing, insurance, real estate &amp; business services</th>
<th>Community, social &amp; personal services</th>
<th>Total Services</th>
<th>Gross domestic product at factor cost</th>
</tr>
</thead>
</table>

*Source: Author’s own calculation from National Income Accounts, CSO, MOSPI. Note: The calculations are made on GDP at constant prices, constant as 1999-00 and 2004-05.*

**C. Employment in the Services Sector**

There has been a lot of debate on employment generating capacity of services sector. It has been argued that employment growth in services sector has not been commensurate to the income growth in the sector (Bosworth and Maertens, 2010) or the rise in its share in India’s GDP (Kochhar *et. al.* 2006). The change in the production structure from agriculture to services has not been reflected by a proportionate change in the occupational structure (Bhattacharya and
Mitra 1990). As a result, services-led growth has been a jobless growth (Banga, 2005 and Bhattacharya and Sakthivel 2004).

In terms of size of total employment (both organised and unorganised), in 1993-94, close to 63% of the population was engaged in agriculture sector and around 21% in services. Over the years, the percentage of people employed in agriculture has declined and employment in services has increased, though the broad pattern of employment has remained the same with agriculture having the highest share. There has been a change in the pattern of employment within the services sector. Wholesale and retail trade account for a substantial part of services sector employment and its share is rising. The share of transport, storage and communication is also increasing. However, the share of public administration and defence has declined (see Table 3 for details).

Table 3: Employment in Different Sectors and Some Services Categories as a Percentage of Total Employment in India

<table>
<thead>
<tr>
<th>Service Category</th>
<th>2009-10</th>
<th>2004-05</th>
<th>1999-00</th>
<th>1993-94</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary/Agriculture</td>
<td>53.2</td>
<td>58.5</td>
<td>61.7</td>
<td>62.8</td>
</tr>
<tr>
<td>Secondary/Industries</td>
<td>21.5</td>
<td>18.1</td>
<td>15.9</td>
<td>15.2</td>
</tr>
<tr>
<td>Tertiary/Services</td>
<td>25.3</td>
<td>23.4</td>
<td>22.4</td>
<td>22.0</td>
</tr>
<tr>
<td>Wholesale and retail trade; repair of motor vehicles, motorcycles &amp; personal &amp; household goods</td>
<td>9.5</td>
<td>9.0</td>
<td>8.7</td>
<td>7.7*</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>1.3</td>
<td>1.3</td>
<td>1.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Transport, storage and communications</td>
<td>4.3</td>
<td>3.8</td>
<td>1.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>0.8</td>
<td>0.6</td>
<td>0.5</td>
<td>1.0*</td>
</tr>
<tr>
<td>Real estate, renting and business activities</td>
<td>1.3</td>
<td>0.9</td>
<td>0.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Public administration and defence; compulsory social security</td>
<td>2.1</td>
<td>1.8</td>
<td>2.5</td>
<td>9.5*</td>
</tr>
<tr>
<td>Education</td>
<td>2.6</td>
<td>2.4</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>Health and social work</td>
<td>0.8</td>
<td>0.8</td>
<td>0.6</td>
<td></td>
</tr>
<tr>
<td>Other community, social and personal service activities</td>
<td>1.9</td>
<td>1.8</td>
<td>2.4</td>
<td>0.3*</td>
</tr>
</tbody>
</table>

Source: Author’s own calculations from NSSO Reports on Employment and Unemployment in India, various issues.

*Note that the classification of services as per the NIC has undergone several changes. In the year 1993-94, NIC 1987 classification is used where services such as wholesale and retail trade; repair of motor vehicles, motorcycles & personal & household goods, hotels, and restaurants...
were clubbed together. Similarly, financial intermediation and real estate, renting, and business activities were clubbed together and public administration and defence; compulsory social security, education, health, and social work were clubbed together.

In 2009-10, it accounted for around 62% of the total organised sector employment. However, within the services sector, over 80% of the employment is in the unorganised sector. Sub-sectors such as finance, insurance, real estate and business services and community, social and personal services largely provide organised sector employment while services such as retail and wholesale trade largely provide unorganised sector employment.

In 1993-04, around 86% of the total organised services sector employment was in the public sector but in 2009-2010 it declined to 75%. Trade, hotels and restaurants is the only sector where the share of public sector is less than the private sector employment. There are state-wise variations in employment in services. Delhi and Kerala have the highest share in organised sector employment. These states also have one of the highest shares of services in the GDP.

Overall, services sector employment in India is low compared to its share in GDP, but it is growing. Services sector has the largest share of employment within the total organised sector employment, but within services, share of organised sector employment is small. Within the organised services sector, public sector dominates the employment in services and thus private sector has not been very successful in creating organised services sector employment.

D. Labour Productivity in Services Sector

Labour productivity is defined as the value added per worker (Wachter 2001). In India, since data on total employment is not calculated on an yearly basis and a large part of employment in services is concentrated in the unorganised sector, it is difficult to undertake productivity analysis. A majority of the studies (Bosworth et. al. 2007 and Bosworth and Maertens 2010) have concluded that labour productivity is the highest in services sector, particularly in the decades after 1980.

Bosworth and Maertens (2010) have estimated the total factor productivity for India using output data from National Accounts Statistics (NAS) and employment data from other secondary sources. They found that total factor productivity was highest in services sector (see Table 4).

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11 Organised sector is also called the formal sector. It consists of registered companies or units. These are professionally managed with a transparent accounting system and follow government regulations and legislations such as labour laws.

12 Economic Survey of India 2011-12.
Table 4: Total Factor Productivity for Major Sectors in India (1980-2006)
(in %)

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Total Economy</td>
<td>2.1</td>
<td>1.8</td>
<td>2.2</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.9</td>
<td>0.7</td>
<td>1.9</td>
</tr>
<tr>
<td>Industry</td>
<td>1.6</td>
<td>0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Services</td>
<td>1.9</td>
<td>3.1</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: Extracted by authors from Bosworth and Maertens (2010), Table 2.3 pp. 119

Eichengreen and Gupta (2010) used the NAS and cross-country data from the European Union (EU) KLEMS\(^{13}\) and showed that the skill content in both manufacturing and services sector is increasing over time. The authors divided the service sectors into three groups (see Table 5) and pointed out that the productivity growth is the highest in Group 3. Within this group, fastest growing sub-sectors are business services, communications and banking. Growth in exports has contributed to the growth of most services in Group 3. Group 1 has low-income elasticity of demand and Group 2 has cost-disease problem\(^{14}\), leading to low productivity.

Table 5: Categorisation of different Services based on their Productivity Growth

<table>
<thead>
<tr>
<th>Group 1 – Traditional services</th>
<th>Group 2 – Hybrid of traditional and modern services</th>
<th>Group 3 – Modern services</th>
</tr>
</thead>
<tbody>
<tr>
<td>retail and wholesale trade, transport and storage, public administration and defence</td>
<td>education, health and social work, hotels and restaurants, and other community, social and personal services</td>
<td>financial intermediation, computer services, business services, communications, and legal and technical services</td>
</tr>
</tbody>
</table>

Source: Compiled by authors from Eichengreen and Gupta (2010).

An on-going productivity research study\(^{15}\) funded by RBI shows that for the period 1980-2008, the total factor productivity growth in India has been the highest in services sector (1.58% per annum (p.a.)) followed by agriculture (1.06% p.a.) and manufacturing (0.3% p.a.). The economy wide estimates recorded a labour productivity growth of around 4.5% p.a. for the period 1980-2008. Growth of labour productivity for services, agriculture and manufacturing were

\(^{13}\) KLEMS refer to growth accounting with capital, labour, energy, material and services.

\(^{14}\) Baumol’s cost disease occurs when there is a productivity lag or low productivity growth, due to the nature of the services (Heilbrun 2003).

\(^{15}\) The study is conducted by researchers in ICRIER. This is a work in progress and the findings of the project are not in public domain.
respectively 3.52% p.a., 1.94% p.a. and 5.45% p.a. In the sub-period analysis, the study found that labour productivity growth rates for services increased from 2.69% p.a. in 1980-99 to 6% p.a. in 2000-2008. This increase was due to a large increase in labour productivity growth rates in services sub-sectors such as post and telecommunications, hotels and restaurants and trading services between 1980-99 and 2000-2008. Sub-sectors in which there was a slowdown in labour productivity growth rates include health and social work, other services and education. The outcome of this study does suffer from the non-availability of disaggregated data. For instance, the study does not distinguish between growth in telecommunications and postal sector. It is expected that the high productivity of the post and telecommunications sector is largely driven by the telecommunications sector, since the postal sector in India is still a government monopoly which suffers from over employment.

It is difficult to compare the different studies on productivity in services due to inconsistencies in the data and sectoral classifications. However, the broad findings of the studies show that total factor productivity in services sector has been the highest and that communications services is one of the major propeller of services sector productivity growth in India.

E. Future Growth of Services

The Indian economic growth has slowed down to 6.9% in 2012. Nevertheless, it is projected to grow at 7.3% in 2013, which is higher than the average projected growth rate for emerging and developing economies (6%). With the rise in GDP and per capita income, the number of people below the poverty line has declined while those in high and middle-income group have increased. McKinsey & Company (2007) forecast that if the Indian economy grows at the rate of 7.3% between 2005 and 2025, then by 2025, 583 million Indians will be in the middle class, which is equivalent to the current population of Australia. The share of middle class in the total population will increase from around 5% in 2005 to 41% in 2025. They will account for 59% of the country’s total consumption by 2025. With increase in income, there has also been an increase in the literacy rate, which is expected to increase further. Moreover, India has one of the youngest populations in the world - with 54% of Indians below 25 years of age. All this is leading to a change in the consumption pattern with an increase in demand for discretionary services like education, private health, personal care and hotels and restaurants. The Indian market is large and unsaturated and majority of services has been opened up for foreign

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16 World Economic Outlook: August 2012
17 World Economic Outlook: August 2012
18 As per the UNDP (2009) between 1980 and 2007, there has been an increase in adult literacy by 25 percentage points and in combined gross school enrolment by 20 percentage points.
19 For details see http://nrhm-mis.nic.in/UI/Public%20Periodic/Population_Projection_Report_2006.pdf (last accessed on April 3, 2012.)
investment. India wants to develop as a knowledge-based hub and the government is promoting exports of services. All these factors will drive the future growth of services in India.

Indian government projection show that services sector will continue to grow at a fast pace. The Planning Commission estimates that the economy will grow at 9.5% in the XIIth Five Year Plan (2012-2017). The services sector is projected to grow at the rate of 10% during 2012-2017. Certain services like trade, hotels and restaurants and transport, storage and communications and financing, insurance, real estate are expected to grow faster than overall services growth while others like community social and person services may grow at a slower pace.

II. Trade and investment in Services

Reforms and liberalisation along with technological development, growth of multinationals and new delivery models, and large unsaturated domestic market have enhanced India’s trade and investment in services.

A. India’s Trade in Services

India enjoys global competitiveness in IT and ITeS services, which has increased services’ exports manifolds. The demand for India’s services exports in the global market has led to an increase in India’s trade surplus in this segment (Alejandro et. al 2010). Services exports have contributed to inclusive economic growth by increasing the number of well-paid jobs and by reallocating labour to a high-productivity sector. Services exports have also increased tax revenues and stimulated domestic demand, including demand for infrastructure.

Existing literature shows that there have been changes in composition of services trade - from traditional services such as travel and transport towards knowledge-based and business services (Chanda 2002). India has export potential in skill-based and labour-intensive services (Ministry of Finance 2007).

Trade in services has been growing rapidly in the past two decades (1990-2010). In 1980s India’s services trade was valued at $6 billion and in 2010 it reached $240 billion. India’s services exports not only grew more rapidly than the country’s merchandise exports, but it also grew faster than global services exports. For the period 1980-2010, India’s service exports grew at a CAGR of 13.2%, while world exports of services have grown at the rate of 7.84%. Substantial

20 Author’s calculation using data obtained from UNCTAD Database on ‘International Trade -Services’,
part of this growth has been in the post reform period (1991-2010) – 21.7%.

In the 1980s and 1990s, India had a negative trade balance in services but from 2004 onwards, it has a positive trade balance in services.

In the 1980s, services trade contributed to 20% of India’s total trade. In 2010, the share increased to 30.4% compared to the global average of 24%. Trade in services as a percentage of GDP increased from 3.2% in 1980 to 13.9% in 2010. However, this is still low compared to contribution of services sector in India’s GDP.

India’s share in world trade in services has increased from less than one percent to over 3% between 1980 and 2010, while it share in goods trade remained constant at one per cent during the same period. While the world’s trade in services is still dominated by the developed countries, emerging economies like China and India are now among the top ten exporters and importers of services among WTO member countries. In 2011, India was the eighth largest exporter and seventh largest importer of services. Comparatively, China was the fourth largest exporter of services.

India has both export and import interest in services. With a huge pool of English-speaking skilled work force available at competitive prices, the country has created a niche for itself in export of knowledge-based services such as software services and engineering services. India needs foreign investment and best management practices in infrastructure services.

Developed countries are major trading partners for India in services. The EU as a bloc is the largest trading partner. By country, the US is the largest export destination followed by the UK and other European countries and other English speaking countries like Canada. India imports bulk of its services from the US, the UK, Australia, Germany, Japan, France and Korea.

The export and import trends of different sub-categories shows that during the period - 2000-2010, financial services grew at average annual growth rate of 34.6%, followed by computer and information services (22.6%) and insurance services (20.2%). Like other developing countries such as Brazil and China, India’s exports of other business services have grown nearly four-fold in last decade. During the period from 1980 to 2010, the exports of business services grew at an

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21 Author’s calculation using data obtained from UNCTAD Database on ‘International Trade -Services’,
22 World Bank, World Development Indicators 2011
23 International Trade Statistics, 2012, World Trade Organization
24 WTO 2012 Press Release (Press 658), April 12th, 2012, Appendix Table 5, Page 20,
25 UNCTAD Database on ‘International Trade - Services’,
average annual growth rate of 12.6% compared to 12% average growth rate in transport and 7.6% in travel services.\textsuperscript{26} In 2010, computer and information services contributed 48.5% in India’s total services export, followed by other business services (23.4%), travel (11.4%), transportation (10.7%) and financial services (4.9%).\textsuperscript{27}

Transportation services accounted for around 37.5% of India’s total import in 2010. During 1980 to 2010, the imports of transportation services grew at an average annual growth rate of 11.5%.\textsuperscript{28}

**India’s Competitiveness in Services Trade**

To understand the pattern of India’s services trade specialisation, and to find whether the sector (in India) is globally competitive, the relative competitiveness of services trade can be examined using the revealed comparative advantage (RCA) as per the Balassa’s index (1965). The formula is:

\[ \text{RCA}_{ij} = \frac{x_{ij}}{X_{it}} / \frac{x_{wj}}{X_{wt}} \]

where,

- \( \text{RCA}_{ij} \) = Revealed comparative advantage of the \( i^{\text{th}} \) country (India), \( j^{\text{th}} \) services,
- \( x_{ij} \) = Exports of the \( j^{\text{th}} \) service of the \( i^{\text{th}} \) country (India),
- \( X_{it} \) = Total service exports of the \( i^{\text{th}} \) country (India),
- \( x_{wj} \) = World’s exports of services sector \( j \),
- \( X_{wt} \) = Total world exports of services

If the RCA is greater than one the country is said to have a comparative advantages in the particular services sub-sector \textit{vis-à-vis} rest of the world.

The RCA for services exports of India is given in Table 6. The table shows that India has a strong comparative advantage in only one sub-sector of services exports - computer and information services.

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\textsuperscript{26} UNCTAD Database on ‘International Trade -Services’,

\textsuperscript{27} UNCTAD Database on ‘International Trade - Services’,

\textsuperscript{28} UNCTAD Database on ‘International Trade - Services’,

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### B. Investments in Services

In the post-liberalisation period, services sector has attracted significant foreign investment due to the availability of skilled labour at lower wages and the large and unsaturated domestic market. According to AT Kearney Global Services Location Index, in 2011, India was the leading outsourcing destination among 50 countries, followed by China. India’s rank is highest due to human resource (2nd) but it ranked poorly in terms of business environment (43rd).

According to the A.T. Kearney’s FDI Confidence Index, in 2012, India ranked as the second most attractive destination for FDI after China. The Inward FDI Performance Index of the UNCTAD, which compares relative performance of 141 countries in attracting FDI inflows, found that India has performed poorly compared to other developing countries. In 2010, India was ranked 97th. Comparative ranks of China, Brazil and Mexico were 79th, 69th, and 84th respectively. Thus, while multinational companies have shown confidence in India, the country has not been able to attract much FDI. This may be because the reform process has slowed down in the last couple of years and this has resulted in uncertainties. The Inward FDI Potential Index of UNCTAD, which evaluates the host country’s ability to attract FDI inflows vis-a-vis other

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29 The index is based on the survey of senior executives of multinational companies from 25 countries, and shows the present and future prospects for FDI flows. For details see http://www.atkearney.com/images/global/pdf/Offshoring_Oppportunities_Amid_Economic_Turbulence-GSLI_2011.pdf (last accessed on May 4, 2012)

30 For details see http://archive.unctad.org/Templates/WebFlyer.asp?intItemID=2471&lang=1 (last accessed on May 18, 2010). Lower the rank the better is the performance of the country in attracting FDI.
countries based on the selected factors,\textsuperscript{31} shows that India has improved its ranking from 86 in 1990s to 79 in 2010. Thus, India has the potential to attract more FDI inflows in future, if appropriate policy measures are undertaken and business hurdles are addressed.

**Trend and Patterns in Total FDI Inflows and Outflows in Services**

The economic reforms in general and liberalisation of FDI policy in particular have led to manifold increase in FDI inflows since the 1990s. In 1980s, India received $0.08 billion worth of FDI inflows, which increased to $42.5 billion in 2008 and then declined due to the global slowdown to $24.6 billion in 2010. The cumulative FDI equity inflows were $179 billion during April 2000 to August 2012\textsuperscript{32}. Bulk of the FDI inflow into India is routed through Mauritius. Other important investing countries include Singapore, Japan, the US and the UK.

Over the years, India’s share in world’s FDI inflows has increased. In 2009, India’s share in world’s total FDI inflows was 2.44%, which increased from 0.15% in 1980s. However, India’s share declined to 1.98% in 2010.\textsuperscript{33}

In India, FDI inflow in services sector is allowed through two routes – the automatic route and the government route\textsuperscript{34}. For sub-sectors such as services related to agriculture and allied sector, services incidental to mining, services incidental to energy distribution and construction, FDI is allowed through the automatic route while for single-brand retail, test marketing, courier services, and natural gas or liquefied natural gas pipeline transportation services, government approval is needed. At present, FDI is allowed in most of the services sectors except some such as the postal services and railways. FDI is partially allowed in air transport services, multi-brand retail, banking services, etc. The current FDI regime is given in Appendix A, Table A1.

\textsuperscript{31} Factors are: (1) GDP per capita; (2) the rate of GDP growth over the past 10 years, (3) the share of exports in GDP, (4) average number of telephone lines per 1,000 inhabitants, (5) commercial energy use per capita, (6) share of R&D spending in GDP, (7) share of tertiary students in population, (8) country risk, (9) the world market share in exports of natural resources, (10) the world market share of imports of parts and components for automobiles and electronic products, (11) the world market share of exports of services; and (12) the share of world FDI Inward stock. For details, see \url{http://archive.unctad.org/Templates/WebFlyer.asp?intItemID=2470&lang=1} (last accessed on March 2, 2012).

\textsuperscript{32} DIPP, FDI Factsheet, August 2012 \url{http://www.wto.org/english/res_e/statis_e/its2012_e/its2012_e.pdf} (last accessed on November 16, 2012)

\textsuperscript{33} Compiled by author from UNCTAD Database on ‘Foreign Direct Investment’

\textsuperscript{34} Under the automatic route, a non-resident investor or company does not require approval from either the government or the RBI. Under the government route, prior approval of the government through the Foreign Investment Promotion Board (FIPB) is required.
In the pre-liberalisation period, bulk of FDI inflow was in manufacturing (87% in 1980)\(^{35}\) but after liberalisation services is the largest recipient of FDI inflows. The trend analysis of sector-wise distribution of FDI in India is shown in Table 7. The FDI inflows within each sector, for example telecommunications, do not distinguish between goods and services. Therefore, it is difficult to give the exact amount of FDI inflow in services. Nevertheless, Table 7 shows that services sector has been the largest recipient of FDI.

India’s total FDI outflows have increased from $4 million in 1980s to $14.6 billion in 2010.\(^{36}\) In 2010-11, India FDI outflow in the services sector was the largest at $10.3 billion.\(^{37}\) In 2011-12, a majority (62.1%) of Indian outward investments were in the services sector, followed by the manufacturing sector (31.4%). Within the services sector, financial insurance, real estate and business services accounted for 29% of India's total outward investments followed by transport, communication and storage services (15.3%) and wholesale and retail trade and restaurants and hotel services (11.5%). Many Indian IT companies have opened offices abroad. Due to the shortage of fossil fuels in India, companies have also started to invest in mining and related consultancy services abroad. Indian hospital chains and educational institutes are venturing into other South Asian countries. The major recipients of FDI from India include Mauritius, Singapore, Netherlands, US and United Arab Emirates (UAE). In future, outward FDI flows in services are likely to increase further as Indian companies have globalised.

\(^{35}\) Kumar and Dhingra (2011).
\(^{36}\) Compiled by author from UNCTAD Database on ‘Foreign Direct Investment’
\(^{37}\) Source: Extracted from Khan (2012), Table 3, pp. 7.
Table 7: Sectoral Composition of FDI Inflows in India  
\(\text{(Value in Rs. Billion)}\)

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<td>1.0</td>
<td>3.9</td>
<td>21.7</td>
<td>0.0</td>
<td>0.3</td>
</tr>
<tr>
<td></td>
<td>Total FDI Inflows (1-14)</td>
<td>24.3</td>
<td>1354.4</td>
<td>1041.5</td>
<td>1020.4</td>
<td>645.3</td>
<td>729</td>
<td>4785.9</td>
<td>28</td>
<td>66.9</td>
</tr>
</tbody>
</table>

Source: Calculated by author based on data compiled from various issues of SIA newsletters, DIPP, Government of India. Note: *includes both goods as well as services.
III. Negotiating Position in WTO and Free Trade Agreements

The negotiating position of a country in the WTO (World Trade Organization) and in the bilateral/regional trade agreements in a particular sector depends on the performance and global competitiveness of the sector. Services sector today is the largest sector in India, accounting for a significant share in India’s trade and investment. India is a proponent of liberalising services trade in the ongoing WTO’s Doha Round of negotiations and in its free trade agreements (FTAs). In fact, India prefers to sign comprehensive FTAs, which include liberalisation of services, investment, trade facilitation and cooperation along with liberalisation of trade in goods. As of August 2012, India has signed four bilateral agreements covering services. These include India-Singapore Comprehensive Economic Cooperation Agreement (August 2005), India-Korea Comprehensive Economic Partnership Agreement (January 2010), Comprehensive Economic Cooperation Agreement between India and Malaysia (July 2011) and Comprehensive Economic Partnership Agreement between India and Japan (August 2011).

India’s trading pattern show that the country has created a niche for itself as an exporter of knowledge-based services such as professional and software services. The country needs foreign investment and technology, especially in infrastructure services. This is reflected in India’s negotiating strategy. In both multilateral and bilateral agreement the core interest of India is to secure greater market access for its professionals under four categories namely: business visitors (BV)\(^{38}\), intra-corporate transferees (ICT)\(^{39}\), independent professionals (IP)\(^{40}\) and contractual service suppliers (CSS)\(^{41}\). India also wants liberal commitments in Mode 1\(^{42}\) or cross border trade and in sectors like computer and related services. On its part, unlike China, India is not willing to undertake forward-looking commitments in the WTO or bilateral agreements. It is willing to bind the autonomous regime subject to the negotiations. In certain sectors such as banking, the country is willing to give preferential treatment to bilateral trading partners on a reciprocal basis. India’s bilateral agreements also have provision for cooperation in sectors such as research and development and audiovisual services. Although Indian companies are expanding their operations abroad, India is not a major demandeur of Mode 3 or commercial

\(^{38}\)A person who visit another country specifically for a) business negotiations and/or (b) for preparatory work for establishing presence for short duration.

\(^{39}\)Employee of a company who transferred from originating country’s office to office of the same company in another country.

\(^{40}\)Employee of a foreign company who enter in another country temporarily in order to perform a service pursuant to a contract.

\(^{41}\)A self-employed person who entered another country to perform a service on contract basis.

\(^{42}\)The GATS distinguishes between four modes of supplying services. Mode 1: Cross-border supply is defined to cover services flows from the territory of one Member into the territory of another Member. Mode 2: Consumption abroad refers to situations where a service consumer moves into another Member's territory to obtain a service; Mode 3: Commercial presence implies that a service supplier of one Member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory to provide a and Mode 4: Presence of natural persons consists of persons of one Member entering the territory of another Member to supply a service.
presence. In fact, India tends to trade off Mode 3 commitments for better market access for its professionals and liberal commitments under Mode 1.

IV. Barriers and Reform Requirements

The analysis in the previous sections show that services sector has been increasingly contributing to India’s GDP, GDP growth, employment, trade and investment. However, there are some concerns. In the past one year, India’s GDP and the services sector growth has slowed down. The shift in employment from agriculture to services has been slow and services sector has not been able to create quality employment. Although India has been portrayed as a major exporter of services, India’s ranking among WTO member countries in services exports is lower than that of China’s. India has the potential for attracting FDI but it has not been successful in doing so.

This section discusses some of the key barriers that are impeding the growth of the services sector and suggests reforms that will enhance productivity, efficiency and global competitiveness of the sector and create quality employment.

- Services sector focus in policymaking: The Indian government’s policy focus is on agriculture and manufacturing. In the post-liberalisation period, services sector has largely been left to grow on its own. There is no nodal ministry at the centre for some service sectors like retail while for others like transport and energy there are multiple ministries with conflicting interest. Many services are under the purview of state governments or are jointly regulated by the central and state governments. Multiplicity of regulatory bodies creates multiplicity of regulations and multiple clearances requirements. For example, there are around 13 regulatory bodies to regulate higher education and each of them functions in isolation.\(^{43}\) There is an urgent need to focus on the services sector. Since services sector is heterogeneous it is important to identify the most important barriers faced by different services sub-sectors and then undertake sector-specific reforms.

While the services sector is heterogeneous, different services are getting integrated due to technological developments. The government should consider this in policymaking. In the case of sectors like transport and energy the different departments of the government should work together to design policy. The policy should lay down short-term strategy (five years coinciding with the Indian Five Year Plans) and long term strategy (10 to 15 years) for development of the sector. A nodal agency can be identified for each services sector and the agency should be given the responsibility to foresee that the strategies have been implemented. To synergise the policies across states, the central government can come up

\(^{43}\) Working Group Report for XII Five Year Plan on Higher Education, Department of Higher Education.
with model regulations, which the state governments can implement. It is important to note that there are disparities in performance across states and poor states seems to do badly in services infrastructure and in delivery of public services like health and education. Policies have to focus on state-wise requirements.

- **Data on Services:** In India, data on services is collected and collated by multiple agencies. For some services such as retail there is no official data. For others like communication services, there is a lack of disaggregated data. Employment data is not collected on a regular basis which makes it difficult to do employment analysis. Also, the services sub-sector definitions in India do not match with international definitions which make it difficult to do cross-country analysis. Moreover, there is a lack of distinction in data collection procedure between goods and services within each sub-sector such as telecommunications and IT.

There is an urgent need to have clear definition of sub-sectors, based on international definitions like the UNCPC. Data should be collected on a yearly basis for understanding the trends and there should be a centralised system of data collection and collation.

- **Regulatory Reforms:** Some regulations do not take into account technological developments while others are outdated or do not often follow international best practices. In sectors like transport there is a lack of comprehensive regulation that can enable integrated door-to-door services. The existing regulations do not take into account the characteristics of the new services sectors such as cloud computing, direct selling, express delivery services. There is a lack of prescribed standards and common accreditation process. This adversely affects services such as construction and education. While deregulation and removal of regulatory barriers is a necessity for services sector growth (see Hoekman and Mattoo 2011 and Jain and Ninan 2010), for India it may not necessarily be true. Privatization of Indian airports has led to an arbitrary increase in tariffs prior to the appointment of the regulator – Airport Economic Regulatory Authority (AERA). Since many services were erstwhile public monopolies, the vested interest of the government and public sector units (PSUs) adversely affects the performance of services sector. Moreover, the government procurement process is not always transparent. Private companies working for the railways have to procure materials from vendors selected by the railways. Price preferences are given to PSUs in sectors like energy. In many services, especially infrastructure services like telecommunications and power, after privatisation it is often difficult for the private sector to enter and operate due to lack of third party access, transparent procedures for sharing of scarce resources, etc. Monopolies in sectors such as railways and postal should be gradually phased out – at least commercially delivered services should be privatised. There is an urgent need to implement the Public Procurement Bill, 2011, which is likely to streamline processes and increase
transparency. Privatisation should be accompanied by appropriate regulations, which should be transparent and non-discriminatory. It should take into account the evolving nature of the services sector, its linkages with other sector and should support the growth of the sector. It is important to remove the procedural hurdles by implementing single window clearances for projects, FDI inflows, etc. The need for a regulator in the specific sector should be examined and if required an independent regulator should be appointed. There is an urgent need to replace the outdated regulation to enable the services sector will grow at a fast pace.

- **FDI restrictions:** According to the Organisation for Economic Co-operation and Development (OECD) FDI Restrictive Index, 2010, India is considered more restrictive than Korea but less than China and Japan (see Figure 3). India is considered more restrictive than Korea in terms of indicators such as equity restrictions on foreigners, screening of foreign applicants, hiring of key personnel and operational conditions imposed on foreigners.

Figure 3: FDI Index for Selected Countries for 2010

![Figure 3: FDI Index for Selected Countries for 2010](image)

Source: Kalinova, et. al. (2010), Table III-1, pp. 19
Note: Closer the score is to zero, more open is the economy while closer it is to one, more closed it is.

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44 The Public Procurement Bill, 2011, seeks to regulate any government purchase of more than Rs 50 lakh ($900000) through a transparent bidding process.

45 For details see Kalinova et. al. (2010). The index is based on combined scores of equity restriction, screening requirements, key personnel requirements and operational restrictions.
India is one of the few countries, which have FDI restrictions on a number of services sectors such as banking, insurance, air transport and multi-brand retail. This is restricting the ability of the country to attract FDI and best management practices. In recent months, FDI inflows have slowed down due to the slow reform process. This also adversely impacts India’s negotiating position in trade agreements as it limits the country’s ability to bargain for greater market access.

India needs to build up domestic consensus in favour of reforms in services and speed up the reform process. FDI liberalisation should be technology neutral and should not distinguish between domestic and foreign companies. To counter the adverse impacts of FDI, appropriate regulations can be in place to monitor the sector. However, these should be transparent and non-discriminatory.

- **Services sector employment:** Services sector has not been able to generate employment in terms of both numbers and quality. There is skill shortage in sectors like IT and organised retail. According the Electronic and Computer Software Export Promotion Council, approximately 5,000 people are needed every year to meet the demand of the IT and ITeS industry, but the total available from educational and training institutes is only a third of this number. This is leading to a rise in the salaries, high attrition rates and high cost of operations. According to a Hewitt report, salaries in the IT and ITeS industry are expected to increase at an average rate of 11% in 2012. Studies (for example, Mukherjee and Goyal 2012) have shown that although employees prefer to work in the organised sector, skill requirements are different and it is not easy for employees to shift from unorganised to organised sector. Gross enrolment ratio is low and there are wide variations across educational institutes. Degrees granted by some private universities are not recognised even within India, further affecting the employability of people. In many cases, companies in the services sector have to invest substantially in training of their employees. Critics have argued that government’s education policy and funding have focused on higher education and have neglected primary education (see Kochhar et. al. 2006). In the Eleventh Five Year Plan, total plan outlay for school education and literacy was $17.04 Billion under the *Sarva Siksha Abhiyan*. Compared to this, the outlay for higher and technical education was $18.68 Billion. The government has also reserved seats for backward classes in higher education.

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but not in primary education. Moreover, the reservation is class-based and not based on income of individuals.

To create quality employment in services sector the long-term focus of the government should be to encourage growth of organised sector employment and modernisation of unorganised sector. The government can work with industry and educational institutes on a public-private partnership basis to identify the skill requirements and to design appropriate academic courses and training programmes to facilitate skill development. As of now, private organisations can only operate as ‘not-for-profit’ institutions in education sector. The government may consider allowing ‘for-profit’ education while putting in place a regulatory framework to ensure that ‘for-profit’ players impart a certain standard of education. This will facilitate private investment in education. Focus on vocational training and development of appropriate curriculum will increase the employability of students in the services sector. Quality and standards of education can be improved through a proper accreditation process.

- **Taxes and subsidies:** India has a high corporate tax - 30-40% compared to around 17% in Singapore and up to 25% in China. Moreover, taxes and levies vary across states and this increases costs and restricts pan-India service operations. In some cases, taxes adversely impact the use of most efficient technology. For instance, although multi-axle vehicles are more efficient than single-axle vehicle, the motor vehicle tax is levied based on gross vehicle weight rather than on potential axle loads. This result in under-taxation of two-axle trucks compared to multi-axle vehicles. Recently, in the Union Budget of 2012-13, the government proposed to impose retrospective tax$^{49}$, which has received significant criticism from foreign companies like Vodafone$^{50}$. Cross-subsidization and wrong subsidies have led to misallocation of resources. In railways the average passenger tariffs in India is 55% lower than China, while average freight tariff is 66% higher.$^{51}$ Similarly, while commercial sector has to pay a higher power tariff, the agriculture sector is highly subsidised. This leads to misuse of power in agriculture and high cost of setting up a commercial enterprise in manufacturing and services.

A number of tax reforms including implementation of Goods and Services Tax (GST), Direct Tax Code Bill, 2010, which are pending should be implemented and cross-subsidization should be minimised. Subsidies should be targeted to poor and needy.

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$^{49}$ The government in the Finance Bill, 2012 has proposed amendments in the Income-tax Act, 1961, with retrospective effect to bring in tax net overseas mergers and acquisitions involving Indian assets.

$^{50}$ A tax of $11.08 billion was levied on the company for capital gains made on the acquisition of Hutchison Essar Limited in 2007.

• **Access and Availability of Infrastructure:** Unlike countries like China where government is a key provider of basic infrastructure like road, ports and power, in India the government investment in infrastructure is low and has not been able to meet demand. For instance, most IT companies have to invest in captive power units due to erratic power supply. This increases their costs. Companies in services sector like construction, IT, hospital services, retail, etc., find it difficult to acquire property due to the lack of urban planning, restrictive zoning regulations, outdated laws related to land conversion and lack of clear ownership and title of land, among others. This causes delays in project implementations. In addition, due to poor infrastructure planning the full benefits of existing investment cannot be reaped.

It will not be possible for the government to fund the infrastructure requirements of the country. The government needs to act as a facilitator so that private developers have access to basic facilities like land. A competitive environment will enable private players to succeed. There is a need for proper urban and infrastructure planning. The focus should not only be on creation of new infrastructure but also an efficient use of existing infrastructure.

• **Research and development (R&D) and information and communications technology (ICT):** In India, R&D expenditure is low, both in terms of its proportion to GDP and in comparison to the rest of the world. The Economic Survey of India (2011-2012) pointed out that in 2012; R&D expenditure is expected to be only around 0.8% of the GDP. India ranks below China and Brazil in terms of capacity for innovation. The share of private sector R&D is only 0.25% of GDP compared to 1.2-2% in developed and emerging economies.

The ICT penetration is also low. In 2010, India had 1.53 internet subscribers per 100 inhabitants compared to 8.35 in China and 35.68 in Korea. This is a cause for concern as India aspires to develop as a knowledge hub. One of the reasons for low ICT penetration may be the lower literacy rate in the country. In India, the adult literacy rate is low (62.8%) compared to China (94%) and Korea (100%). Due to low IT penetration, 67% of revenue of the Indian IT an ITes sector is from exports and domestic market only accounts for 33%.

The Indian government can encourage investments in the R&D through public private partnership model. In-house innovations and R&D can be encouraged through fiscal incentives. These benefits can also be offered to companies that tie-up with educational institutes for R&D. ICT penetration can be increased through education and appropriate policy initiatives like incentives for setting up of broadband infrastructure in rural areas or

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52 Economic Survey of India 2011-12.
54 UNDP (2011).
55 Author’s calculation from author from NASSCOM Strategic Review Report (2012).
development of content in local languages. Low-cost consumer devices such as laptops, tablets, and personal computers, can support ICT penetration.

- **Trade:** Services is a key component of India’s trade and India is a proponent of liberalising trade in services in the WTO and in its bilateral trade agreements. However, there are certain issues. First, as of date, India’s services trade largely comprise of few services and exports are concentrated in a few markets. For instance, the US accounts for 56.5% of the total computer software/services exports in 2009-10 followed by the EU (31.3%).\(^{56}\) India wants greater market access and removal of discriminatory barriers for temporary movement of people through the WTO and its bilateral agreement. This is a sensitive sector for its trading partners. Also, if India wants to increase trade in services the country has to focus on exports through all four modes of services trade and across a number of sectors. India’s trading partners would like it to make commitments beyond the existing FDI regime, which India is unable to do due to the slow pace of domestic reforms. Unless the country implements domestic reforms, it cannot benefit from trade agreements. India should be willing to offer liberalisation commitments on a reciprocal basis. The government should focus on diversifying export markets. It should work with industry to identify services sectors for exports. The government can also pursue certain external policies such as signing trade agreements with its major services trading partners, signing mutual recognition of qualifications agreements\(^ {57}\) and double taxation avoidance agreements, which will remove/reduce external barriers to services trade. India should develop consensus on how it should negotiate services agreements. For instance, if there is a plurilateral negotiation in services under the WTO what should be India’s position?

V. **Conclusions and the Way Forward**

Services sector is the fastest growing sector in India, contributing significantly to GDP, GDP growth, trade and FDI inflows. The sector is projected to be on a high growth trajectory in the next five years. The share of services sector in India’s total trade is higher than the global average and India is among the top 10 WTO member countries in services exports and imports. However, the increase in employment in services has not been commensurate to share of the sector in the GDP. Moreover, majority of the people employed in the services sector are concentrated in the unorganised sector, which offers lower salary and limited job security. Hence, the quality of employment in this sector is a cause for concern. There are other areas of concern such as India’s services sector growth and export of services is lower than that of China.

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\(^{56}\) Electronics and Computer Software Export Promotion Council, Statistical Year Book, 2009-10

\(^{57}\) A mutual recognition agreement or MRA is an international agreement by which two or more countries agree to recognize each other’s standards.
There are disparities in access of services and a major proportion of the poor in India do not have access to basic services such as health and education. India’s export competitiveness is in a few services sector and there are wide variations in growth across different sub-sectors of services.

The paper found that the services sector faces a number of barriers, which makes it difficult for the sector to reach its full potential and contribute to inclusive growth. Specifically, a lack of policy, which takes into account the heterogeneity of the sector and its evolution and integration, multiple governing bodies, and lack of coordination among them, lack of regulation in some sectors and over regulation in the others, are adversely affecting the growth of this sector. Regulatory uncertainties due to the slow pace of reforms and FDI restrictions have adversely affected investments in services sectors. In India, infrastructure facilities are poor and cost of service deliveries is high. Although India wants to develop as a knowledge hub there is no uniformity in the quality and standard of education and formal education does not guarantee employability.

The paper highlights reform measures that will enable the services sector to not only to grow at a fast pace but also create quality employment and attract investment. It is important for a developing country like India with a large and young population to generate quality employment and move up the value chain. India needs private investments in key infrastructure services such as transport, energy and telecommunications. It can only attract FDI and private investment with a stable, transparent, non-discriminatory and competitive policy environment. If the reforms are implemented it will not only enhance the productivity and efficiency of the services sector but will also lead to overall growth of the economy through backward and forward linkages. It will enhance India’s global competitiveness and trade in services.
References


http://planningcommission.nic.in/plans/planrel/12appdrft/approach_12plan.pdf (last accessed on March 27, 2012)


### Table A1: FDI Limits in Services Sectors in India

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Services Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FDI IS NOT ALLOWED OR PROHIBITED</strong></td>
<td></td>
</tr>
<tr>
<td>Real estate business or construction of farm houses, railway transport services (other than mass rapid transport systems), postal services, telegraph services, professional services (legal services, accounting, auditing and book-keeping services, taxation services, public opinion polling services), atomic energy, lottery business including government/private lottery, online lotteries, etc. and gambling and betting including casinos etc.</td>
<td></td>
</tr>
<tr>
<td><strong>FDI IS ALLOWED UP TO 20 PER CENT</strong></td>
<td>Banking services – public sector*</td>
</tr>
<tr>
<td><strong>FDI IS ALLOWED UP TO 26 PER CENT</strong></td>
<td>Broadcasting services (terrestrial broadcasting, uplinking), print media* and insurance services*</td>
</tr>
<tr>
<td><strong>FDI IS ALLOWED UP TO 49 PER CENT</strong></td>
<td>Petroleum refining by the public sector undertakings (PSU), air transport services- domestic scheduled passenger airline (100 per cent for NRIs), private security agencies, financial Services*, cable networks</td>
</tr>
<tr>
<td><strong>FDI IS ALLOWED UP TO 51 PER CENT</strong></td>
<td>Multi-brand retail trading*</td>
</tr>
<tr>
<td><strong>FDI IS ALLOWED UP TO 74 PER CENT</strong></td>
<td>Broadcasting services (teleports, direct-to-home (DTH), mobile TV and headend-in-the-sky (HITS), air transport services (non-scheduled air transport service), satellites – establishment and operation and telecommunication services</td>
</tr>
<tr>
<td><strong>FDI IS ALLOWED UP TO 100 PER CENT</strong></td>
<td>Services related to agro and allied sector, services incidental to mining*, oil and gas, services incidental to energy distribution, audiovisual services*, publishing and printing services, telecommunication services*, distribution services*, single-brand retail trading*, courier services for carrying packages, parcels and other items which do not come within the ambit of the post office*, construction development*, non-banking finance companies for the following activities*, education services, health and related services, tourism and travel related services, environmental services, transportation services, research and development services, rental/leasing services with operators, professional services, business services, recreational, cultural and sporting services including entertainment services, libraries archives, museums and other cultural services</td>
</tr>
</tbody>
</table>

*Source: Compiled by authors from DIPP (2011) and DIPP (2012). Note: In the sector marked with ‘*’, there are additional conditions imposed on foreign companies, over the domestic policy requirement.