



# Asia Pacific Bulletin

Number 119 | June 27, 2011

## Incomplete Reform of India's Service Sector

BY MATTHEW REISMAN

India is one of the United States' key partners in Asia for international trade in services. Services, also known as intangibles, include a diverse range of industries, such as banking, insurance, telecommunications, education, travel, health care, and retailing. Services accounted for nearly 70 percent of global output in 2008 and almost a fifth of global trade. US exports of such services to India totaled US\$10 billion in 2009, led by industries such as education and travel, but US imports of services from India were even larger, totaling over US\$12 billion. 2009 marked the fourth consecutive year that the United States ran a services trade deficit with India—a deficit that tripled in size over that period. Within Asia, only Japan exports more services to the United States. This article examines why India's service sector has grown so rapidly and how additional regulatory reforms could benefit both India and its trading partners.

**Matthew Reisman**, International Trade Analyst at the US International Trade Commission, “[e]xamines why India’s service sector has grown so rapidly and how additional regulatory reforms could benefit both India and its trading partners.”

Service industries have played a pivotal role in India's economic rise over the past twenty years. Between 1991 and 2009, service industries grew faster than the overall economy in every year except 1994. This “services revolution” has been driven by rising demand for services within India, smarter regulation, and an Indian workforce well-suited to the competitive production of exportable services.

India's middle class is growing rapidly in absolute terms, even if it remains small compared to India's total population. The McKinsey Global Institute estimated that the number of people earning between 200,000 and one million rupees per year (US\$4,376 to US\$21,882 at constant 2000 prices) totaled about 50 million in 2005, up from less than 20 million a decade earlier. These newly-empowered consumers have driven internal demand for services such as telecommunications, health care, education, and tourism.

The telecommunications industry illustrates the benefits of reform. Once the exclusive domain of poorly-performing, state-owned companies, a series of measures beginning in the early 1990s opened the industry to private Indian and foreign competition. Companies now compete intensely to satisfy rising demand, and subscribership has increased dramatically: the number of mobile subscribers mushroomed from 52 million in 2004 to 347 million in 2008. However, regulatory reform has not been a total success—the allocation of second generation (2G) spectrum licenses in 2008 was marred by corruption, and the market is so fragmented that firms struggle to turn a profit.

Regarding services exports, according to the International Monetary Fund, India has been the world's leading exporter of computer and information services since at least 2005. This industry includes activities such as custom software design, information technology consulting, and data processing. Corporate clients in Europe and North America have been attracted by the country's pool of skilled, English-speaking workers, whose wages are low—albeit rising—when compared to their counterparts in developed countries. Indian firms have capitalized on their comparative cost advantages, cultivated the skills and talent of their labor force, and benefited from Indian government



initiatives encouraging investment. Today several Indian companies—such as Tata Consultancy Services, Wipro, and Infosys—are global leaders in the production of computer and information services.

However, for all of India's successes in the services sector, many service industries have not fulfilled their growth potential. Firms in these industries continue to encounter substantial barriers to doing business. These include limits on foreign direct investment (FDI) in industries such as air transport, legal services, insurance, and retailing.

**“Service providers from the United States and other countries would certainly stand to gain significantly from liberalization, but the most important beneficiaries would be the hundreds of millions of Indians who would be afforded additional employment opportunities, lower prices, and expanded access to high-quality goods and services.”**

The retail industry is a case in point. India does not permit FDI in “multi-brand” retail businesses—US retailers, such as Walmart and Target, may not own and operate stores in India that sell multiple brands of merchandise. Maintained at the behest of the millions of *kiranas* (mom-and-pop shops) that dominate retailing in India, the ban has slowed the development of modern retail chains. Consequences for India's consumers include higher prices, limited product choice, and a scarce supply of clean, modern shopping environments.

The ban on FDI in multi-brand retail also hurts India's farmers. A 2010 paper published by India's Department of Industrial Policy and Promotion noted that farmers in countries where unorganized retail predominates—such as India—receive significantly less of the final price paid for food than countries where organized retail is more common. The paper also pointed out the pivotal role that foreign retailers could play in developing India's refrigerated transport infrastructure for fresh produce. Such infrastructure is woefully underdeveloped in India, and the consequence is wastage of food on a massive scale. One recent study found that 30 percent of India's fresh fruits and vegetables go to waste due to the scarcity of cold storage.

India's barriers to services FDI are also costly to India's trading partners. In a recent working paper, the US International Trade Commission examined the relationship between these barriers and cross-border imports of services. The study found that relaxation of India's barriers to FDI could increase India's services imports by nearly 50 percent, depending on the extent of market opening. The gains to US services exporters could be substantial.

The East-West Center promotes better relations and understanding among the people and nations of the United States, Asia, and the Pacific through cooperative study, research, and dialogue. Established by the US Congress in 1960, the Center serves as a resource for information and analysis on critical issues of common concern, bringing people together to exchange views, build expertise, and develop policy options.

The *Asia Pacific Bulletin* (APB) series is produced by the East-West Center in Washington. The views expressed in this publication are those of the authors and do not necessarily reflect the policy or position of the East-West Center.

EastWestCenter.org

EastWestCenter.org/Washington

Broader problems in India's business environment affect every industry, including services. These incorporate rigid labor laws, slow and costly licensing and permitting procedures, weak systems for enforcing contracts, poor transport and energy infrastructure, and corruption. Such constraints have proven frustratingly obstinate. According to the World Bank, in 2005 India ranked 116th out of 155 economies for the ease of doing business; in 2010 it ranked 134th out of 183.

Recent data suggest that additional reforms are becoming more urgent. According to the United Nations, FDI into India declined by over 32 percent in 2010, while it increased in other dynamic Asian economies, including China, Indonesia, Malaysia, and Thailand. The decline in FDI may reflect in part investors' frustration with the slow pace of reforms. Opening the door to more foreign investment in services, including retailing, would signal the Indian government's commitment to improving the environment for business. Service providers from the United States and other countries would certainly stand to gain significantly from liberalization, but the most important beneficiaries would be the hundreds of millions of Indians who would be afforded additional employment opportunities, lower prices, and expanded access to high-quality goods and services.

*This article stems from a USITC Office of Industries Working Paper entitled An Overview and Examination of the Indian Services Sector, authored by Lisa Alejandro, Eric Forden, Allison Gosney, Erland Herfindahl, Dennis Luther, Erick Oh, Joann Peterson, Matthew Reisman, and Isaac Wohl.*

Matthew Reisman is an International Trade Analyst at the US International Trade Commission. The views expressed here are solely his own and do not necessarily represent those of the US International Trade Commission or the United States Government. He can be contacted by e-mail at [matthew.reisman@usitc.gov](mailto:matthew.reisman@usitc.gov).