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HONG KONG'S UNIQUE SERVICE ECONOMY

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The Nature of Services

In the past decade, Hong Kong's service industry has increased tremendously. This increase is perceived by many to be a threat, as it is assumed to have occurred at the expense of manufacturing. In fact, however, as will be illustrated in this paper, this is not the case at all. Rather, the growth of the service industry has taken place as a result of the parallel growth in manufacturing, and the two have combined to increase the dynamism of Hong Kong.

The production of services is distinguished from that of goods in only one way. Unlike goods, services do not realize themselves in any particular object. Classical economics has unfortunately seized upon this feature of services, thereby including them in the category of unproductive labor because they perish at the very instant of production and do not endure to add to the value of the subject upon which they are bestowed.

In the 1930s, economists studying the stages of economic growth described the production of services as tertiary activities and included in it all output that did not originate from the agricultural or industrial sector. The residual approach and the classical notion of unproductive services combined to imply, perhaps inadvertently, that services were of a lower order of importance than agriculture or industry and somehow dependent on primary and secondary output.

Modern economics has abandoned entirely the notion that goods and services differ in any important economic sense. Nevertheless, old perceptions die hard, and are often reinforced by legislative and administrative arrangements that continue to distinguish between the two entities. Indeed, the way in which we collect and compile our economic statistics reflect these outdated notions.

Dubiously Low Productivity of Services

Productivity differs enormously across sectors. In most economies, measured productivity in the service sector appears to grow more slowly than does that in the goods sector. One should note however that measures of productivity are fraught with problems

of measurement, in part because quality improvements in the service sector are notoriously difficult to capture. Nevertheless, the slow growth of measured productivity in the service sector is often regarded as the cause of many economic problems, such as slowing economic growth, rising inflation, increasing unemployment, and polarization of the rich and the poor. Though there is little empirical support for some of these concerns, they have contributed to a highly lopsided view of the increase in services and the demise of manufacturing, wherever such trends have been observed. Hong Kong is just one example.

While it may be the case that a shift in focus from manufacturing to services would eventually lead to a lower measured rate of productivity growth, this conclusion suggests a misleading view of the role of the service sector in overall productivity levels and growth in Hong Kong, where the growth of the service sector is entirely due to the growth of intermediate or producer services. These services support manufacturing, which, although the location of its operation has largely shifted offshore, has continued to thrive. This unique feature of the service economy contributes significantly to the dynamism of Hong Kong.

Growth of Intermediate or Producer Services in Hong Kong

Service industries have grown rapidly in Hong Kong as a result of the globalization of economic activity, rapid economic growth and integration of the Asia-Pacific region, and the opening of China. In the decade between 1983 and 1993, the share of service sector employment in Hong Kong grew from 55.0% to 77.5%, while the share of manufacturing employment fell from 41.0% to 19.7%. The share of the service sector in the GDP grew from 62.3% to 78.1% and the share of the manufacturing sector in the GDP fell from 23.0% to 11.2%.

A linear extrapolation of the employment trends of this decade implies that by the year 2003 all employment in Hong Kong would be in the service sector. Many observers have expressed alarm at such a prospect. They point out that de-industrialization or hollowing-out will retard productivity and economic growth, increase the proportion of low quality service jobs, and adversely effect income distribution. This disastrous scenario represents at best unfounded pessimism and at worst faulty reasoning.

To begin with, the manufacturing sector in Hong Kong has not declined at all, but has merely shifted the bulk of its production activities offshore. Manufacturing companies themselves are primarily serviced from Hong Kong, and between 1983 and 1993 they expanded their scope of operation enormously. It is estimated that in China alone Hong Kong manufacturers employ as many as 3 million workers. The demise of Hong Kong manufacturers is an illusion.

The most important feature of service sector growth in Hong Kong is that all of it is in intermediate or producer services. An intermediate or producer service is used as an input into the production of other goods and services. It is distinguished from

consumption services in that it is not directly consumed by the consumer. To distinguish between final and intermediate or producer services, using existing data however, is not a trivial matter. We have to make use of both product-based and expenditure-based estimates of GDP.

In Hong Kong, the share of consumption services in the GDP declined from 29.5% in 1983 to 28.7% in 1993 (see section IIB of the table). In contrast, during this period the share of final consumption services in Singapore, South Korea, Taiwan, Japan, and the U.S. all rose somewhat. The increase is especially pronounced in the case of Taiwan.

During the same period, the share of intermediate or producer services in Hong Kong's GDP rose spectacularly, from 32.5% to 46.0% (see section IIB of the table). While the growth of services in general and of intermediate or producer services in particular is evident in all the other economies, Hong Kong presents a striking case of rapid service sector growth that is due entirely to the existence of intermediate or producer services.

What are these intermediate or producer services that have expanded so quickly in the past decade? The rapidly expanding areas in the service producing sector are imports and exports, finance, insurance, business, and real estate services (see section IIA of the table). The combined share of these services in the GDP rose from 28.6% in 1983 to 43.4% in 1993.

The growth of intermediate or producer services in Hong Kong is closely linked to (1) the expansion of goods-producing activities of Hong Kong manufacturing firms across the border into south China, and (2) the growing integration of trade - and investment-related activities within the Pacific region. These links result in two effects.

First, the increase in demand for intermediate or producer services is derived from the growing demand for goods that are either exported, re-exported, or imported through Hong Kong. These autonomous changes propel the service economy forward. There are, of course, further interactions whereby increases in the demand for some services will generate increases in the demand for intermediate or producer goods, and the process feeds on itself.

The second effect stems from the role of intermediate or producer service inputs as a dynamic force driving the production of goods. According to this view, intermediate or producer service industries are the vehicle by which new technology is introduced into the goods production process. This new technology can lead to the lowering of production costs, the development of improved and new products, and new and more efficient methods for the distribution of goods. These are service inputs that respond to a greater demand for goods and in turn contribute to and change the mix of demand for goods.

A large proportion of all services is produced by bankers, accountants, engineers, and scientists whose output is used by firms in producing goods. In addition, there are the transportation and distribution services without which there could only be self-sufficiency in production and consumption. Finally, it is possible to interpret the production of education and medical services as inputs into the creation and maintenance of society's stock of human capital and health capital. Without this expenditure, the productivity of any population would fall quickly.

Intermediate or Producer Services and Economic Growth

In free market economies, the satisfaction of consumers is continuously increased through better and cheaper products. Entrepreneurial firms draw heavily on highly educated workers. They also develop and apply new technological and scientific knowledge. They sell advice and deliver innovative services to other firms. These firms in the service industries are the main vehicles through which the human and knowledge capital of society is produced and introduced into the production process. Evidence of the greater educational attainment of service sector workers when compared with workers in the goods-producing sector supports this view.

Human capital is enhanced not only through investments in education and on-the-job training, but also through investment in health care, nutrition, and even the kind of moral and ethical standards which make for honesty and reliability of workers and create a willingness to work hard. Knowledge capital is all the scientific and engineering knowledge which permits the design of more efficient machinery and products. It also includes the knowledge which makes for the efficient organization of firms and society in general. Therefore, even if the measured rates of productivity growth of these intermediate or producer services are not high, their existence is the reason that firms in the goods-producing sector can enjoy high rates of productivity growth.

Economists have long recognized that labor productivity is enhanced when the production process is reorganized and becomes more "roundabout," that is, when it includes more stages of production and employs an increasing number of intermediate or producer inputs. Labor and capital becomes more specialized as a result of "roundaboutness."

The growth of the service sector goes hand in hand with the appearance of more specialized firms producing a greater diversity of intermediate or producer services. In Hong Kong, the average number of persons engaged per establishment in the finance, insurance, business, and real estate services sectors declined from 11.6 in 1983 to 8.2 in 1993; a decline of almost 30%. By contrast, the decline in the average establishment size in the overall economy was about 16.6%. The greater decline of the average establishment size found in the finance, insurance, business, and real estate services sector in Hong Kong reflects the process of increasing "roundaboutness" and is a sign of enhanced economic efficiency and dynamism.

Specialization through the market has variously been called the process of “dehiving,” “unbundling,” “vertical disintegration,” and “contracting out.” The process is facilitated when the size of the market grows and the transactions costs of doing business through the market is reduced. The increasing complexity of business operations, rising cost of monitoring the performance of employees in large organizations, rapid rates of technological change in increasingly specialized activities, and falling cost of information and communication in the marketplace have all contributed to this process.

Any close examination of the service sector in Hong Kong reveals that it is a highly heterogeneous industry. The rapid expansion of the service sector reflects a positive dynamic market process at work, whose purpose is primarily to support the growth of goods-producing industries, which have expanded overseas and across the border into south China. Hong Kong’s service economy developed, in response to market demands, to service the requirements of firms wishing to operate across borders, in different nations, and under different jurisdictions in what is an increasingly integrated regional and global economy.

Table : Value-Added by Sectors

| Year | Hong Kong | | Singapore | | South Korea | | Taiwan | | Japan | | U.S.A. | |
|--|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | 1983 | 1993 | 1983 | 1993 | 1983 | 1992 | 1983 | 1993 | 1983 | 1993 | 1983 | 1992 |
| I. Goods Producing Sector | 32.46 | 18.68 | 40.02 | 36.61 | 54.50 | 53.30 | 51.32 | 42.71 | 43.84 | 42.37 | 29.72 | 29.77 |
| Agriculture & mining | 0.76 | 0.22 | 1.19 | 0.28 | 15.73 | 7.56 | 7.10 | 3.79 | 3.74 | 2.41 | 3.68 | 4.00 |
| Manufacturing | 22.95 | 11.15 | 25.22 | 27.53 | 28.24 | 33.77 | 36.43 | 31.08 | 29.05 | 26.80 | 18.79 | 18.58 |
| Construction, electricity & gas | 8.75 | 7.31 | 13.61 | 8.80 | 10.52 | 11.97 | 7.79 | 7.83 | 11.05 | 13.16 | 7.25 | 7.19 |
| IIA. Service Producing Sector (production based estimates) | 62.26 | 78.11 | 59.98 | 63.39 | 42.46 | 45.33 | 50.45 | 58.58 | 58.09 | 59.26 | 70.32 | 70.96 |
| Imports-exports | 10.95 | 17.54 | | | | | | | | | | |
| Wholesale, retail, restaurants & hotels | 9.50 | 9.54 | 17.45 | 17.79 | 12.17 | 12.25 | 12.93 | 15.51 | 14.91 | 12.53 | 16.08 | 17.55 |
| Transport, storage & communications | 8.20 | 9.52 | 12.80 | 14.44 | 7.56 | 8.74 | 6.29 | 6.33 | 6.17 | 6.31 | 6.04 | 6.79 |
| Finance, insurance, business services & real estate | 17.65 | 25.84 | 22.99 | 26.86 | 10.77 | 14.89 | 13.48 | 18.98 | 15.43 | 16.17 | 22.49 | 21.43 |
| Community & personal services | 10.38 | 9.09 | - | - | 3.75 | 4.31 | 5.23 | 6.96 | 13.05 | 16.36 | 12.52 | 13.46 |
| Government services | 5.58 | 6.62 | 6.74 | 4.30 | 8.21 | 5.14 | 12.52 | 10.81 | 8.53 | 7.90 | 13.19 | 11.73 |
| IIB. Service Producing Sector (expenditure based estimates) | 62.26 | 78.11 | 59.98 | 63.39 | 42.46 | 45.33 | 50.45 | 58.58 | 58.09 | 59.26 | 70.32 | 70.96 |
| Consumption services | 29.45 | 28.71 | 21.63 | 23.75 | 20.85 | 21.33 | 23.48 | 31.65 | 29.53 | 29.73 | 36.57 | 37.97 |
| Producer services | 27.23 | 42.78 | 31.61 | 35.34 | 13.41 | 18.86 | 14.45 | 16.13 | 20.03 | 21.63 | 20.56 | 21.26 |
| Government services | 5.58 | 6.62 | 6.74 | 4.30 | 8.21 | 5.14 | 12.52 | 10.81 | 8.53 | 7.90 | 13.19 | 11.73 |
| Overall Economy | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Note: For Hong Kong and Japan nominal shares were used because figures for real value-added were not available.