How services can drive the growth of emerging economies

Can service-led growth be a viable development strategy for the developing world? If so, who benefits? Tianyu Fan, Michael Peters, and Fabrizio Zilibotti examine whether the increase in employment in India's service sector was the cause of India's growth, or merely a symptom of it.

Context
Industrialised countries have historically undergone remarkably similar structural transformations across the world, with labour shares transitioning from the agricultural sector to an industrial sector, and then services – including a diverse range of employees from janitors, store clerks and accountants – eventually becoming the main source of employment growth (Herrendorf et al., 2014).

Today, however, many developing countries appear to be taking a different path. In fast-growing economies like India and several countries in sub-Saharan Africa, labour seems to be transitioning from agriculture directly to services. From 1987 to 2011 in India, even as the per capita income increased nearly threefold, the agricultural employment share dropped, and manufacturing remained stagnant. The service sector largely absorbed the workforce exiting the fields. Many scholars find this pattern of "premature de-industrialisation" (Rodrik 2016) concerning: as technical progress in manufacturing has traditionally been the main engine of growth, some fear the service sector might be an inadequate substitute.

Methodology

In a recent study on service-led growth in India, Fan, Peters, and Zilibotti (2021) gather micro data on employment, wages, and human capital since the late 1980s. The researchers leverage a new methodology to infer productivity growth from these data for roughly 400 Indian districts. To distinguish between different heterogeneous activities that fall under the service sector, the researchers focus on two aspects – the nature of the typical buyer as well as whether the value added by these services is tradeable – to classify them into ‘consumer’ and ‘producer’ services. The authors crucially exploit the income elasticity of consumers’ service demand – that is, the increase in spending on consumer services if income increases by 1% – as their key source of identification.

The results

The researchers find that productivity growth in services must have significant to account for the extent of ‘tertiarisation’ in the Indian economy. That is, growth was largely service led; if productivity in services had been stagnant since 1987, Indians’ real income would have been 30% lower, a welfare impact that is greater than the aggregate impact of India’s industrial productivity growth over the same period. This is good news, as the authors note that the lack of a pronounced industrialisation does not mean that India’s growth is bound to fall.

However, their researchers further indicates that while the productivity of the service sector grew substantially, the gains were strikingly unequal and benefitted mainly richer consumers in cities, where services tend to be concentrated. While consumer services growth accounted for almost 40% of income growth for the richest quantile of consumers, this effect was halved for consumers below the median. Such a ‘pro-rich’ service-led growth further exacerbates the rural-urban divide.

Lessons from service-led growth

Understanding how the productivity growth of India’s service sector came about is vital in thinking about policy design, but also of importance to development across the world is whether service-led growth can be successful in other developing countries, too. Furthermore, documenting the gendered-nature of service-led growth – where women might be particularly suited in so far as it makes fewer ‘brawn’ demands (Rendall, 2013) – is another crucial domain for future research to explore.

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