

Service Industry Growth in Hong Kong

- Presentation (Presented at the Plenary Session of the Symposium on Services Promotion, Hong Kong into the 21st Century : The Servicing Economy, Tuesday, 12 March 1996, Lecture One, 27/F., Hong Kong Convention and Exhibition Center)

SERVICE INDUSTRY GROWTH IN HONG KONG

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Nature of Services

The production of services is distinguished from that of goods in only one way, and that is, unlike goods, services does not realize itself in any particular object. Classical economics, as represented say by the work of Adam Smith, unfortunately seized upon this feature and included services in the category of unproductive labor because it perishes in the very instant of production and does not endure to add to the value of the subject on which it is 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 was not of 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 and somehow dependent on primary and secondary output.

Modern economics has abandoned entirely the notion that goods and services are different in any important economic sense. Nevertheless old perceptions are difficult to get rid off and are often bolstered by legislative and administrative arrangements that continue to distinguish between the two. Indeed the way in which we collect and compile our economic statistics reflect these old notions.

The service industries have grown rapidly in Hong Kong as a result of the opening of China, the globalization of economic activity, and rapid growth of the Asia-Pacific region. In the decade between 1983 and 1993, the share of service sector employment has grown from 55.0% to 77.5%. A linear extrapolation of the events in this decade implies that by the year 2003 all employment in Hong Kong would be in the service sector. Some regard such an outcome as economic armageddon. They point out that deindustrialization or hollowing out will be retarding productivity and economic growth, increasing the proportion of low quality service jobs in employment, and worsening income distribution

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among households and workers. They call for government to intervene to arrest the process through aggressive industrial and other policies.

Apart from the fact that manufacturing employment is unlikely to vanish, this disaster scenario is at best unfounded pessimism and at worst faulty reasoning. The most important feature of service sector growth is that most of it is concentrated in intermediate services. An intermediate service is a service that is used as an input in the production of other goods and services. However, to distinguish between final and intermediate services is not a trivial matter with existing data.

Let us start with a simple traditional taxonomy based on the categories of the product based GDP. The taxonomy first divides output into a goods producing sector and a service producing sector. The latter is further divided into the distributive, consumer, producer, and government service sectors.

Using this taxonomy we can see from Tables 1 and 2 that most of the growth in value added and employment shares are found in import-export services and producer services. The share of import-export services in value added increased from 10.95% to 17.54% in a decade; the employment share increased from 6.72% to 18.67%. The value added share of producer services increased from 17.65% to 25.84% and the employment share increased from 7.75% to 13.79%. The growth of consumer services is much more limited; the value added share decreased from 14.54% to 13.42% and the employment share increased from 17.30% to 20.41%.

One is probably correct to conclude that import-export services and producer services are primarily intermediate inputs that are used in the production of goods and other services and that consumer services are primarily used in final consumption. To see this more clearly it is useful to use a slightly different classification system for the services sector. Table 3 divides the services sector into consumption services, government services, and intermediate services.

Consumption services (to be distinguished from consumer services given in Tables 1 and 2) are all those services that are used in final consumption and is obtained from the expenditure based estimates of GDP. The share of consumption services in GDP had declined from 29.45% in 1983 to 28.71% in 1993. Government services are the same as those based on the production based estimates of GDP.

Intermediate services are measured as a residual category after deducting consumption services and government services from total services. This measure of intermediate services is a good approximation of all those services that are used as intermediate inputs. The share of intermediate services in GDP had risen from 32.52% in 1983 to 45.99% in 1993. It is apparent that the growth of the service sector in Hong Kong is closely linked to the expansion of the goods producing activities of Hong Kong

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manufacturing firms across the border into south China. This linkage produced two different effects.

First, the growth in the demand for intermediate services is driven autonomously by the growth in goods production. By analogy, increases in the demand for some services result in further increases in the demand for intermediate goods. This first effect explains the rapid growth of the services sector, but it does not explain in itself the rise of labour productivity in the manufacturing sector found in Table 4.

Second, the role of intermediate services can be considered as a dynamic force driving the production of goods. According to this perspective, intermediate 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 greater demand for goods and in turn contribute to and change the mix of demand for goods. This second effect accounts for the enormous growth of labour productivity in the manufacturing sector.

A large proportion of all services is produced by bankers, accountants, engineers, and scientists whose output is used by firms 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, productivity of any population would fall quickly.

Productivity by Sector

Labor productivity differ enormously across sectors. Table 4 presents crude measures of output per worker-hour and their growth rates by sector. The measures reveal a commonly found result about productivity growth: it rises faster in the goods producing sector than in the service producing sector. There are, of course, exceptions, like the wholesale and financing services in Hong Kong. One should note that these measures are fraught with problems of measurement and, in particular, because we have not been able to use appropriate sector specific deflators for the services and also because quality improvements in the service sector are notoriously difficult to capture.

The slow growth of productivity in the service sector is often perceived as the cause of many economic problems, like slowing economic growth, rising inflation, increasing unemployment, worsening income inequality, and polarization of the rich and the poor. Some of these concerns have very little empirical support, but have contributed

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to a very biased view of the growth of services and the demise of manufacturing, wherever this has taken place in the world, including Hong Kong.

While it may be true that a shift to services would eventually lead to a lower measured rate of productivity growth, this conclusion presents a misleading view about the role of the service sector in overall productivity levels and growth. The importance of intermediate services stems in large part from the influence they have on economic growth and dynamism.

Intermediate 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 higher educational attainments of service sector workers when compared with those 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 in these producer service industries are not high, they are the reason why firms in the goods producing sector can have high rates of productivity growth.

Economists of the Austrian and Swedish Schools have long recognized that labor productivity is enhanced when the production process is reorganized and becomes more “roundabout”, that is, with more stages of production and employing an increasing number of intermediate 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 services. In Hong Kong, the average number of persons engaged per establishment in the producer services sector has declined from 11.6 in 1983 to 8.2 in 1993; a decline of almost 30% (see Table 5). By contrast, the decline in the average establishment size in the overall economy is about 16.6%. The greater decline in the average establishment size found in the producer

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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 market place 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 services sector reflects a positive dynamic market process at work requiring little government intervention. Fears of low productivity following deindustrialization does not appear to be a genuine problem, especially in Hong Kong because the rise of our services sector has been primarily to support the growth of the goods producing industries, which have expanded overseas and across the border into the Chinese mainland.

Given the important role of intermediate services in the growth of productivity and international competitiveness., the role of the government in promoting services remains the classical ones of provision of infrastructure investment, maintaining a stable and transparent business environment, and in the age deregulation, liberalization, and privatization, to explore opportunities whereby economic efficiency can be further enhanced through a greater reliance on private initiative and competitive market processes.

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Table 1 : Value Added by Sectors

Sectors	HK\$ mil.		% distribution	
	1983	1993	1983	1993
Goods Producing Sector :	65,407	155,071	32.46	18.68
Agriculture & mining	1,541	1,809	0.76	0.22
Manufacturing	46,242	92,582	22.95	11.15
Construction, electricity & gas	17,624	60,680	8.75	7.31
Servicing Producing Sector :	125,459	648,413	62.26	78.11
Distribution Services	49,349	267,443	24.49	32.22
Wholesale, retail, imports/ exports	32,820	188,449	16.29	22.70
Wholesale	2,992	13,148	1.48	1.58
Retail	7,758	29,655	3.85	3.57
Imports/exports	22,070	145,646	10.95	17.54
Transport and related services	12,655	58,101	6.28	7.00
Storage and communications	3,874	20,893	1.92	2.52
Storage	457	1,268	0.23	0.15
Communications	3,417	19,625	1.70	2.36
Consumer Services	29,301	111,456	14.54	13.43
Restaurants and hotels	8,384	36,013	4.16	4.34
Restaurants	6,313	25,354	3.13	3.05
Hotels	2,071	10,659	1.03	1.28
Community & personal services	20,917	75,443	10.38	9.09
Producer Services	35,563	214,549	17.65	25.84
Financing services	13,103	83,272	6.50	10.03
Insurance services	1,527	9,201	0.76	1.11
Real estate	15,387	91,581	7.64	11.03
Business services	5,546	30,495	2.75	3.67
Government Services	11,246	54,965	5.58	6.62
GDP at factor cost (production-based estimates)	201,515	830,169	100.00	100.00

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Table 2 : No. of Persons Engaged by Industry

	No. of Persons engaged		% distribution	
	1983	1993	1983	1993
Goods Producing Sector :	937,483	552,022	44.96	22.51
Agriculture & mining	N.A.	N.A.	N.A.	N.A.
Manufacturing	855,417	483,628	41.02	19.72
Construction, electricity & gas	81,295	67,894	3.90	2.77
Servicing Producing Sector :	1,147,860	1,900,358	55.04	77.49
Distribution Services	455,593	881,055	21.85	35.93
Wholesale, retail, imports/ exports	365,866	726,930	17.54	29.64
Wholesale	59,774	68,784	2.87	2.80
Retail	165,880	200,409	7.95	8.17
Imports/exports	140,212	457,737	6.72	18.67
Transport and related services	70,267	117,701	3.37	4.80
Storage and communications	19,460	36,424	0.93	1.49
Consumer Services	360,863	500,533	17.30	20.41
Restaurants and hotels	166,093	221,951	7.96	9.05
Restaurants	143,389	181,845	6.88	7.42
Hotels	22,704	40,106	1.09	1.64
Community, social and personal	194,770	278,582	9.34	11.36
Producer Services	161,692	338,095	7.75	13.79
Financing services (incl. Banks, DTCs, etc.)	73,719	125,795	3.54	5.13
Insurance services	8,040	19,813	0.39	0.81
Real estate dev. Leasing, Brokerage and management	26,424	62,783	1.27	2.56
Business services	53,509	129,704	2.57	5.29
Government Services	169,712	180,675	8.14	7.37
Overall Economy	2,085,343	2,452,380	100.00	100.00

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Table 3 : Value Added by Sectors

Sectors	HK\$ mil.		% distribution	
	1983	1993	1983	1993
Goods Producing Sector :	65,407	155,071	32.46	18.68
Agriculture & mining	1,541	1,809	0.76	0.22
Manufacturing	46,242	92,582	22.95	11.15
Construction, electricity & gas	17,624	60,680	8.75	7.31
Servicing Producing Sector :	136,107	675,098	67.54	81.32
Consumption Services	59,338	238,330	29.45	28.71
Intermediate Services	65,523	381,803	32.52	45.99
Government Services	11,246	54,965	5.58	6.62
GDP at factor cost (production-based estimates)	201,515	830,169	100.00	100.00

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Table 4 : Labour Productivity (value added per labour hour)

Sector	Thousands of HK\$ at 1993 constant Prices		Average Annual Growth Rate (in %)
	1983	1993	1983-1993
Goods Producing Sector :	90	190	7.72
Agriculture & mining	N.A.	N.A.	N.A.
Manufacturing	30	77	9.76
Construction, electricity & gas	236	358	4.28
Servicing Producing Sector :	199	224	1.17
Distribution Services	150	141	-0.67
Wholesale, retail, imports/ exports	122	113	-0.74
Wholesale	50	77	4.31
Retail	47	59	2.36
Imports/exports	158	127	-2.12
Transport and related services	202	198	-0.22
Storage and communications	224	230	0.28
Consumer Services	104	99	-0.48
Restaurants and hotels	63	71	1.26
Restaurants	49	56	1.23
Hotels	102	106	0.39
Community, social and personal	121	113	-0.68
Producer Services	384	415	0.78
Financing services	200	294	3.96
Insurance services	213	206	-0.32
Real estate	654	649	-0.08
Business services	116	105	-1.07
Government Services	75	133	5.86
Overall Economy	91	136	4.09

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Table 5 : Average No. of Persons Engaged per Establishment

	Persons per Establishment	
	1983	1993
Goods Producing Sector :	20.1	14.5
Agriculture & mining	N.A.	N.A.
Manufacturing	18.8	13.1
Construction, electricity & gas	74.0	60.4
Servicing Producing Sector :	9.3	8.0
Distribution Services	5.4	5.4
Wholesale, retail, imports/exports	4.5	4.7
Wholesale	5.4	4.6
Retail	3.7	3.9
Imports/exports	5.6	5.1
Transport and related services	23.6	16.0
Storage and communications	163.5	67.2
Consumer Services	14.7	15.0
Restaurants and hotels	26.5	23.4
Restaurants	25.9	21.5
Hotels	30.9	38.8
Community, social and personal	10.6	11.7
Producer Services	11.6	8.2
Financing services (incl. Banks, DTCs, etc.)	18.0	17.1
Insurance services	6.9	3.9
Real estate dev. Leasing, Brokerage and management	7.3	5.7
Business services	10.5	7.4
Government Services	N.A.	N.A.
Overall Economy	51.7	43.1