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Service Sector Reform in China

Ryan Rutkowski

Ryan Rutkowski *has been a research analyst at the Peterson Institute for International Economics since 2012. He works with Senior Fellow Nicholas R. Lardy on economic issues relating to China. He joined the Peterson Institute after living and working in China for five years. He was a senior consultant for KPMG management consulting in Beijing developing China market entry and business expansion strategies and a research associate for Z-Ben Advisors in Shanghai analyzing developments in China's asset management industry.*

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Faced with slowing economic growth, Chinese policymakers now recognize that the service sector of the economy—transportation, communications, finance, and health care—could spur economic activity and employment. The catch is that China must reform these and other areas to accomplish this goal. Chinese leaders have outlined an ambitious agenda for reform, but myriad vested interests could slow or block their plans. This Policy Brief evaluates the steps taken so far and the difficulties that lie ahead in implementing them. Failure to enact serious changes in the organization and state control of services would impair the prospects for growth.

During the third plenum of the 18th Chinese Communist Party in November 2013 proposed structural reforms to trade, investment, fiscal, market, legal, political, and social systems. Since then China has begun to enact changes in three areas that could, over time, raise service sector growth. First is lifting price controls and changing tax incentives favoring industry. This may seem unrelated to service sector reform, but removing these distortions will lead to higher investment in services. For example, liberalizing deposit interest rate controls, which have historically subsidized industry by keeping capital costs low, will encourage private capital to move from more capital-intensive industry to less capital-intensive services as the cost of capital rises.

Second is removing barriers to private investment in many services, such as finance, aviation, and telecommunications. Such investment currently is low due to restrictions on private entry and competition, ensuring the dominance of state monopolies. Greater competition from private firms after the barriers are removed will improve the quality and growth of investment in services. Third is China's privatization of a larger share of state assets, most of which are in the service sector. This could further reduce state investment in nonstrategic services, such as real estate or retail, and eliminate underperforming state monopolies in other services.

The current Chinese leaders are more capable of overcoming barriers to service sector reform, such as vested interests, than their predecessors were. In November 2013 President Xi Jinping and Premier Li Keqiang broke from the previous Hu Jintao and Wen Jiabao administration in making an unprecedented commitment to market reform. In a further break from

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the past, they have embarked on a widespread anticorruption campaign toppling state-owned enterprise (SOE) managers, including the former head of the government agency in charge of SOE management. These efforts make it more likely that the current leadership will succeed in reforming the service sector.

Yet the degree of state control of services remains excessive. Although some degree of state ownership is common in certain sectors, such as transport, education, and health care, it is difficult to justify continued state ownership in everything from airlines to finance to business services. Early reforms are making it easier for private companies to enter previously restricted sectors, such as banking, but time will tell if private firms will be able to compete fairly with incumbent SOEs. Managers of powerful state-owned monopolies such as China Mobile or the Industrial and Commercial Bank of China will likely resist competition. Regulators such as the National Development and Reform Commission may also resist relinquishing controls on market prices, as it will effectively reduce their power over the economy. However, with growth slowing in industry and real estate, China can no longer afford investment in services to be dominated by less productive state firms.

Chinese leaders want to reach developed-economy levels of per capita GDP by 2050, to cap carbon emissions by 2030, and maintain stable job creation, all while decreasing dependence on capital investment to support growth. The output and employment the service sector generates are low for China's current level of development, and as services create more jobs per unit of GDP and are less polluting than industry, China's lackluster performance in services impedes both employment and antipollution efforts. China's extensive state ownership of service-sector businesses is also a drag on productivity and growth. Ultimately, encouraging greater private participation and investment in services is needed for China to achieve its long-term goals.

THE SERVICE SECTOR AS AN ENGINE OF GROWTH

Services are often the largest and most diverse portion of an economy. China considers all sectors outside of agriculture, mining, manufacturing, construction, and utilities to be services,[1] including a wide array of activities aimed at consumers (e.g., retail, health care, education, hotels, restaurants, airlines, and rail) and businesses (e.g., leasing, consulting, telecommunications, information technology, finance, legal, and engineering).

Typically low-income countries may see a decline in the share of services in GDP relative to industry as they reach a middle income level. After further growth, services once again dominate in a high-income economy. However, the development of China's service sector is low even for a middle-income economy. In 2013 services accounted for just under half of GDP and only 37 percent of employment. Figure 1 shows that services as a share of GDP in China are below the middle-income country average in terms of service sector development and well below developed economies such as the United States, where services generate closer to 78 percent of output and around two-thirds of all employment. Other studies have also found China's service sector to be low for its level of development.[2]

The low level of services development in China reflects the number of government policies that have favored the development of industry. For example, by lowering the cost of capital and energy, government controls on interest rates and energy prices effectively subsidized investment in industrial sectors (Lardy 2014, 128–32). The continued dominance of state-owned monopolies in many service sectors has also contributed to underdevelopment (Lardy 2014, 132–35).

Increasing the share of output generated from services will benefit the Chinese economy. First, Chinese policymakers want to ensure that growth remains fast enough to create adequate employment. As mentioned above, the service sector can generate more jobs per unit of GDP than industry, which would allow China to maintain higher job creation even as headline growth slows. A move to higher-skilled service jobs would also benefit China's large base of college graduates, which is now second only to the United States in size.[3] Second, services require less energy and resources and producer fewer emissions per unit of output than industry, which will help Chinese policymakers in their "war against pollution" and efforts to cap carbon emissions by 2030.[4] If future reforms could open up these sectors to greater private and foreign investment, the economic gains would help policymakers meet their goals for income growth as well. President Xi has outlined two goals for economic growth, including doubling per capita national income over 2010 levels by 2020 and becoming a fully developed and modern nation by 2049.[5] The productivity gains associated with reforms to the

1. China divides its service sector into 14 sectors, including wholesale and retail services, transport, storage, and postal services, hotels and restaurant services, information transmission, software and information technology services, financial services, real estate services, leasing and business services, scientific and technical services, water, environment, and utilities management services, public administration services, household services, education services, health and social services, and culture, sports, and entertainment services. In 2012 the top three service sectors by share of GDP were wholesale and retail (9.5 percent), real estate (5.7 percent), and finance (5.5 percent). The remaining services accounted for around a quarter of GDP. Even the top service sectors are still smaller than manufacturing and agriculture, which accounted for 31 and 10 percent of GDP, respectively, in 2012. The remainder comes from construction and utilities at 6.83 and 2.2 percent of GDP respectively.

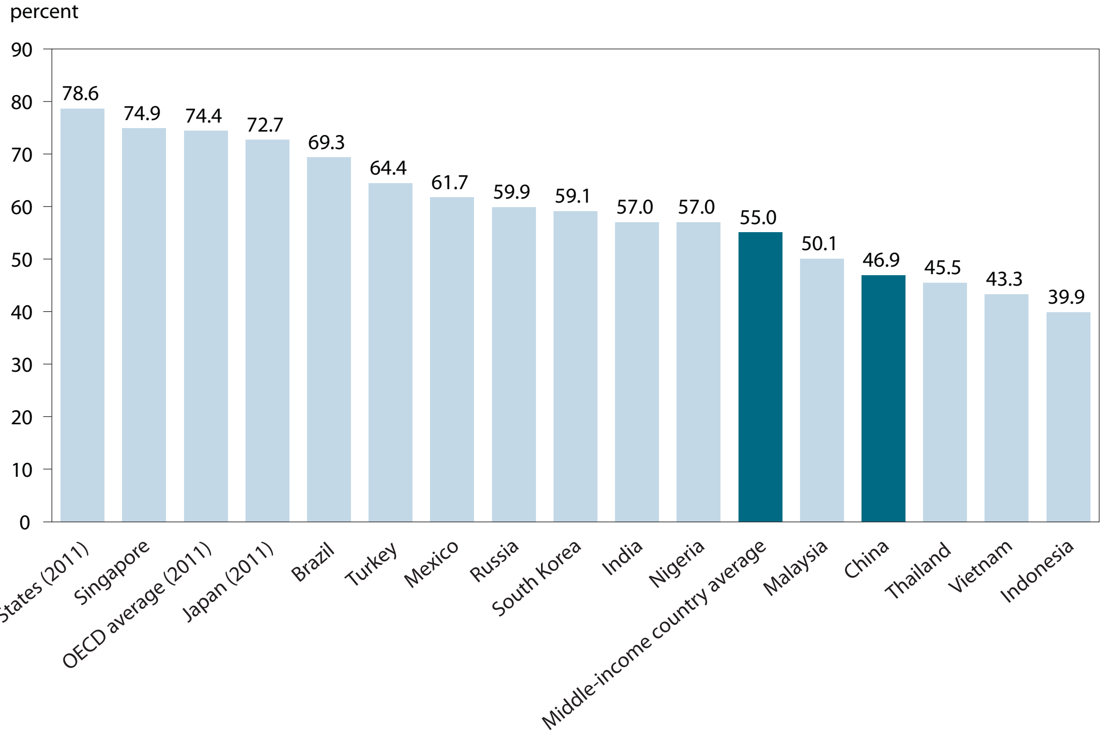
2. An Asian Development Bank study shows that the share of GDP originating in services in China throughout the reform era is below the share predicted based on the relationship between the growth of per capita GDP and the share of services in 12 Asian economies (Park and Shin 2012, 7).

3. According to China's 2010 population census there were 74 million working age Chinese between the ages of 25 and 64 with a college degree. Available at www.stats.gov.cn (accessed on January 15, 2015). In the same year there were 130 million Americans of working age with a college degree according to the OECD. Available at stats.oecd.org (accessed on January 21, 2015).

4. On March 4, 2014 Premier Li announced that China would "declare war" on pollution. See "China to 'declare war' on pollution, premier says," Reuters, March 4, 2014, www.reuters.com (accessed on January 21, 2015). Some of the detailed targets following this announcement include a commitment to reduce reliance on coal and fossil fuels to generate energy and reach peak carbon emissions by 2030. See "China, U.S. agree limits on emissions, but experts see little new," Reuters, November 12, 2014, www.reuters.com (accessed on January 21, 2015).

5. After taking office in 2012, Xi Jinping, Chinese president and general secretary of the Communist Party, highlighted the two 100-year goals (两个一百年) as a key component of the "Chinese Dream" (中国梦). The goal consists of doubled GDP per capita and disposable income per capita from 2010 levels by 2020, and becoming a powerful, wealthy, civilized, and harmonious society and modern nation state by the party's 100th anniversary in 2049. In economic terms this could be considered reaching the US level of per capita GDP. See "Li Yiping: realizing the two "hundred year goals" needs what kind of speed,"

Figure 1 Service sector share of GDP, 2013



OECD = Organization for Economic Cooperation and Development

Source: World Bank, *World Development Indicators*, data.worldbank.org (accessed on January 15, 2015).

service sector will help China realize these goals by raising GDP growth.

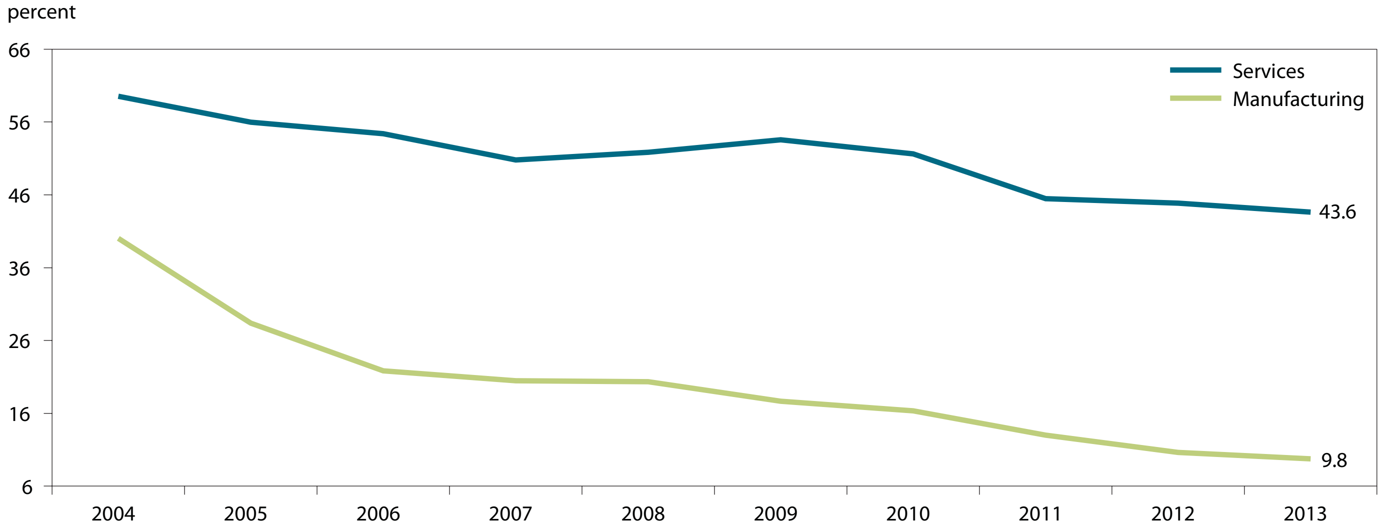
The service sector remains relatively closed to private investment compared to manufacturing, presenting an opportunity for productivity gains from greater private participation. In manufacturing, figure 2 shows that in the past decade alone the state share of investment has declined rapidly, from 40 percent in 2004 to 10 percent in 2013. The productivity gains associated with more private investment have contributed to the rapid expansion and rising competitiveness of China's manufacturing sector. In contrast, opening of the service sector to private and foreign competition has lagged (Lardy 2014, 133–35). China's privately owned services firms are twice as productive as state firms but contribute only just over half of total investment.[6] The state share of investment has declined in services, and rapidly in certain key sectors—especially retail, hotels, restaurants, and real estate—but the total share remains close to 50 percent, five times higher than the state's share in manufacturing.

The Chinese state retains substantial control over traditional service sectors, including transportation, education, health care, and telecommunications, in which, as figure 3 shows, the share of state investment was 70 percent or more in 2013. State investment in airlines and rail was over 80 percent. In rail, a state-owned monopoly, China Railway Corporation, remains the sole operator and owner of railway assets in the country. In telecommunications, state monopolies maintain control over fixed line and cellular services, cable and broadband, and satellite services. China is also unique in the extent of state ownership across service industries. In addition to traditional sectors of state influence, the state also looms large in financial services, technical services (e.g., legal, accounting, architecture, and engineering), and entertainment. In 2013 state firms accounted for over half of all investment in radio, television, and motion picture programming. Central and provincial government-owned television channels monopolize television broadcasting. The state share of investment in a number of other sectors, such as leasing and business services, real estate, and even hotels and restaurants, remain higher than the average share of state investment in manufacturing.

People's Daily, January 7, 2014, theory.people.com.cn (accessed on January 21, 2015).

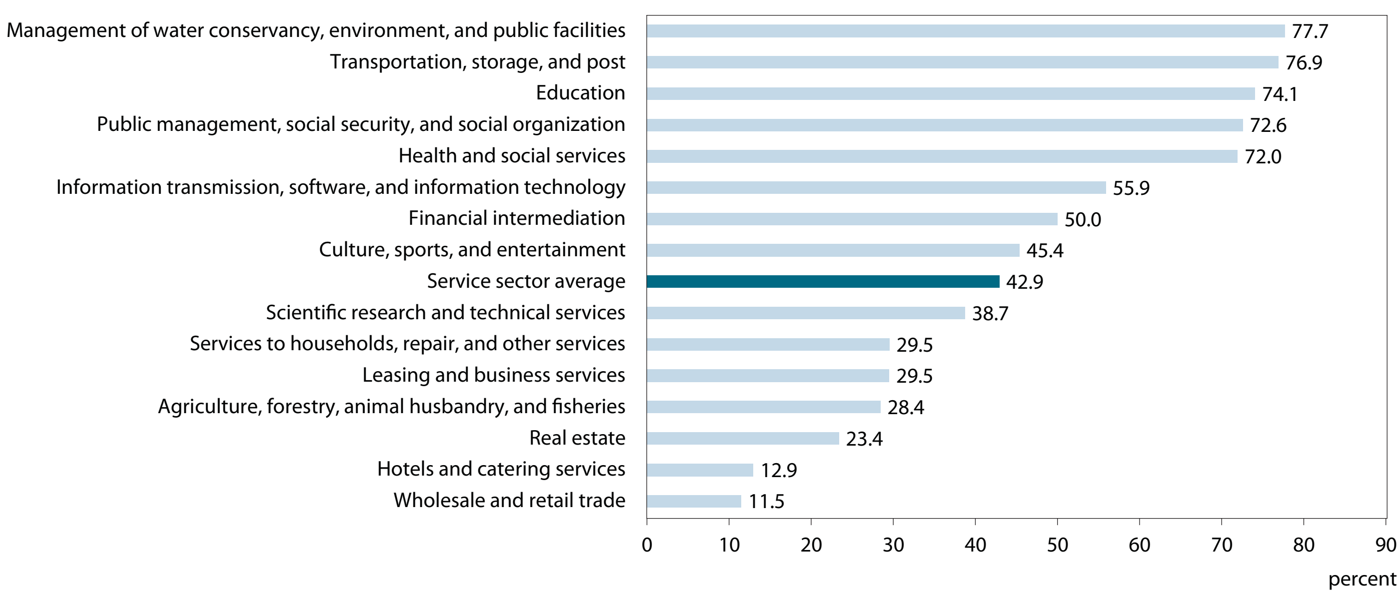
6. The 2008 economic census showed that average returns on assets for non-state firms in 10 of 15 tertiary sectors excluding real estate, transport, storage, post, public management, finance, and international organizations were 6.6 percent—double the 3.4 of state-controlled enterprises.

Figure 2 State share of fixed asset investment by sector, 2004–13



Source: National Bureau of Statistics, www.stats.gov.cn (accessed on January 15, 2015).

Figure 3 State share of fixed asset investment in services by subsector, 2013



Source: National Bureau of Statistics, www.stats.gov.cn (accessed on January 15, 2015).

As mentioned above, even in many advanced economies, public enterprises own education, health care, telecommunications, and transportation assets. However, the level of public ownership in China is unique by international standards. The Organization for Economic Cooperation and Development (OECD) product market survey shows that public ownership in China is higher than it is in OECD and non-OECD countries. In 2013 China's telecommunications sector had the highest degree of public ownership and barriers to entry among 34 OECD and non-OECD countries.[7] This is also true for transport sectors, such as airlines, rail, and roadways.

7. The 2013 OECD product market regulation indicators survey regulations at the sectoral level for 43 countries: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, South Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak

Table 1 Policies to remove market distortions favoring industry

Distortion	Effect
Remove controls on deposit interest rate	Increase the cost of capital for industry
Remove controls on energy prices	Increase costs for energy intensive sectors
Remove controls on exchange rate	Increase the price of manufacturing exports
Increase resource taxes and introduce pollution tax	Increase costs for resource and pollution-intensive sectors
Replace business tax with value added tax on services	Allow service sector investment to be deducted from sales tax

Sources: Lardy (2014, 128–32), Chi (2014, 73–87).

REFORMS TO ACCELERATE GROWTH IN SERVICES

China's government is currently pursuing three reform initiatives that could accelerate service sector growth. First, policymakers are eliminating market distortions that have historically reduced the cost of capital, energy, and resources at the expense of services. Second, China is removing or reducing regulatory barriers to private and foreign entry in the service sector. Third, China is planning to privatize a greater share of assets owned by the state, potentially opening the door for private and foreign ownership and competition.

Eliminating Market Distortions

Price controls and tax incentives have contributed to the underdevelopment of China's service sector: By subsidizing the industrial sector, they have reduced private investment and therefore growth in services. Removing these distortions will accelerate service sector growth. Table 1 highlights the potential effects of reforming price controls and tax incentives favoring industry over services.

Among possible reforms, China's effort to liberalize deposit interest rate controls could have the greatest effect on service sector growth. The central bank maintains a ceiling on deposit interest rates, which lowers the cost of funding for banks and leads them to pass on lower funding costs to borrowers (Lardy 2014, 129–30). Lower funding costs are more beneficial to investors in the industrial sector because investment in industry generally requires greater fixed investment than investment in services. If funding costs rise as a result of liberalization of deposit rates, private investors will likely shift more money into less capital-intensive services.[8]

China's central bank is currently in the process of gradually removing deposit interest rate controls. Last year they removed the cap on foreign currency deposit rates in Shanghai and increasing the ceiling on renminbi deposit interest rates to 1.2 times the benchmark rate, from the previous 1.1.[9] As liberalization continues, this is sure to be a boon for service sector investment.

Ongoing reforms to remove controls on energy prices will also spur investment in services. The government traditionally has controlled the prices of refined oil, electricity, and natural gas, fixing them at a level too low for energy companies to generate adequate returns. Keeping the price of energy low subsidizes industrial firms that consume two-thirds of energy production (Lardy and Borst 2013, 5). As these controls are removed and energy prices rise, profit margins on services will rise relative to industry, encouraging private investors to shift money away from industry and toward less energy-intensive service sectors. In recent years China has made great inroads in removing controls on refined petroleum products and natural gas.[10] It has also begun to allow greater flexibility in electric

Republic, Slovenia, Spain, Switzerland, Turkey, United Kingdom, Brazil, China, India, South Africa, Bulgaria, Croatia, Cyprus, Latvia, Lithuania, Malta, and Romania. In 2013, China scored 3.6 out of 6.0 for the level of public ownership of telecommunications, higher than the average of 1.25, and higher than Brazil or South Africa (0.06 and 2.07, respectively) but lower than India (4.5). A higher score reflects a higher degree of state ownership. China's public ownership score for rail and airlines was 6 and 3.82 respectively. The score for barriers to entry in road transportation was 4.5, indicating high barriers. See OECD, "Productivity and Long-Term Growth: Indicators of Product Market Regulation Homepage," www.oecd.org (accessed on January 15, 2015).

8. Funding costs could be substantially higher if deposit interest rate controls are removed. The quasi-deposit financial instruments—such as bank wealth management products—are free of interest rate controls, and thus reflect, to some extent, the rates banks could offer depositors in a liberalization environment. These products are currently yielding up to 200 basis points higher than traditional bank deposits under current controls.

9. Although the ceiling on deposit rates was lifted, because the benchmark deposit rate was reduced by 25 basis points, the effective deposit interest rate was unchanged.

10. For more details see Ryan Rutkowski, "China Price Reform Update—1H2014," China Economic Watch, Peterson Institute for International Economics, August 6, 2014, blogs.piie.com (accessed on January 15, 2015).

power prices for certain sectors.[11] However, there is still substantial room for further liberalization.[12]

The service sector will also benefit from removing exchange rate controls. For over a decade China has managed to keep its currency undervalued, which increases the returns on industry relative to services because the majority of tradable goods in China are manufactured goods (Goldstein and Lardy 2009, 10, 59). Liberalizing the renminbi exchange rate will raise the price of manufactured goods, reducing the margin on selling manufactured goods and selling services. Today the renminbi can only trade against other currencies within a band around a benchmark rate the central bank sets daily. The flexibility of the renminbi around this band is increasing, however—a sign that policymakers are committed to eventual liberalization. In March 2014, the People's Bank widened the renminbi trading band for the first time in two years, doubling it from 1 percent to 2 percent.

China is also changing its sales tax system in a way that benefits services. In 1994 it adopted a value-added tax (VAT) for the industrial sector but maintained a turnover tax for the service sector. The VAT system creates a greater incentive to engage in capital investment and exports because it allows firms to deduct the cost of capital investment and intermediate inputs (Rutkowski 2014, 21). The deduction also effectively reduces the final price of industrial goods relative to services because it leads to a lower built in sales tax. The VAT distortions favoring the industrial sector are now being removed.[13] However, tax authorities still need to add some particularly significant sectors to the VAT. For example, the real estate sector is the largest service sector in terms of value added output, but continues to use a turnover tax.

Increasing taxes on polluting firms will also benefit investors in services. China currently taxes on the sale of certain resources that harm the environment, such as crude oil and coal. This year, the State Council told local governments to shift from a tax on the volume of coal sales to the value of coal sales, a move that will likely lead to a higher effective coal tax.[14] It also raised the current tax on the value of crude oil sales by 100 basis points, to 6 percent. In addition to the resource tax regulators are mulling a potential carbon tax. The resource and carbon taxes would decrease the returns on investment in industrial firms, as they are the dominant users of carbon-intensive resources. The industrial sector is responsible for 95 percent of all coal consumption; in particular, coking coal is integral to steel production.

Deregulation and Opening Up Services to Private and Foreign Entry

Many private and foreign investors cannot invest in the service sector because of barriers to entry. Removing these barriers will accelerate private and foreign investment in the service sector. Table 2 highlights recent policy measures designed to open up previously restricted sectors to private and foreign investment.

Private firms now can enter certain previously restricted sectors for the first time. After a six-year hiatus in new approvals, the Civil Aviation Administration of China (CAAC) once again began approving new airline companies in 2013. In 2014, China's banking regulator began approving the establishment of new private banking institutions for the first time. As of July, there were five new banks established by private enterprises, including Alibaba, Tencent, and Fosun Group. The Chinese government also offered licenses to private players to sell cellular services for the first time in 2013. Since then the Ministry of Industry and Information Technology (MIIT) has offered mobile virtual network operator (MVNO) licenses to allow a growing number of private companies to provide cellular service.[15]

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11. In December 2013 the National Development and Reform Commission called for a tiered pricing system for aluminum producers. Aluminum smelters consuming between 13,700 and 13,800 kilowatts per ton will be charged an additional 0.02 renminbi per kilowatt. Producers consuming more than 13,800 kilowatt per ton will be charged an additional 0.08 renminbi per kilowatt. See "China to impose tiered power pricing for aluminum smelters," Reuters, December 22, 2013, www.reuters.com (accessed on January 21, 2015).

12. The returns of electric power distributors are below the cost of capital. This is an indicator that electricity prices are too low, because in a market environment electric power distributors should be able to cover their cost of capital. For example, in September 2014 the annualized return on assets (earnings before tax divided by total assets) of electric power distributors were only 2.6 percent, well below the average bank lending rate over the period of 7.3 percent. Estimated from data available at www.stats.gov.cn (accessed on January 21, 2015).

13. China began a pilot to allow a selected group of services to transition to a VAT in 2012. By August 2013 the Ministry of Finance expanded this program nationwide. Coverage has since expanded to include railway, post, and telecommunications. Financial services, construction, and entertainment sectors will be added in 2015.

14. The reformed coal resource tax will be 2 to 10 percent of the selling prices of coal products, compared with the current tonnage-based coal resource tax of 2 to 4 renminbi per million tons ($0.33–$0.65/mt) for noncoking coal and 8 renminbi per million tons for coking coal. Currently coal prices are at one of their lowest pricing points in recent years, mitigating the effects of this change, but industry insiders expect this to lead to a higher effective tax rate, especially as coal prices begin to rise again. See "New Coal Tax to Push Industrial Reform," *China Daily*, December 3, 2014, usa.chinadaily.com.cn (accessed on January 15, 2015).

15. In December 2013, the MIIT began issuing MVNOs to 11 private companies, including Alibaba, JD.com, and HiChina. As of December 2014, MIIT has completed five rounds of licensing and awarded licenses to 42 private companies. Given the government's goal of 50 million MVNO connections by 2015, GSMA suggests MVNO connections could account for

Table 2 Policies to reduce barriers to entry in services, 2005–14

Date	Policies
February 2005	Old 36 guidelines
May 2010	New 36 guidelines
May 2013	CAAC lifts ban on new airline approval
September 2013	Shanghai FTZ established
July 2013	CBRC begins approving new private banks
November 2013	CAAC eliminates floor on airline ticket prices
December 2013	MIIT begins awarding MVNO licenses to private firms
August 2014	Wholly foreign-owned hospitals allowed
October 2014	Foreign entry into payment services allowed
December 2014	Three new FTZs announced in Tianjin, Fujian, and Guangdong
December 2014	Reduced restrictions on foreign bank branches

CAAC = Civil Aviation Administration of China; CBRC = China Banking Regulatory Commission; FTZ = free trade zone; MIIT = Ministry of Industry and Information Technology; MVNO = mobile virtual network operator

Source: Various government documents and news sources (on file with author).

China is also reducing some longstanding barriers to foreign investment in services. Experiments in new free trade zones such as the Shanghai Free Trade Zone have sought to reduce the number of services subject to barriers, such as value-added telecommunication businesses.[16] China is also pursuing some new liberalization outside of these zones. Last year it eliminated barriers to foreign investment in previously restricted sectors such as hospitals and credit card payment services after experimentation in the zone.[17] The Chinese government also announced it would ease various restrictions on the expansion of foreign banks.[18]

China's renewed commitment to pursuing international trade agreements could lead to even greater liberalization of services to foreign investment. The recently concluded free trade agreement between Australia and China contained more far-reaching commitments to service sector liberalization than previous agreements did.[19] China is negotiating a bilateral investment treaty with the United States and has expressed interest in joining the Trade in Services Agreement (TISA), both of which will demand more liberalization of services to foreign investment. Future agreements with the United States, such as a US-China free trade agreement or Chinese entry into the Trans-Pacific Partnership, would require further, more far-reaching liberalization (Bergsten, Hufbauer, and Miner 2014, 404–407). Finally, China is moving toward a more fair and equal playing field between private and state-owned firms in

3.5 percent of the market by 2015. See GSMAIntelligence, "China Mobile Tells MVNOs: We Are Open for Business," *Mobile World Live,* June 12, 2014, www.mobileworldlive.com (accessed on January 15, 2015).

16. In January 2014 the MIIT and the Shanghai municipal government issued the Opinions on Further Opening up Value-added Telecommunication Business to Foreign Investments in the China (Shanghai) Pilot Free Trade Zone. The opinion lifts China's ban on the creation of foreign-invested telecom enterprises in application store services, store-and-forward business services, call center services, internet access services, and domestic multiparty communication services. It also allows foreign investment in online data and trade processing services and domestic internet virtual private network services, subject to 55 and 50 percent ownership restrictions respectively. See Wang Rui, "China's (Shanghai) Free Trade Zone Paves Way for Foreign Investment in China's Value-Added Telecommunication Service Market," *China Bulletin,* May 2014, www.kingandwood.com (accessed on January 15, 2015).

17. In July 2014 the National Health and Family Planning Commission and the Ministry of Commerce announced that it will allow wholly foreign-owned companies to own and operate hospitals in Beijing, Tianjin, and Shanghai, as well as the provinces of Jiangsu, Fujian, Guangdong, and Hainan. Previously foreign companies were only allowed to own and operate hospitals as joint ventures. See "China further loosens foreign ownership of hospitals," Reuters, August 27, 2014, www.reuters.com (accessed on January 21, 2015). In October the State Council released a statement allowing foreign and domestic-invested companies to apply to establish bank card settlement organizations. In the past, the central bank required all payment cards to be settled through China UnionPay. See "China to free clearing market for bank cards," Reuters, October 29, 2014, www.reuters.com (accessed on January 21, 2015).

18. On December 20, 2014 China's State Council announced it would drop a requirement that a foreign bank's parent transfer a specific level of operating funds in order to fund new branch openings. Foreign banks will be eligible to apply to conduct renminbi transactions after operating for only one year, down from the previous three. The government also dropped a requirement for foreign banks to maintain two consecutive years of profits in China in order to open new branches. See People's Republic of China State Council Order no. 657, www.gov.cn (accessed on January 15, 2015).

19. The China-Australia free trade agreement will give Australian firms privileged access to Australian health care, law, and value-added telecom companies. For more information see Sean Miner, "At Long Last, A China-Australia FTA," Peterson Institute for International Economics, China Economic Watch, December 4, 2014, blogs.piie.com (accessed on January 15, 2015).

Table 3 Policies to privatize state-owned assets

Policies	Effect
Corporatization and public listing	Makes it easier to sell off shares of state assets to the public
Mixed ownership enterprises	China will sell down the state's share in state-owned companies
Platform companies	State shares in enterprises will be actively managed by investment management companies

Source: Chi (2014, 99–11).

the service sector. For example, although private firms have been allowed to establish airlines since 2005, the government set a floor on the price of airline tickets that adversely affected many private airline companies, mostly those competing as low-cost airlines. Last year's removal of this floor on ticket prices will allow private-invested low-cost airlines to more effectively compete with established state-owned players.[20]

Privatization of State Assets

China's state ownership of service-sector assets is substantial across many sectors. Some SOEs monopolize certain service sectors, such as transportation and telecommunications, leaving little room for private or foreign entrants to compete. The sale of some of these assets to private players could generate greater investment in services and open up certain monopolized sectors to private and foreign competition. Table 3 highlights some of the policy initiatives the government has announced to reform SOE ownership. These will particularly benefit the service sector because 62 percent of all SOEs are in that sector.

For a little over a decade China's government has sought to corporatize state-owned assets to improve corporate governance and performance. However, as of today only around 60 percent of central enterprises are publically listed.[21] At the local level, even fewer assets are publically listed. The central and local governments are announcing plans to accelerate this process. The Guangdong announced plans to securitize 60 percent of state-owned assets by 2015, up from only 20 percent today.[22]

Corporatization and public listing of state-owned firms will allow private investors to hold equity in those firms. Today private investors already own a little over half of the shares of publically listed corporatized state-owned firms.[23] The amount of equity sold to private investors could increase even more in the future. The government announced plans to increase the number of mixed-ownership enterprises, or companies with both private and state capital. So far these sales are still experimental, but there is potential for growth in the future. At the central level, the regulator in charge of central nonfinancial SOEs—the State-Owned Asset Supervision Administration Commission (SASAC)—announced that Sinopharm and China National Building Materials Group (CNBM) would experiment with mixed ownership reforms. Sinopec also recently announced a high profile sale of a 30 percent stake in its retail unit to private investors. Other state-owned financial institutions and local SOEs have announced similar experiments.[24]

Perhaps more promising is the prospect of a change in the management of state assets. Listed SOEs, even those with private investors, have traditionally been majority owned and managed by unlisted state-owned groups and regulated closely by the SASAC, local governments, or government ministries. This could change if China commits to a more market-oriented, passive approach to managing state controlled assets. The SASAC is experimenting with the creation of state-owned asset management platforms to manage corporatized state ownership rights.[25] These platform companies could have greater discre-

20. In November 2013 the CAAC removed a rule requiring airlines to charge a minimum domestic ticket prices. According to a rule published in 2004, airlines had to set fares not higher than 1.25 times and not lower than 60 percent of a base price. See Jasmine Wang, "China Scraps Floor Price for Air Fares to Boost Budget Travel," Bloomberg, November 6, 2013, www.bloomberg.com (accessed on January 15, 2015).

21. In March 2014 SASAC indicated that 56.97 percent of central enterprise assets have been publically listed. See "Xi Jinping: State-Owned Enterprises to Be Self-Improved by Reformation," *Xinhua,* March 11, 2014, www.sasac.gov.cn (accessed on January 15, 2015).

22. See Wei Tian, "Provinces Drawing Up Plans for State Asset Management," *China Daily,* December 13, 2013, Africa.chinadaily.com.cn (accessed on January 15, 2015).

23. In March 2014 SASAC indicated that 53 percent of the shares of central listed firms and over 60 percent of the shares of local listed firms are owned by nonstate-owned investors (非国有股权). See "Xi Jinping: The Improvement of State-Owned Enterprises as part of Deepening Reform, *Xinhua,* March 11, 2014, www.sasac.gov.cn (accessed on January 21, 2015).

24. In July 2014 the Bank of Communications announced it was studying plans to deepen its mixed ownership structure to introduce more private and foreign investment into the bank. Currently the Ministry of Finance is the dominant owner of the bank with a 27 percent stake. See "China's Bank of Communications seeks more private investors," Reuters, July 25, 2014, www.reuters.com (accessed on January 15, 2015). At the local level, Shanghai Guangming, a leading milk producer, and Guangdong's Gree, a leading appliance maker, announced plans for mixed ownership reform. See "Zhuhai begins State-owned assets reform," *China Daily*, February 20, 2014, www.chinadaily.com.cn (accessed on January 15, 2015).

25. In July 2014 SASAC designated the State Development and Investment Corporation (SDIC) and China National Cereals, Oils, and Foodstuffs Corporation (COFCO) to be reorganized into investment companies on a trial basis. Similar experiments are also being conducted at the local level. In

tion to divest underperforming state assets, and even reduce the state role in firms to that of a passive investor if necessary, to help management generate higher returns.

OBSTACLES TO SERVICE SECTOR REFORM

It will be difficult for the current Chinese leadership of Xi Jinping and Li Keqiang to achieve the ambitious reforms outlined above. Some regulators are concerned that removing market distortions could put additional stress on a slowing economy. In particular, deposit interest rate liberalization could negatively affect small and medium-sized banks, overcapacity industrial sectors (e.g., steel), and investors in the real estate sector.

Vested interests and reluctance to relax government control also impede reforms to open up the service sector to private and foreign investors. Some of the managers of China's top 113 central SOEs are selected directly by the party and hold a vice-ministerial or ministerial rank—the equivalent of the head of government ministries. Many of these companies are among the largest in the world, such as the Industrial and Commerce Bank of China and China Mobile. Some of China's chief regulators are also former SOE executives, particularly in banking (Lardy 2014, 21). In addition, many services, such as education, media, and telecommunications, are considered public goods and closely tied to the leadership of the Chinese Communist Party. (See box 1.)

Such obstacles impeded efforts to reform the service sector during the previous Hu and Wen administration. A decade ago China's State Council passed a number of measures designed to relax private entry into certain service sectors known as the old 36 guidelines. Among them, private firms were allowed into the aviation sector for the first time, leading to the creation of several new private airline companies.[26] The old 36 guidelines were updated in 2010 to further reduce barriers to private investment in certain sectors, known as the new 36 guidelines.[27] The effects of these measures in increasing private investment were relatively limited. For example, the state share of service sector investment fell only slightly, from 56 percent in 2005 to 54.4 percent in 2012. In particular, the entry of new private players into the airline sector had very little effect on state monopolies. By 2012, the state share of investment in air transport was still 91 percent, down just 2.5 percent since private firms were first allowed entry in 2005.

IMPLICATIONS OF SERVICE SECTOR REFORM FOR THE CHINESE ECONOMY

If current leaders can overcome obstacles to reform, the Chinese economy will see immediate benefits. Rebalancing the domestic economy will require a decline in the growth of investment, particularly in overcapacity sectors such as industry and real estate. Under these circumstances raising productivity and employment in services will be important to sustaining GDP and net employment growth in the medium term.

Employment

Increased private participation in services will generate more employment opportunities even as GDP growth slows. From 2007 through 2012, private enterprises and household businesses added a total of 41.5 million jobs in the service sector, more than four times the jobs that state-owned firms added in the same period. This is substantial considering private investment in the service sector was actually 30 percent less than that of state firms over this period.

Productivity

Increased private participation in services would also improve the productivity of the service sector. A number of studies have found China's service sector to be less productive than manufacturing (Lardy 2014, 133). Over the last five years, the average value-added output generated per unit of fixed asset investment was only 1.7 percent, lower than the 2.2 percent in secondary

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December 2013, the Shanghai Government announced the goal of transferring the ownership of unlisted state-owned group corporations and listed state-controlled corporations a single asset manager, Shanghai State-Owned Capital Operations Platform Company. Following the announcement, the four groups are SAIC Motor, Shanghai International Port (Group) Co., Ltd., Shanghai Jiao Yun Co., Ltd., and Shanghai Textile Co. Six listed companies—Huayu Automotive Systems Company Limited, Shanghai Diesel Engine Company Limited, Shanghai International Port (Group) Co., Ltd., Shanghai Jiao Yun Group Co., Ltd., Shanghai Dragon Corporation, and Shanghai Shenda Co., Ltd.—were transferred to the platform company.

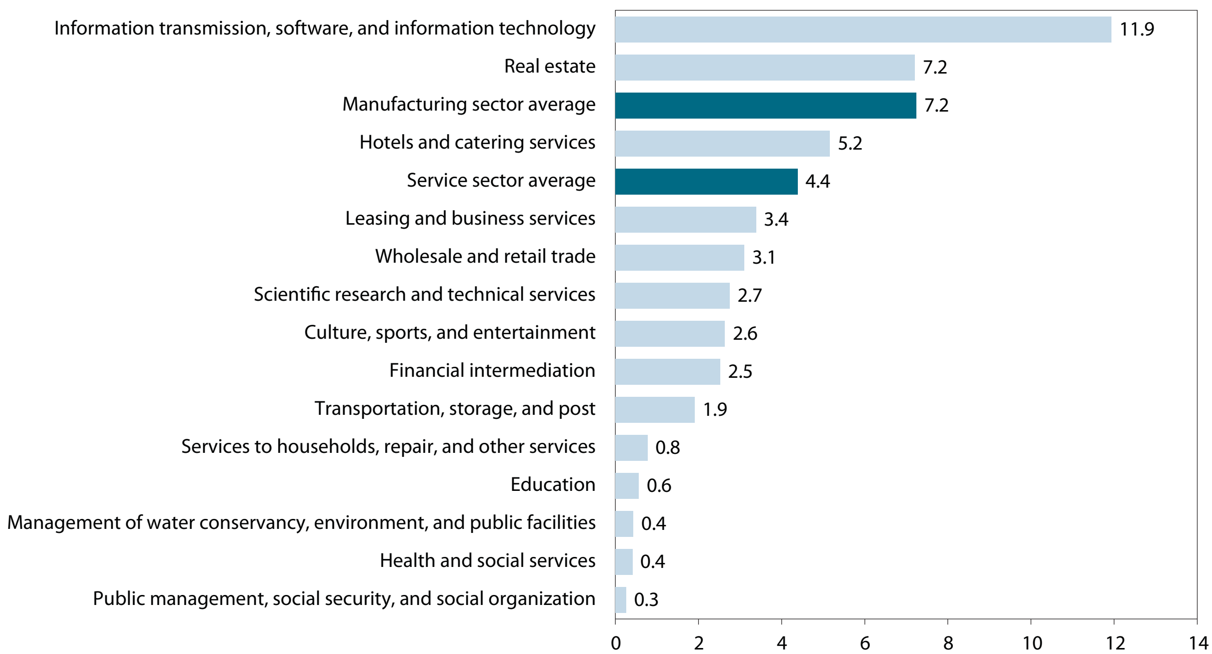
26. Spring Airlines, Okay Airways, Juneyao Airlines, and East Star Airlines were established in 2005. See Wang Xu, "Slowly, Private Firms Chisel an Investment Wall," *Caixin Online,* April 20, 2010, english.caixin.com (accessed on January 15, 2015).

27. In May 2010 the State Council released "measures to encourage and guide healthy development of private investment." These measures are an expansion of a similar policy announced in February 2005. The new document encouraged private investment in infrastructure, such as railroads and train stations, coal transport facilities, highways, waterway transport, ports, and airports, and financial services such as county banks and rural cooperatives. The 2005 document had focused primarily on investment in electric power, telecommunications, railways, civil aviation, and petrochemicals. Available at Government of China State Department, "State Council to Encourage and Guide Private Investment in the Healthy Development of a Number of Views," May 13, 2010, www.gov.cn (accessed on January 15, 2015).

Box 1 Obstacles to opening services to foreign companies

The sensitive nature of services impedes opening them up to foreign competition in many countries. Certain sectors, such as transportation, banking, health care, education, media, and telecommunications, are considered sensitive for national security reasons. In addition, policymakers in developing economies are often concerned with the infant industry dilemma in opening up to foreign firms with a competitive advantage in providing services. These issues are also evident in China's restrictions on foreign investment in services. Although the foreign share of investment in services is similar to manufacturing, it is generally concentrated in less sensitive sectors. Figure 4 shows that in 2013, the foreign share of investment in services was 4.4 percent, close to that of manufacturing, a sector mostly free of restrictions to foreign entry. However, foreign investment is mostly concentrated in information technology, real estate, hotels and restaurants, and wholesale and retail. In other more sensitive sectors, such as technical services, financial services, transport, education, and health care, the government imposes substantial restrictions on foreign investment.

Figure 4 Foreign share of investment in services, manufacturing, and services subsectors, 2013



Note: Foreign refers to foreign-funded enterprises and Hong Kong, Macau, and Taiwan-funded enterprises.
Source: National Bureau of Statistics, www.stats.gov.cn (accessed on January 15, 2015).

The Organization for Economic Cooperation and Development (OECD) regularly publishes a Services Trade Restrictiveness Index scoring 34 OECD member countries and 6 nonmember countries, including China, based on restrictions to foreign direct investment into various services, such as audiovisual, distribution, financial, transport, legal, telecommunications, and construction services. The latest index, published in November 2014, shows that China is ranked in the top 5 out of 40 countries in 14 out of 18 categories, reflecting a relatively high level of restrictiveness to foreign investment in China. Various other studies have also found China's service sector barriers to be relatively high (Bergsten, Hufbauer, and Miner 2014, 202–205). Even if restrictions on entry are lifted, foreign investors could still face barriers to competition with state-owned or privately owned domestic companies. For example, foreign banks have been allowed to engage freely in local currency business since 2006. However, they still point

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Box 1 Obstacles to opening services to foreign companies *(continued)*

still point to unequal treatment relative to domestic banks. A PricewaterhouseCoopers (PwC) survey of foreign banks in 2013 highlighted that a newly established China branch of a US commercial bank can conduct US dollar business in China, but must wait an additional three years to be licensed for renminbi business (PwC 2014, 66). Although much of the restrictions on foreign branch openings were removed this year, it remains to be seen whether this will allow foreign banks to gain market share in China. Foreign banks currently only occupy 2 percent of bank assets, lower than the OECD average of 12 percent and even well below many developing countries. Whereas the foreign bank share of banking assets in Indonesia and Malaysia were 32 and 18 percent, respectively (Claessens and van Horen 2012, 33–36).

industries (e.g., construction).[28] Greater private sector participation could narrow this efficiency gap. In the industrial sector, private firms were on average three times more productive than state firms over the past decade.[29] As noted earlier, in the service sector, Chinese government data shows private firms are twice as productive as state-owned firms. Some studies have also found that improvements in competition and higher levels of service sector provision improve productivity in the manufacturing sector (Jensen 2011, 20). In 2013, the IMF found that deregulation and increasing the share of labor employed in services would lift productivity (Nabar and N'Diaye 2013, 14).

Table 4 shows three reform scenarios. In the conservative scenario, the state reduces its share of investment in all services to the equivalent level of manufacturing, with only health care, education, water, environment, utilities management, public administration, and transportation remaining at current levels. The baseline scenario assumes that state investment in health care, education, water, environment, utilities management, and transportation falls to 50 percent. A more aggressive liberalization scenario assumes that the average state investment in services falls to the equivalent level of manufacturing, or 10 percent in 2013.

The three reform scenarios assume there will be economic gains from an increase in private participation in services and reduced market distortions in terms of employment and productivity. In the baseline scenario, if the state share of investment falls to 25 percent and the average GDP generated per unit of investment would rise to 2.0 percent—higher than the 1.8 today, but still lower than the 2.2 percent productivity in secondary industry in 2013. Employment gains by sector are also generated from output productivity gains from higher private investment.[30] In this model reforms will begin slowly in 2014 and gradually accelerate until they reach the terminal values for each scenario in table 4. The reform scenarios assume the services share of fixed asset investment will return to 2002 levels—the period before the introduction of many price and tax distortions—as a result of the elimination of market price distortions.[31] The projection also assumes an economic rebalancing in which the average investment growth over the period is one-half its historic 10-year average.[32]

The projections show that as service sector reforms continue, China can meet long-term growth objectives even as investment growth continues to slow. Reforms will raise the services share of GDP to or above the middle-income country average by 2020.[33] The productivity gains from greater private

28. The value-added output per unit of fixed investment is calculated by dividing each sector's share of gross capital formation by its share of value-added output. The sector's share of gross capital formation is estimated based on the sector's share of fixed asset investment. For example, in 2013 the tertiary sector's share of fixed asset investment was 55 percent. When applied to 28.036 trillion renminbi in gross capital formation, that would imply the amount of gross capital formation generated by the service sector was 15.420 trillion renminbi. Therefore, the tertiary sector's value added output of 27.589 trillion renminbi divided by the tertiary sector's share of gross capital formation would be 1.8 percent in 2013. Available at www.stats.gov.cn (accessed on January 21, 2015).

29. The return on assets for state-controlled industrial enterprises between 2013 and 2003 averaged 5.2 percent, compared with 10 percent for private enterprises over the same period. Available at www.stats.gov.cn (accessed on January 21, 2015).

30. Employment gains are generated using the ten-year average ratio of growth in workers to growth in GDP for primary, secondary, and tertiary sectors. For example, the three-year average ratio of growth in tertiary employment to value added was .23. With a projected growth rate for tertiary-sector value added in 2014 of 11 percent, the growth rate in the tertiary labor force would be 2.5 percent. The tertiary sector labor force would then grow to 303 million, almost 7 million more workers than in 2013.

31. In 2013 the service sector's share of fixed asset investment was 55 percent. The scenario analysis assumes that, with reform, this will rise to 62 percent by 2020. This is close to the share of investment the service sector held before the introduction of various price distortions in 2003. In 2001 the services share of fixed asset investment was 61 percent. Available at www.stats.gov.cn (accessed on January 21, 2015).

32. South Korea's gross capital formation peaked as a share of GDP in 1991. The growth rate for the ten years before the peak averaged 20.3 percent. The following 10 years growth averaged 10.8 percent, or around half the previous decade average. For China the ten years of growth before 2013 averaged 17.6 percent. If China were to follow a path similar to Korea, growth would fall to an average of 8.8 percent over the following decade.

33. Table 4 shows that service sector share of GDP and employment of 46.9 and 37.1 percent, respectively, in 2013 would rise to 56.3 and 44.3 percent,

Table 4 Scenario analysis of service sector reform, 2014-20

		Terminal assumption for 2020		
Component	**2013**	**Conservative**	**Baseline**	**Aggressive**
State share of investment in services (percent)	43.5	35.0	25.0	10.0
Services share of investment (percent)	54.9	61.9	61.9	61.9
Return on investment in services (percent)	1.7	1.9	2.0	2.2
Investment growth (percent)	10.9	8.6	8.6	8.6
	2013	**Projected 2014–20**		
GDP per capita relative to 2010 level, end of period	1.4	2.5	2.6	2.8
Average net job creation (millions of jobs)	2.7	1.6	2.4	3.5
Tons of SCE consumed per RMB1,000 GDP, end of period	7.0	6.3	6.2	6.1
Average GDP growth (percent)	7.7	7.4	7.8	8.4
Services share of GDP, end of period (percent)	46.9	55.2	56.6	58.7
Services share of employment, end of period (percent)	37.1	45.5	45.9	46.4

SCE = standard coal equivalent

Sources: National Bureau of Statistics, www.stats.gov.cn (accessed on January 21, 2015); Wind Information Systems; author's calculations.

investment in services will ensure China could double per capita GDP over 2010 levels by 2020.[34] China will be able to maintain net job creation above 2 million jobs a year. As mentioned above, greater reliance on the service sector also would make further inroads in China's fight against pollution.[35]

CONCLUSION

China's current leadership has the will, opportunity, and capability to open up the country's service sector. Since the 18th Communist Party Politburo Standing Committee took office in November 2012, China's real output growth has declined precipitously. The new leadership is concerned that GDP growth should stay above 7 percent to ensure adequate job creation for an expanding urban labor force.[36] At the same time, they are committed to rebalancing the economy away from the investment-driven growth that produced high GDP growth in the past, and thus are resisting a broader increase in credit and infrastructure investment. These conditions are making it increasingly difficult for policymakers to resist reforms to accelerate growth in the service sector, which can deliver higher productivity and employment.

China's leaders recognize the importance of reform. In its first year in office, the 18th Politburo Standing Committee released a comprehensive reform agenda in November 2013, placing a high priority on deepening reform. In a break from the past, the agenda committed China's leaders to a deadline of completing most reforms before 2020. A small group was also established, composed of the party's leading bureaucrats to coordinate the execution of reforms across various levels of party and government organizations.

Led by President Xi, the 18th Politburo is more capable of taking on vested interests than its predecessors were. Since taking office Xi has led an unprecedented crackdown on corruption, focused on removing many former or sitting SOE managers.[37] President Xi has also actively spoken in favor of reform to reduce the wealth and power of SOE managers.[38]

respectively, by 2020 in the baseline scenario. The middle-income country average for services share of GDP in 2012 was 55 percent.

34. Table 4 shows that, following reform, 2020 per capita GDP would be more than double 2010 levels.

35. Table 4 shows that, even in a conservative service sector reform scenario, the tons of standard coal equivalent (SCE) consumed per unit of GDP would fall from 7.0 in 2013 to 6.3 by 2020.

36. In a speech on October 21, 2013 Premier Li said that China needs to maintain a GDP growth rate of 7.2 percent to ensure it can meet an annual employment target of 10 million new urban jobs. He estimated that every percentage point of GDP growth could generate 1 million new jobs, and this could rise to 1.3 million or 1.5 million with further growth in services. See "Li Keqiang: GDP Growth of 1 Percentage Point to Pull 150 Million," *Workers' Daily,* November 5, 2013, finance.sina.com.cn (accessed on January 15, 2015).

37. In November 2014 Reuters calculated that at least 55 SOE leaders had been placed under investigation in the past year. See "China reform plan to loosen grip on some state firms," Reuters, November 4, 2014, www.reuters.com (accessed on January 21, 2014). Among them, in September 2013 the head of the State-Owned Assets Supervision and Administration Commission (SASAC), Jiang Jiemin, was removed from office and detained for disciplinary violations. Jiang Jiemin was the former chief executive of PetroChina. In April 2014 the chairman of China Resources, Song Lin, was accused of disciplinary violations.

38. In April 2014 President Xi called to curb the salaries of SOE managers. See "Xi Jinping targets China's corporate titans with pay curbs," *Financial Times,* August 22, 2014, www.ft.com (accessed on January 21, 2014).

China is preparing an ambitious array of reforms that will benefit the service sector. By bolstering private participation in this sector, the reforms could unlock efficiency gains that increasing output and employment growth in a period of weakness in industry and real estate. At the same time, if policymakers fail to reform and open up the service sector, they run the risk of slower growth in output and employment. Either way, in the near future, it is clear the service sector will play a larger role in the success or failure of China's economic transition.

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