

Offshore Outsourcing of Services: Trends and Challenges for Developing
Countries

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1. Introduction

Offshoring of services, meaning the outsourcing of business functions and services by developed country firms from all sector of economic activity to captive units or independent suppliers located in other countries, in particular developing countries, has for some time now been a source of academic and political debate in the developed countries, especially in the U.S. The controversy has risen because offshoring involves not just the transfer abroad of new job opportunities that would have arisen otherwise in the developed countries, but also the loss of existing jobs in those countries to offshore locations. Consequently, there is a growing body of literature, across different disciplines, analysing the offshoring phenomena.¹ Also, this issue has figured prominently in recent flagship publications of international inter-governmental institutions.² Studies have sought to identify the drivers for outsourcing in general³; and to identify a set of potential benefits and disadvantages of this practice.⁴ Also, the assessment of why firms decide to outsource in foreign countries instead on their own has been subjected to close scrutiny, as its limits, advantages and disadvantages discussed. The implication for the home economy of the offshoring of business functions and services has received in particular considerable attention in recent years. Most of the studies in this context focus mainly in assessing the employment and income effects, both on its level and its distribution, of the phenomena on the offshoring countries. A number of empirical analyses have sought to measure the impact of this process in the offshoring economies.⁵ Offshoring presents interesting theoretical challenges, and significant efforts have been also undertaken to incorporate these new realities in the framework of theoretical trade models.⁶

¹ Among many other studies refer to: Bartels F (2005) "Outsourcing Markets in services: International Business Trends, patterns and Emerging Issues", UNIDO 2005 Outsourcing Trend and Development Conference, 8-9 June, 2005, Shenzhen, China; Working paper IWPS 002/05. Mann C.L, (2003) Globalization of IT Services and White Collar Jobs: The Next Wave of productivity Growth, International Economics Policy Brief 03-11, December, Institute for International Economics, Wash, D.C.

² UNCTAD (2004) World Investment report 2004. UNCTAD (2003) E-Commerce and Development report 2003. World Trade Organization (2005) World Trade Report 2005.

³ Among many other studies refer to: Morgan Chambers (2001) Outsourcing in the FTSE 100, available at www.cw360.com/outsourcingreport Also, Outsourcing Institute (2005) New Workplace: Outsourcing in Japan, available at www.outsourcing.com

⁴ Holtz, Wermer, Reinstaller Andrea & Windrum, Paul (2005) "Organizational Innovation, information technology and outsourcing of business services" Maastricht Economic Research institute on Innovation and technology (MERIT) and International Institute of Infonomics; MERITR-Infonomics Research Memorandum Series 2005-030.

⁵ Görg H & Hanley A (2004) "labor Demand Effects of International Outsourcing: Evidence from Plant Level Data, The University of Nottingham, Research paper Series 2004/37.

⁶ Markusen, James (2005) Modelling the Offshoring of White-Collar Services: From Comparative Advantage to the New Theories of Trade and FDI, Prepared for the Brookings Forum, "Offshoring White-Collar Work: The Issues and Implications, May 12-13.

There seems to be a general acknowledgment of the potential positive and significant role of offshoring of services on the economic growth and development of developing countries. Conventional wisdom⁷ increasingly tells us by now that offshoring is a process that is just beginning and will continue to grow exponentially for the foreseeable future, and that it is a trend that can not be rolled back offering tremendous opportunities for developing countries in general as it has created a global marketplace for services where these countries could enjoy a competitive advantage.⁸ In the extreme it is even postulated that it could enable many developing countries to potentially leapfrog the industrial development stage turning their services sectors, through export activity, as the main engine of economic growth and development.⁹ The perceived potential of services offshoring for developing countries has been reflected in the increasing and prominent role that this issue is playing in the current negotiations on services, in the context of the Doha Work Program in the World Trade Organization (WTO), under GATS Article XIX. Some developing countries have emerged as principal demanders in these negotiations seeking specific commitments on cross-border trade in services (mode 1 in GATS parlance) from main offshoring countries as a way and means to overturn the growing protectionist backlash observed in those countries.

Even though there is growing consensus on the potential development gains accruing to developing countries from offshoring of services, there are still a number of questions that need to be answered to assess, both at the national and systemic levels, the developmental implications of this process. The future scope and dimension of the offshoring phenomena is still highly uncertain, and the impact of offshoring on the recipient developing country has not received equal attention that the one conferred to the current and potential impact on developed countries. Empirical studies of its impact on host countries are few, and existing ones focus mainly on the Indian experience, country that has led the way among developing countries in the offshoring process.¹⁰ In fact,

⁷ "...the hallmark of the conventional wisdom is acceptability. It has the approval of those to whom it is addressed. ...Numerous factors contribute to acceptability of ideas...But perhaps most important of all, people most approve of what they best understand...Because familiarity is such an important test of acceptability, the acceptable ideas have great stability. ...The fatal blow to the conventional wisdom comes when the conventional ideas fail signally to deal with some contingency to which obsolescence has made them palpably inapplicable. This, sooner or later, must be the fate of ideas which have lost their relation to the world." J.K. Galbraith, *The Concept of Conventional Wisdom*, in *The Affluent Society*, 40th anniversary ed. (Boston Mariner/Houghton Mifflin, 1998) pp. 6-17.

⁸ UNCTAD (2005) *Business Process Offshore Outsourcing: Untapped Opportunities for SMEs*, New York and Geneva. Refer also to, Mattoo A & Wunchs S (2004) "Pre-empting Protectionism in Services: The WTO and Outsourcing", World Bank Policy Research Working Paper 3237, March.

⁹ Radwan, I & Gihani, F (2005) *Sri Lanka Offshoring Professional Services: A Development Opportunity*, World Bank, SASFP, August.

¹⁰ Among other contributions refer to: Kumar, N & Joseph K.J (2005) "Export of Software and Business Process Outsourcing from Developing Countries: Lessons from the Indian Experience", *Asia-Pacific Trade and Investment Review*, Vol 1, No 1, April; Joseph, K J (2002) "Growth of ICC and ICT for development: realities of the myths of Indian experience", Discussion paper No 2002/78 WIDER-UNU August. Srinivasan T N (2005) "Information Technology Enabled Services and India's Growth Prospects", mimeo, September.

emerging conventional wisdom feeds on the extrapolation of the Indian experience as a potential developmental alternative available for all developing countries.

This paper presents some preliminary reflections, as food for thought, on the potential implications of offshoring for the development prospects of developing countries. The following section discusses some general issues and trends of offshoring that are relevant for assessing the potential development gains resulting from the process. The third sections analyses, based on existing studies, the current and potential growth and welfare impact off offshoring of services by developed countries firms on host developing countries, assessing some of the proposals and preliminary conclusions advance by today's conventional wisdom on the issue. The final section presents some general thoughts as conclusions on the potential developmental impact of offshoring and its policy implications.

2. Offshoring Main Trends and Issues

Outsourcing takes place when one company delegates responsibility for performing a function or series of tasks to another company. This process has also been called "externalization".¹¹ When the other company is located in another country outsourcing becomes *offshoring*. Outsourcing reflects the increasing division of labor in the economy, and was initially concentrated in production tasks within the domestic economy. Increasingly, due mainly to technological innovations, other type of tasks are being also outsourced. The process turns corporate functions, other than production tasks, into market services provided by specialized services firms. The process of externalization of corporate functions is not new. It partially explains structural transformation of the economies accounting for the increasing share of services in total valued added generated in developed market economies.

The structural change experimented by developed economies from agriculture to a services economy has been widely analyzed in economic literature focusing on the factors accounting for the continuous shift to service industry employment. Differing supply and demand factors have been examined to explain the observed evolution in the structure of developed economies. Among them there are: the shift in the structure of final demand from goods to services as income rises; the effect of inter-industry productivity differentials; and the impact of changes in the inter-industry division of labor, favoring the emergence of specialized services activities through a process of externalization of functions by firms in all sectors of the economy.¹² The process of economic growth and development of industrialized countries has been the result of a positive cross-fertilization, a close and symbiotic relationship between manufacturing and services, where growth has mutually reinforced the dynamism of manufacturing and services activities and has increasingly blurred the boundaries between them.¹³ The growing *externalization* of functions by other economic activities, and also by services companies themselves, is reputed to explain growth of modern business services in

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¹² Schettkat R. & Yocarini Lara (2003), *The Shift to Services: A Review of the Literature*, Institute for the Study of Labor, IZA DP No 964

¹³ OECD (2000), *The Services Economy*, Business and Industry Policy Forum Series.

developed countries, and their contribution to enhancing overall economic efficiency through specialization and economies of scale effects. In a parallel process, manufacturing industries are increasingly generating a higher proportion of their income through the sales of services.¹⁴ At the same time services have emerged as the main source of demand for ICT products, and other technology-embodied capital goods, sustaining increasing levels of production of many manufacturing activities. In developed countries, the intermediate demand for producer services originating from the manufacturing sector has emerged as a strategic variable for international specialization and as a determinant of the competitiveness of countries in producer services.¹⁵

Outsourcing, in strict sense should only refer to those tasks and functions that can be done inside the firm, but that due to cost and efficiency considerations are delegated to external suppliers. There are a number of services that are not prone to be done inside the firm, and also the capacity of different firms to do certain tasks is highly differentiated by firm size and sector of activity. This introduces a degree of complexity when attempting measuring the extent of the outsourcing process at the economy level.

Offshoring is a relatively new phenomenon within the general process of outsourcing. The first wave of offshoring, that took place during the 1970s and 80s, witnessed the relocation of labor-intensive production tasks in the manufacturing sector from developed economies to low-cost developing countries. The international relocation of labor-intensive services, such as data entry and call centers, started in the 80's and intensified during the 1990's signaling the beginning of a new international division of labor, that has been called the "second wave of globalization".¹⁶ Offshoring of services has been made possible and spurred by technological developments. The information and communications technology (ICT) revolution, with the associated decreasing costs of data transmission, has increased the tradability of services, allowing for the segmentation of the value chain in the provision of services (UNCTAD). Companies have fragmented and dispersed various service functions worldwide to take advantage of marginal differences in costs, resources, logistics and markets leading to a rapid increase of offshoring and trade in services activities that may have been considered non-tradable in the past.

During the current decade the relocation of more high-value added business processes and services, such as customer management, architectural sub-contracting, financial tasks, and contract R&D, has begun and is intensifying.¹⁷ Services offshoring is expected to continue growing as competitive pressures turn this practice as a key cost-reduction element in the international strategy of manufacturing and services firms. A study predicts that labor outsourcing will increase over time as information technology

¹⁴ OECD (2000), *The Service Economy*, Business and Industry Policy Forum Series; Howells J. (2000). *Innovation and Services: New conceptual framework*, CRIC Discussion Paper no 38, Center of Research on Innovation and Competition, University of Manchester.

¹⁵ Guerrieri P. & V. Meliciani, (2004), *International Competitiveness in Producer Services*, March, found at: <http://ssrn.com/abstract=521445>.

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¹⁷ Narayan S (2004) *Globalization of Services Activities: The view from India: Policy Brief No 7*, The William Davison Institute, University of Michigan Business School, September.

becomes more pervasive in the economy, as outsourcing seems to be associated with the increasing technological compatibility between the firms use of its own technology and the ability to use others technology. The compatibility reduces the adjustment costs of outsourcing thereby increasing the demand for it.¹⁸ As the offshoring process proceeds it is expected that there might be enough scope for successful entry of many developing countries in the market in the future because: (i) the market is growing; (ii) improvements in technology will allow for further expansion of activities that could be offshored; (iii) companies might tend to diversify in order to spread risk; (iv) recipient countries could succeed in establishing niche markets; and, (v) early entrants may cease certain types of offshore activities as they move up on the value-added ladder.¹⁹ However, as discussed below the real scope for many developing countries to benefit might be quite limited.

A wide variety of different terms are utilized on the literature to define the segments of the offshoring business. Commonly the broad terms "information technology enabled services" (ITES) services and "business process outsourcing" (BPO) are employed, and different authors utilized different classifications of services within these activities.²⁰ Different approaches derive from the fact that many of the services being traded do not neatly fit into any existing classification of services. Box I present a categorization of the type of function or services whose international trade has been enabled by ICTs. This categorization attempts to highlight the different market segments of offshoring addressing some particularities of the services involved. However, the boundaries between these segments are not always easy to be drawn, as each of them often combines several activities. When discussing different aspects of offshoring, attempting its measurement and also when assessing its implications most analyses tend to blur together IT-enabled-BOP services (ITE-BOP's), on-line delivery of professional services (ODPS), and software services (SS). These three sets represent services activities showing enough differences as to justify a separated assessment of their development implications. However, such a task goes beyond the scope of this paper. Nevertheless, some of the most salient features of each set are briefly highlighted below as relevant for our purpose.

ITE-BOP's constitute those activities that more closely resemble the common understanding of services offshoring. These are activities which could be done inside the companies, in most sectors of the economy, and that are outsourced mainly in order to reduce costs and to reap benefits from efficiency gains brought about by specialization and economies of scales of independent suppliers. These are fundamentally export-oriented activities in developing countries catering firms in the offshoring country, not depending on the dynamism of the domestic market to sustain their activities. The skill level required to undertake this tasks ranges from low-skill personnel in routine clerical

¹⁸ Bartel Ann, Lach Saul and Sicherman, Nachum, (2005) "Outsourcing and Technological Change" National Bureau of Economic research, Working paper 11158, February

¹⁹ UNCTAD (2005) Report on the Expert Meeting on Strengthening the Participation of Developing Countries in Dynamic New Sectors of World Trade: Trends, Issues and Policies; TD/B/COM.1/EM.26/3, 1 March.

²⁰ Business process outsourcing can be defined as contractual services to completely manage, deliver, and operate one or more business process or function.

work usually requiring only basic skills, as in data processing and order taking, to technical work requiring some level of training such as in call centers and other forms of customer support; and to higher skills in some business processes servicing. Some of these later tasks require professional supervision but can be undertaken by technical personnel.

BOX 1

International Trade in Business Services through Cross-Border Transactions

A. IT-enabled BOP Services (ITE-BOPs): Back-office-processes

- 1. Data encoding**
- 2. Customer Servicing: Call centers or "contact center industry"**
- 3. Business Processes Servicing:**
 - **Customer care:** database marketing, customer analytics, telesales/tele marketing, web sales and marketing, sales and marketing administration.
 - **Finance:** billing services, accounting transactions, tax consulting and compliance, risk management, financial reporting, and financial analysis.
 - **Human resources:** benefit administration, education and training, recruiting and staffing, payroll services, hiring-administration, and records management.
 - **Payment services:** credit/debit card services, check processing, and transaction processing.
 - **Administration:** tax processing, claims processing, asset management, document management, transcription and translation.

B. Software Services (SS):

- Custom developed solutions
- System integration
- Database management
- IT consultancy

C. On-line Delivery of Professional Services (ODPS)

- Accounting
- Legal
- Engineering
- Health
- R&D

the domestic market. In the case of the software industry, for example, domestic developments have been identified, with the exception of the Indian case, as the primary drivers of long-term growth.²¹ The internal capabilities of firms in different sectors of the economy, in particular of SME's to undertake in-house many of these tasks are more

²¹ Arora, A and Gambardella, A (2005) "The Globalization of the Software Industry: Perspectives and Opportunities for developed and developing Countries": Innovation Policy and the Economy, No 5, 1-32.

limited than in the case of ITES due to the required high degree of specialization and skills. Therefore, there is high propensity to outsource these services and in many cases these services are procured from specialized independent companies, either onshore or offshore, through arm's length transactions.

The first choice confronting firms involves choosing between keeping the task, or undertaking a new one, in-house and outsourcing it. Once the decision to outsource has been adopted then the firm has to decide if it will outsource onshore or offshore, and if the provider will be a captive unit of the firm or an independent supplier. The literature on the drivers of outsourcing is profuse. There is an emerging consensus regarding that outsourcing seeks mainly cost-reductions and that there are limits to the tasks susceptible to outsourcing, determined, *inter alia*, by the sensitivity attached by firms to their core activities and the standardization propensity of the different tasks. Also, the same cost and efficiency considerations weight heavily in the decision to offshore instead to outsource in the domestic market. Regarding the decision to procure from a captive supplier or from an independent firm, literature tends to coincide that it depends mainly on the perception by the firm of the sensitivity of the proprietary information, concerning *inter alia*, strategies and processes in particular when high R&D costs are involved, that would be needed to be shared with an independent supplier. Also, the transaction costs, including those related to the setting of contractual arrangements, involved in the process of offshoring are highlighted as intervening elements in the decisions by firms.

Table I combines the categories of services whose trade has been enabled by the ICT's revolution with the different procurement possibilities in terms of the location of the supplier and its relationship with the purchasing company. Share services are those that emerge when a firm decides to create an independent unit, located in the same country, to undertake a certain tasks in benefit of the mother company, or of the conglomerate of companies under its control. This happens, *inter alia*, when a division inside the company has reached certain size and degree of specialization, and its independence can improve performance. Also, units are made independent when they will capable of providing services to other firms in the economy that are seeking outsourced services. Independent units, under control of the firm, can also be established abroad. This is the case of captive-offshoring. The other alternative is to procure services from third parties. When the third party is located in a different country then offshoring emerges. The online transactions with suppliers, captive or independent, located in another country constitute cross-border trade in services (Mode 1). Also, the transactions of a captive unit in a third country supplying services to residents in that country constitute, according to the GATS, trade in services through commercial presence (mode 3). This is also the case when an onshore captive unit owned and controlled by foreigners sale services to domestic firms or individuals. Offshoring in general refers to the situations arising in cells 7 to 12, excluding the sales of captive units selling services in the host domestic market..

Table 1
Services Transactions: By Type of Service and Control and Location Features

<i>Location</i>	ONSHORE		OFFSHORE	
<i>Control</i>	Captive	Outsourced	Captive	Outsourced
ITE-BOP's	Shared services 1	4	7	10
SS	Shared services 2	5	8	11
ODPS	Shared Services 3	6	9	12

Measuring the extent of offshoring activity is an extremely difficult task in view of the lack of comprehensive and internationally harmonized data. Estimates provided by different sources differ widely. The main sources of information are surveys conducted by consulting firms and other institutions, and Balance of Payments data. Discrepancies in the data arise with regard to the size of the global IT expenditures itself, the size of the outsourcing market, and also with respect to the share of offshoring of the total outsourcing market. The OECD (2004) has estimated the global volume of the offshoring market, excluding domestic outsourcing, in 2003 to have been anywhere between US \$ 10 billion on the low end to 50 billion on the high end.²² McKinsey estimates the global offshore service market, captive and outsourced from third parties, at 37.7 US\$ billion. WTO (2005) presents a review of different estimates and discusses the problems associated with existing data. The WTO concluded that available information would suggest that IT and software expenditure worldwide in the order of 650 to 710 billion in 2003. Total outsourced IT services, excluding software, to be around 285 billion, and offshored services in the order of 40 to US \$ 45 billion. Including SS the total value of outsourced services would be significantly higher. Offshoring, according to this data, would represent 15.6 per cent of the total worldwide outsourcing market for these services. Alternatively a study by the research firm Nelson Hall estimates that offshoring accounted only for 2 percent of the total contract value of outsourced business processes in 2003 and that its participation could be expected to rise to 6 percent by 2008.²³ These estimates point out that to the fact that the bulk of outsourcing of services still takes place in the domestic economy

At this stage it is almost impossible suggest any approximation to the size of the offshoring market by the type of services presented in Table I. Partial information suggest however that the bulk of offshoring, in terms of value, takes place in the SS segment of the market. ITE-BOPs still represent a small share of the total business being expected to rapidly increase its participation. (UNCTAD 2005). ODPS, that implies the offshoring of "judgemental" processes and analytical and expert services still remain a comparative

²² OECD (2004) Economic Outlook of the OECD, Paris.

²³ Cited in Suri (2005)

small proportion of the total business and are only expected to account for 10 percent of offshore activity in 2006.²⁴

From the review of the literature is possible to identify some main trends characterizing the process of offshoring to date:

- An important feature highlighted by many is the predominance of captive offshoring as the preferred strategy of firms relocating tasks abroad. Offshoring to date constitute mainly intra-firm trade in intermediaries. It is estimated that up to 70 percent of offshoring is done through captive units in the foreign country. Therefore, trade in these services is closely interlinked with FDI flows. Developing countries that have been successful in attracting FDI are the ones increasingly participating in trade in the more dynamic services activities. They are also the ones that have been able to reap benefits from merchandise trade: There is a high and growing concentration of trade both in goods and services originating in those developing countries.
- World trade in "other commercial services", category that includes offshored services trade is highly concentrated. Twelve developed countries account for 67.1 percent of total exports of "other commercial services", and three developing countries - i.e. India, China and Hong Kong, China - for an additional 8.2 percent. The most dynamic segment of trade in services is that of "other commercial services"²⁵. Those services represent 47 percent of total world exports and have experienced two digit growth rates - up to 16 percent - in recent years. "Other business services", which are a sub-category within "other commercial services", encompassing a wide range of services activities, represent almost 50 percent of world exports of these services, while financial and insurance services, and royalties and licenses fees account for an additional 17 and 13 percent respectively. Contrary to developed countries, most developing countries still concentrate their supply on traditional travel and transport services, whose demand has grown at a significant lower rate than that of other commercial services, indicating the limited participation on trade of the more dynamic services. Nevertheless, national studies indicate that a process of gradual diversification of services exports might be taking place in some developing countries and that other commercial services are representing an increasing share of total their exports. Developing countries currently account for approximately 25 percent of total world exports of business services.
- As the case of all trade in services offshored services are concentrated in relative little number of countries. McKinsey (2003) reported that Ireland, India, Canada

²⁴ Suri, Navdeep (2005) Outsourcing and Development, paper prepared for the UNCTAD Experts Meeting on Strengthening the Participation of Developing Countries in Dynamic and New Sectors of World Trade, Geneva 7-9 February 2005.

²⁵ Includes the following items: construction, insurance, financial, computer and information services, personal cultural and recreational services, other business services, and, royalties and license fees.

and Israel, in that order, accounted for over 71 percent of the offshored market in 2001 (McKinsey 2003). Most recent data by the same firm, finds that by now India is the main provider of offshored services with 32.4 per cent of the total market, follow by Ireland (22.8), Canada (10%), Israel (9.5) and China with 9 percent. (2005). These four countries account for almost 80 percent of the worldwide offshoring services industry, and data shows a growing concentration of the activity worldwide..

- Trade in all services is still concentrated in developed countries that account for 78 percent of total world exports and a similar percentage of total imports. Available data confirms that industrialized countries overwhelmingly dominate in the same vein the offshoring process. Contrary to the common perception, the rest of the world outsources more services from developed countries than the reverse. (Amiti and Wei: 2005). Developed countries are the principal exporters and importers of offshored services. The process is still mainly a north-north phenomenon. In the case of the US, 85 percent of offshoring is with other OECD countries.
- North-south offshoring is highly concentrated. The main offshoring countries are the US and the UK. The US accounts for more than 70 percent of all worldwide offshoring. On its part India explains over 80 percent of all offshoring activity in developing countries, and 82 percent of its exports of software and IT-enabled services go to the US and the UK. (UNCTAD 2005).
- The geographical spread of the offshoring to developing countries has been quite limited. Besides India that accounts for 80 percent of all jobs created by offshoring in developing countries, few other developing countries have been able to make a significant inroad into the process. Among few others: Philippines, China, Thailand, Singapore, Hong Kong, Brazil, Mexico, and South Africa are identified as important players. Also, some transition economies in Eastern Europe have started catering to the European market. The degree of concentration of services trade among developing countries can be appreciated by available data on trade in services The 12 leading developing countries exporters of services, that includes the above mentioned countries, account for over 70 percent of the total services exports of the group. This concentration ratio increases when considering only exports of "other commercial services" category that could be used as proxy for offshored services.
- A pattern of specialization is emerging in the provision of offshored services. In South and East Asia, and the Indian Ocean Region (IOR), area that is leading the process, different countries are beginning to specialize in different types of offshoring activity, with different policy objectives and instruments. In ITE-BOPs, China, Malaysia, Philippines and Australia are significant hosts. The dominant hosts for call centers and shared service centers, are found in IOR. The offshoring of financial services is hosted, mainly, in China, Hong Kong, Singapore and the United Arab Emirates. Contract R&D (for product adaptation

and development rather than fundamental research) is increasingly performed in Australia, China, India, Singapore and Taiwan Province of China.²⁶

3. Offshoring for Development?

The enormous potential that the new wave of globalization may offer to development countries allowing them to reap significant developmental gains from services and trade in services is by now common place on the literature. The emerging new international division of labour is perceived as providing an opportunity to developing countries to redefine the terms of their integration into the world economy being unequivocally beneficial for employment, exports, growth and overall welfare. Primo Braga (1995)²⁷, UNCTAD (2005)²⁸, OECD (2004)²⁹. This section of the paper focuses on the developmental implications of the offshoring of services. Online-cross border trade in services is highlighted, in the context of the broader discussion on the issue of services and development, as one of the main areas of potential benefits; offering almost unlimited opportunities to developing countries. In order to assess if this expectations are reasonably grounded in reality we explore four main questions: How big the gains could be? Who is more likely to benefit? How sustainable the process could be? And, finally, what is the overall impact of offshoring of services in the host economy?

3.1 Employment and income generation effects: How big gains?

Employment generation and its associated income effects are highlighted in the literature as the main developmental gains that could accrue to developing countries from the offshoring of services by developed economies. These effects would materialize to the extent that the hypothetical possibility of a significant share of employment, current and new, would be relocated from developed countries to developing ones. Therefore, to assess the potential impact of offshoring as a driver of development in developing countries is necessary to measure its current magnitude and its potential future scope and dimensions. However, those issues remain highly uncertain due to serious statistical limitations. UNCTAD (2004), for example, concludes referring to the potential benefits of offshoring for developing countries, that the opportunities for all countries, not least developing and transition economies, to attract employment and income-creating work as result of offshoring are significant, although at this stage, it is impossible to say exactly

²⁶ Bartels, Frank (2005) Outsourcing Markets in Services: International Business Trends, patterns and Emerging Issues, UNIDO 2005 Outsourcing Trend and Development Conference, 8-9 June 2005, Shenzhen, China

²⁷ Primo Braga, Carlos (1996) "The Impact of the Internationalization of Services on Developing Countries", available at www.worldbank.org/fandd/english/0396/articles/070396.htm

²⁸ UNCTAD (2005) Business Process Offshore Outsourcing: Untapped Opportunities for SMEs, New York and Geneva

²⁹ OECD (2004) Nielson Julia and Taglioni, Daria, "Services Trade Liberalization: Identifying Opportunities and Gains". OECD Trade Policy Working Paper No 1, February.

how significant.³⁰ In order to assess if the current optimism surrounding offshoring is grounded in real possibilities we need to explore two main issues. What has actually happened since offshoring of services begun? And; what can we expect in the foreseeable future?

Studies attempting measuring the employment effect of offshoring in developed countries tend to coincide that there has been a relative loss of jobs in certain sectors and affecting certain categories of workers, but in the aggregate the positive effects associated with the process have tended to compensate for those losses, being the overall employment effect at the most only marginal. A recent study, proposing a new empirical approach to identify at a detail level for the entire economy industries and occupations that are tradable, finds that there is considerable employment in tradable activities, and that there is job insecurity associated with employment in these activities including services. The study found that the higher job losses are found in tradable industries with the greatest difference outside manufacturing, and that at the lower end of skill distribution employment growth is negative for tradable services. At the occupation level it found that the rate of job losses is higher in tradable occupations, with the greater difference in white-collar occupations.³¹

Other studies arrive at similar conclusions. Shultze (2004) concludes that the effect on jobs on the US due to offshoring is negative but very small³². Lawrence & Baily (2004) finds a loss of jobs in the IT and in the low-wage IT enabled occupations in the US, but that the evidence suggests that the jobs transferred abroad is tiny relative to total employment in services.³³ After reviewing a number of studies Brainard and Litan (2004) points to the evidence that low skill jobs are being affected, but being replaced by higher paid jobs.³⁴ Amiti & Wei (2004) found no evidence in the UK to support the notion that sectors with higher growth of services outsourcing would have a lower rate of growth, concluding that the risk of services outsourcing dramatically reducing job growth in the advanced economies has been greatly exaggerated.³⁵ In another study, on the US, the same authors found that offshoring would not induce a fall in aggregate employment, but that a negative effect can be detected when data is disaggregated at higher sectoral level, therefore signalling job losses in certain activities.³⁶

The analysis of the employment effect of offshoring in developed countries tend to suggest, independently of their conclusions on the overall impact on the domestic

³⁰ UNCTAD (2004). World Investment Report

³¹ Bradfords Jensen & Kletzer Lori (2005) "Tradable Services: Understanding the Scope and Impact of Services Offshoring, mimeo, Revised July.

³² Shultze, C (2004) "Offshoring, Import Competition and Jobless Recovery, Brookings Institution Policy Brief, 136 August..

³³ Baily M.N & Lawrence R (2004) "What Happened to the Great US Job Machine? The Role of trade and Electronic Offshoring", in Brookings Papers on Economic Activity, 2, Wash.

³⁴ Brainard L & Litan R (2004) "Offshoring services Jobs: Bane or Boon and What to Do? The Brookings Institution Policy Brief No. 132.

³⁵ Amiti, Mary & "Wei Shang-Jin (2004) "Fear of service Outsourcing: Is it Justified?", National Bureau of Economic Research, Working Paper 10808, September

³⁶ Amiti, Mary & "Wei Shang-Jin (2004) "Services Outsourcing, Productivity and Employment", cited in Amiti and Wei (2004a)

economy, that offshoring might have already generated a number of jobs outside the offshoring countries. However, an approximation to its quantification can not be derived directly from those studies. Estimation of the actual jobs lost in the developed countries due to offshoring, and the respective employment effect in host countries, faces considerable hurdles, and the estimations varies considerably. A survey conducted by the US Labor Department, Bureau of Labor Statistics, found, for example, that only 4,633 jobs were moved overseas during the first quarter of 2004, data that would demonstrate very little activity in this regard. According to a source the US economy, the leading world outsourcer, might have exported 1.9 million jobs since 1995.³⁷ A report by Forrester Research situates the number of US jobs offshored at 315,000 up to 2003 (McCarthy 2004). The US Chamber of Commerce estimates that 250,000 call centres jobs have been outsourced worldwide by US corporations.³⁸ McKinsey (2005) projects that total offshored employment worldwide will increase from 1.5 million in 2003 to 4.1 million by 2008, equivalent to 1 per cent of total services jobs in developed countries.³⁹

Estimates of the total jobs actually relocated to developing countries are even hard to find. McKinsey (2005) estimates that, in the eight sectors covered by its report, 565,000 jobs were performed in low-wage countries for companies or consumers in developed countries in 2003, and that the number is expected to increase to 1.2 million by 2008.⁴⁰ According to this source only 37.6 percent of all jobs relocated up to 2003 as a consequence of offshoring went to low-cost developing countries, and its projections are that by 2008 only 29.26 percent of all offshored jobs will go to developing countries. Data on employment in India, the leading offshoring developing country, provides an approximation of the employment effect of the process. ITE-BOPs and SS sectors in India accounted for 813 thousand jobs for the year 2003-2004, of which nearly 500,000 (260,000 in SS and 245,000 in ITE-BOPs) have been primary for export-oriented activities. If we combine this data with McKinsey estimates it would lead to conclude that a significant share of the employment generated in developing countries through offshoring, up to date, might have taken place in India.

ITE-BOPs being labor-intense low value-adding activities create significantly more jobs through offshoring than SS. In the case of India, estimating employment per million dollars of exports ITE-BOPs create more than twice the jobs than SS.⁴¹ In general SS and ODPS, being high productivity high value activities, create relative less jobs in the host country through offshoring activity. In the case of Ireland, for example, a leading location for outsourced SS, employment in the industry amounts to only 25,000 jobs, and

³⁷ Zielinski, R.H (2004) *The Offshoring of Teleservices: opportunities and macroeconomic Effects in Developing Countries*, Dissertation Submitted for the Degree of Master's in arts, University of East Anglia.,

³⁸ Robinson James (2004) "Trade, Sourcing and the Future of the American Workforce", US Chamber of Commerce

³⁹ McKinsey (2005) Quarterly November 2005

⁴⁰ McKinsey&Company (2005) *The Emerging Global Labor Market: Part I The Demand of Offshore Talent n Services*, June.

⁴¹ Kumar, N & Joseph K.J (2005) "Export of Software and Business Process Outsourcing from Developing Countries: Lessons from the Indian Experience", *Asia-Pacific Trade and Investment Review*, Vol 1, No 1, April

in the case of Israel, another mayor exporter of software, only 15,000 jobs have been generated by the industry. Besides the case of India, there are no reliable data sources, other than anecdotal evidence, on the actual jobs created in individual developing countries by offshoring.

It can be concluded, based on available data, that to date the employment impact of offshoring on host developing countries has been positive but, after more than a decade since the offshoring process was unleashed, by no means impressive taking into consideration the share of all offshoring jobs relocated to developing countries, and in the light of the employment needs of these countries.

The associated optimism with respect to the potential developmental gains accruing from offshoring derive from broad estimates of the amounts of jobs that can be created in the long-term, both by the reallocation of existing jobs and the new jobs that could be created in the host developing countries instead that in the home country. Some far reaching statements assuming that almost all jobs could be exported from developed countries contribute with such optimism. A crucial question in this respect is what can be realistically expected in the near future? There have been some attempts to assess the potential long-term impact of offshoring on the labour markets of developed economies. These estimates could provide, at least a first order of magnitude, of the potential employment impact of offshoring in developing countries .in a longer term assuming that those jobs are relocated to developing countries. However, an accurate estimation of the potential job creation in developing countries as a result of offshoring would need, *inter alia*, adjusting the number of potential jobs created for productivity differentials.

Estimates of the hypothetical potential long-term employment effect of offshoring of services vary greatly. According to the World Bank (1995) between 1-5% of total employment in the G-7 countries could be affected by offshoring.⁴² The OECD, analysing occupation employment data for selected OECD countries sought to determine the share of total employment that could potentially be affected by international outsourcing, meaning offshoring, of IT and ICT-enabled services. Conclusions of such work suggest that close that close to 20 per cent of total employment in OECD countries could potentially be affected by offshoring.⁴³ To estimate the "outer limits" of employment potentially affected by offshoring, data on employment by occupation by industry was used calculating the share of people employed who mainly perform the type of functions that could potentially be carried out outside the firms .as result of technological advances in ITC's and the increase tradability of services.⁴⁴ This estimation was confirmed in an OECD subsequent study.⁴⁵ Barham and Kroll (2003) estimate that

⁴² World Bank (1995) Global Economic Prospects..

⁴³ van Welsum, D and Vickery, G (2005) "Potential Offshoring of ICT-intensive Using Occupations, DSTI, Information Economy Working Paper, DSTI/ICC/IE(2004)19FINAL, OECD, Paris.

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⁴⁵ van Welsum, Desirèe & Reif, Xavier, (2005) Potential Offshoring: Evidence from Selected OECD Countries, OECD, DSTI-ICCP, July. These estimations however assess the total potential of outsourcing business processes, and not necessarily the overall potential for the offshoring of those functions. Data on occupations also include those in the services sector that have already been domestically outsourced and that have a high propensity to be offshored.

offshoring could adversely affect up to 14 million service jobs, through either relocation to another country or downward pressure on wages and benefits in US remaining jobs. Deloitte Research (2003) estimates that a little over 15 percent of the 13 million jobs in financial services in developed countries could go abroad. The consultancy firm McKinsey (2005) estimates that 160 million jobs, or about 11 percent of the projected 1.46 billion worldwide services jobs in 2008 could in theory be carried out remotely, barring any constraints on supply. It estimates that 9 per cent of all services jobs in the US could be offshored. Nevertheless, McKinsey stress the fact that all the offshoring potential will not materialized because of regulatory restrictions, company policies and specific concerns about language and culture.

In the case of ITES and SS sectors the hypothetical outer limit of the employment impact of offshoring would be set by total employment in related occupations. In the US total employment in IT and low-wage IT enabled occupations in 2003 was around 4 million, of which 2.6 million in IT occupations and 1.4 million in low-wage IT-enabled occupations. It can be safely assumed that the later ones have a higher propensity to be offshored. In the case of the U.K a leading services economy and exporter of services, for example, if all current jobs in IT and call centres in the economy are relocated abroad, and all to developing countries, it will imply a net gain of jobs for those countries of around 1.46 million jobs, (271 ICT managers, 124 software professionals, 276 IT operations technicians, 87 call centre agents and operators, and 287 in customer care occupations).⁴⁶

There is widespread agreement, in line with McKinsey conclusions, that there is a wide gap between the hypothetical number of jobs that could be offshored and the number of jobs that may actually be transferred abroad. A number of factors, besides the ones already mentioned *supra*, have been identified explaining this gap. Quantitative and qualitative supply-side constraints limit the real possibilities to relocate a number of activities that in theory could be offshored; and there are technical and managerial limitations to the type of tasks that can be offshored. Also, the limitations imposed by institutional constraints have been highlighted as a limiting factor for the spreading of offshoring. Trefler (2004), referring to institutional limitations, points out to the fact that developing countries for expanding the range of services they can provide they will eventually need to enter into activities that require constant innovation; and for that to be possible and adequate institutional setting is needed. Such setting providing protection of IPRs, assuring a functioning legal framework, supporting equity and debt markets, and, balancing the needs of inside innovators against those of outside innovators is not present in developing countries, and such institutional framework, if possible at all, will require a long time to materialize.⁴⁷ The gap between potential and real offshoring is significant. McKinsey predicts that only 2.56 percent of all offshorable services jobs may in practice move abroad by 2008, and concludes that offshoring will continue producing a global

⁴⁶ UK Office of National Statistics (2005) "Offshoring and the Labour market: It and call centre occupations considered". Labour market Trends, September.

⁴⁷ Trefler Daniel (2004) "Offshoring: Threats and Opportunities". Paper prepared for the Brookings Trade Forum 2005, The Offshoring of Services: Issues and Implications, 12-13 May.

labour market, but that its size is likely to be relative small and unlikely to affect the overall level of wages and employment in developed countries.

There are some estimates attempting to measure the expected employment effects of offshoring in the long-term. McCarthy (2004) finds the pace of offshoring activity increasing to about 200,000 to 300,000 jobs annually in the US, and predicts a cumulative job loss by 2015 of 3.4 million jobs, and an associated wage loss of 151 billion. Jaffee (2004) estimates a possible cumulative job loss of 3.7 million over 15 years.⁴⁸ Goldman Sachs researchers find that, depending on the assumptions, up to 6 million services jobs could be offshore over the next decade.⁴⁹ These estimates suggest, that in the longer term, the employment effect of offshoring, even though it could be significant for certain sectors and category of occupations in the economy losing the jobs, in the aggregate would have a limited overall employment impact in the developing world. There are also some estimates on the possible effect of offshoring on the growth of related employment in the home economy. In the case of the US a study by Global Insight (GI) predicts that the offshoring of services will cut the growth of IT employment by half over five years.⁵⁰

Estimates of job losses in the offshoring country as proxy for job creation in host countries may underestimate the total impact of offshoring on employment. They may understate the total impact because domestic companies with expanding worldwide employment may locate many of newly created jobs abroad even when they did not reduce their home country employment. Therefore, the potential for job creation in developing countries due to offshoring would have to consider both the reallocating of existing jobs from developed economies, plus the newly created jobs in offshoring activities in developing countries. The rate of growth on new jobs in developing countries reflecting those that would have been created in developed ones will depend on the pace of the outsourcing process, and on the expansion of the demand for those services. However, all offshoring will no necessarily take place in developing countries, some develop countries would remain as preferred offshoring sites, in particular for the high-end part of technological services. As discussed above, developed countries are still expected to gain a significant share of offshoring job creation.

An issue that has not received adequate attention is the impact on employment of offshoring from developing countries. Firms in developing countries are also engage in offshoring tasks to suppliers' abroad, in particular foreign companies that relay in their international networks. There is clear evidence that this is already happening, among other, in the telecommunication industry and in the financial sector. Contrary to the case of developed countries this issue has not been yet raised or empirically asses. The extent of offshoring by foreign companies, and also domestic ones, needs further research as it

⁴⁸ Jaffee Dwight (2004) "Globalization, Offshoring, and Economic Convergence: A Synthesis", prepared for the Conference Understanding Global Outsourcing, Stern School of Business, December 10. mimeo.

⁴⁹ Quoted in Alan Garner (2004)

⁵⁰ Global Insight (2004); "The Impact of offshore IT Software and Services Outsourcing on the US Economy and the IT Industry", cited in; Bivens Joseph, "Truth and Consequences of Offshoring", Briefing Paper, Economic Policy Institute, Wash. <http://epinet.org>

may have a significant impact on certain occupations, and limit the expected employment effects of FDI in the host country.

3.2 Distribution of Development Gains: Who will benefit?

A systematic analysis of the offshoring trend still is not available. (Antras and Helpman 2003).⁵¹ However, existing information, as discussed in the second section of this paper, allows asserting with a high degree of confidence that the process is characterized by two main trends. On the one hand the predominance of developed countries in the process, both as offshorers and insourcers. On the other hand the high concentration of offshoring activity by developed country firms in few developing countries, with an overwhelming predominance of India. There are two main issues regarding the question: who will benefit in the foreseeable future from offshoring? One is the extent to which developing countries will be able to make a significant dent on the offshoring business currently being done in developed economies, and that activity being reallocated to developing countries. A second issue is how far offshoring will spread among developing countries, increasing the number of beneficiaries from the process.

Available information points out that developed countries will continue to play an important role as suppliers of offshored services. The UNCTAD WIR (2005) finds that a significant proportion of export-oriented FDI projects in call centres, shared services centres, IT services and regional headquarters, during the period 2002-2003, were oriented to other developed countries.⁵² As mentioned before, McKinsey forecast that almost 70 percent of all jobs created by offshoring, during the period 2003-2008, will take place in developed countries. A survey done to European countries finds, for example that 51 of all offshoring projects will be done in Europe (UNCTAD & Ronald Berger Strategy Consultants 2005). In the case of Canada, an important exporter of offshored services, an assessment concludes that even if there could be some relative loss of business in the low end of technology services, in particular in call centres, it is expected that the country will continue to be an important player in the offshoring market. (Bank Financial Group 2005)⁵³ In the case of the UK, a leading offshorer of services, even in the call center segment of the industry, a positive development it is forecasted for the near future.⁵⁴ It could be expected, therefore, that developed economies will be sharing the benefits of the offshoring process with the developing countries. Further specialization in the industry might however take place with developed countries retaining the technology high-end of the offshoring business, while some of the more labour-intensive and low technology, activities, migrating to lower cost locations in developing countries.

⁵¹ Antras and Helpman (2003) Global Sourcing, NBER Working paper 10082, November

⁵² The share of FDI projects going to other developed countries were as follows: Call centres 54 percent, shared-services 35 percent, IT services 46 percent, regional headquarters 60 per cent.

⁵³ Bank Financial Group (2005), Offshore Outsourcing of Services - Not Just a Passing Fad, TD Economics, Special report, November.

⁵⁴ UK Office for National Statistics (2005) op.cit

A more relevant issue for our purposes is assessing the extent to which the offshoring process will benefit a growing number of developing countries, reversing the high concentration trend that can be observed until now. In this regard, the prospects of offshoring spreading widely through the development world seem rather bleak. It has been noted that in general apart from few exceptions, the developing countries of Sub-Saharan Africa, Latin America and the LDCs will remain largely marginalized from this third wave of globalization (Moore and Lewis 2000).⁵⁵ In the offshoring business the continuation of the current concentration of activities in today's successful countries, with the possible inclusion of few other locations, is the most likely outcome. Some forecasts point in that direction. According to Forrester Research, by 2015, 70 per cent of jobs moved offshore will go to India, 20 percent to Philippines and 10 per cent to China. Datamonitor (2004) analyzing the Latin American market finds that 86 of the total employment to be generated in call centres will take place in Mexico and Brazil, countries that already area leading the offshoring process in the region.⁵⁶

The expectation that the same developing countries will concentrate the bulk of future offshoring activity is also grounded in some other indicators. Different indexes measuring the offshore location attractiveness coincide in ranking the same countries as having the best prospects to attract further offshore activity.⁵⁷ Various surveys applied to developed country firms, both general and at the sectoral level, inquiring on the preferred location for offshoring, and regarding the actual plans for future projects coincide in that most of the future offshoring will still be concentrated in the same locations.⁵⁸ In the particular case of the SS segment of the industry there are solid arguments pointing to the possibility that the experience of today successful countries might hardly be reproduced by other developing countries in the future. Ashish concludes that it took an extraordinary confluence of events for export-oriented software industries to develop in India, Ireland and Israel and that other countries will have a difficult time in repeating this feats, moreover while in many cases having to overcome the additional challenge of not having an English-speaking workforce. The conditions that made the impressive development off SS identified by the author were: (i) abundance of high-skilled, underemployed workforce; (ii) key innovations by firms; and, (iii) the timing to have these conditions at the onset of the global IT boom.⁵⁹

⁵⁵ Moore and Lewis (2000) *Foundations of Corporate Empire: Is History Repeating Itself*, London, Prentice Hall

⁵⁶ Datamonitor (2004) "Call Venter Ooutsourcing in Latin American and the Caribbean to 2008", Datamonitor, N.Y. This report found that call centre employment is growing at 17 per cent, rising from 336,000 in 2003 to 730,000 in 2008.

⁵⁷ A. T. KERANEY (2004) *Making Offshore Decisions*, A.T Kearney's 2004 Offshore Location Attractiveness Index.

⁵⁸ Datamonitor report "Global Sourcing in European and American Financial Services". Economist Intelligence Unit (2004) "Scattering the Seeds of Innovation: The Globalization of research and development" September. UNCTAD and Ronald Berger Strategy Consultants (2005) op.cit. McKinsey (2005) op.cit. Deloitte Research (2004) Report "Making the Offshore Call: The Road Map for Communications Operators".

⁵⁹ Arora Ashish, "The Emergence Offshore Software Industries and the United States Economy " mimeo.

A number of factors, *inter alia*, (i) agglomeration economies; (ii) the incumbent advantages; (iii) the availability of human resources; and, (iv) the role of public policies, help explaining the current, and possible future concentration of offshoring in a limited number of developing countries, and also highlight some of the challenges confronting new entrants in the offshoring business. These issues are briefly discussed below.

Agglomeration economies

Agglomeration economies explain the increasing concentration of economic activity in certain locations, at the global and national levels. Leamer and Storper (2001) argue that there are significant agglomeration tendencies even for intellectual and innovative activities, and that these are likely to be geographically clustered.⁶⁰ The pattern of concentration in the software development industry in India attests at the drive for agglomeration at the national level. Agglomeration is driven by the availability of infrastructure, skill base and other resources, and by the synergies produced by the close proximity of the firms. At the same time a critical mass of activity is needed to promote the enhancement of the required infrastructure and skill-base to sustain firm activities. Agglomeration economies are operating already in some of the main offshoring locations in developing countries, increasing the attractiveness for new ventures to select such locations. For many newly entrants achieving the required critical mass of activity to foster economies of agglomeration might not be that easy, if possible at all.

Incumbent advantages

Another factor that would reinforce the competitiveness of those countries that are already providing offshore service refers to the issue of "incumbent advantages". These are particularly important in the case of offshoring. Offshored services present some characteristics that especially enhance the incumbent advantages. These services are mostly customized; and in many cases price is not a determining variable in choice. They imply a high level of expertise and credence values, that is consumers finding it difficult to assess ex-ante competing offerings, and often feeling unqualified to fully assess the information they obtain; and value in transaction seems to be perceived, both by providers and users, quite differently than use-value of goods⁶¹. Size and geographical scope seem to play a crucial role in the performance and competitiveness of firms, the larger and the more global they the better.⁶² Finally, the environment in which project-

⁶⁰ Leamer, E and Storper, M (2001), "The Economic Geography of the Internet Age" *Journal of International Business Studies*, 32:4.

⁶¹ Lapiere J. (1997), "What does value mean in business-to-business professional services?" *International Journal of Service Industry Management*, Vol 8, Issue 5, p. 377.

⁶² In the case of services, firm size has been found to positive correlate with firm's performance. See: Phu Nguyen Van, Francois Paisley, Ulrich Kaiser, "The Performance of German Firms in the Business-Related Service Sector: A dynamic analysis", *Journal of Business & Economic Statistics*, July 2004, Vol 22, Issue 3, p. 274. See also: Weiren Wang, (2000) "Evaluating the Technical Efficiency of Large US Law Firms", *Applied Economics*, Volume 22, Number 6/May. .

selling firms operate has been described as something in between markets and networks.⁶³ These characteristics make competitiveness to be rooted in intangible assets, with intangibles as brand awareness, or reputation, and perceived leverage providing significant incumbency advantages. Also, previous participation in a network, the international scope of the firm, and the knowledge acquired on building relationships with clients and addressing contractual issues reinforces the position of those already engaged in the offshoring business; significantly reducing transactions costs for their clients. These advantages might make it very difficult for new entrants to compete with firms already well established in the market.

Connectivity

The competitiveness of the offshoring industry rests in the development of the associated telecommunications services and other infrastructure, and the extent of the spreading of ICT's technology in the economy. The overall "connectivity" of the economy allows for the offshoring business to take hold on a certain location, in particular the availability and the costs of "broad band" connection. There is a significant and widening digital gap between developing countries as measured by different indicators with respect to their connectivity.⁶⁴ Some developing countries are lagging so far behind that its potential in the foreseeable future to entering the offshoring business could be seriously questioned.

Most developing countries have embarked in the liberalization of the telecommunications sector as means to develop world class services in their economies that would support the overall competitiveness of their firms in different sectors of economic activity, and building the offshoring highway. However, the results have been mixed. In many cases the process has not necessarily lead to a competitive environment prone to sustaining the modernization and wide spreading of these services through out the economy, and to its regional dispersion. These has been particularly the case of LDC's, and in other developing countries in which the size of the domestic market and international traffic flows do not turn the required investments in telecommunications infrastructure specially attractive. The location of countries with respect to the availability of optical lines is another factor that may marginalize some countries from entering the offshoring business. In Africa, for example, the francophone West Coast, which lies on the route of high quality fiber-optic link between Europe and Latin America, is emerging as a preferred destination for some French companies' offshoring services, taking advantage besides of the language of the availability of the infrastructure (GRAY 2004).⁶⁵ The possibilities of developing countries in participating in offshoring are intrinsically tied to the development of their telecommunication sector and its efficient articulation with international networks.

⁶³ Cova B. and Ghauri A., (1997) "Project Marketing. Between Mass Marketing and Networks" Working Paper, European Seminar on Project Marketing and System Selling.

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⁶⁵ Gray, John (2004) "Senegal Calls: "Outsourcing a la Francaise", Reuters, www.reuters.com/newsArticle.jhtml?type=business&storyID=5699278

Availability of Skills

Offshoring depends on the availability of human resource, both in terms of their skills and also in quantitative terms. In the SS and ODPS segments of the market, particularly the availability of a large enough pool of high-skill human resources is the determining factor for success. Skills among developing countries are highly concentrated in those countries that have undertaken significant efforts in the past to upgrade their educational systems, and to adjust the supply of skills to the needs of their productive sectors. The development of these activities in turn has promoted additional national efforts in upgrading and adjusting the supply to the skills requirements of the industry. McKinsey (2005) highlights the wide gap between the overall supply of skills and the employability of human resources in the offshoring industry. Therefore, some countries already enjoy a significant advantage in terms of the human resources that are at their disposal to further engage in, and for reaping the benefits of, offshoring.

A main challenge for new entrants is upgrading the required pool of human resources needed to engage in offshoring of SS and ODPS. The upgrading of educational systems has proven to be a long-term process. There is a significant time gap between the implementation of the required measures and the materialization of the results, providing incumbents with the opportunity to further capture new opportunities arising in the offshoring of services. The skill level needed to undertake ITE-BOP services offshoring is less demanding. In this segment of the market new entrants among developing countries, having *inter alia* the required degree of connectivity and competitive costs, may have a greater opportunity to attract offshoring business in the short-term.

Public Policies

Available evidence strongly suggests that public policies have played a significant role in those countries that have been successful in exporting services, in particular in offshoring of services, and that public policies are equally necessary to ensure that services exports contribute to the achievement of national policy objectives. Active public policies have been instrumental both in enhancing the development of the required infrastructure and improving the connectivity of the economies, and also in fostering the competitiveness of the firms engaged in offshoring services. The extent to which offshoring would spread to more developing countries; the conditions under which this process will take place, as well as the potential benefits accruing to offshoring countries will depend to a large extent to the evolution of the public policies that are put in place to become a player in this segment of services trade.

Many developing countries are adopting active policies to promote the development of these activities in their territories, including extensive state support programs. State support measures are oriented to enhancing telecommunications infrastructure, to increase the utilization of these services by households and firms; to strengthening their domestic services capacities and competitiveness in ICT based

services, and promoting services exports.⁶⁶ In the telecommunication sector, recognizing the growing importance of these services and the positive externalities attached to its development, many countries provide a range of incentives both to domestic and foreign companies aiming at infrastructural development. In the OECD countries there is public support for the development of broadband access enabling the expansion of offshoring business.⁶⁷ Among developing countries, the cases of Korea where state support was instrumental in developing broadband services: and the case of Singapore, where the state actively supports the development of the communications networks and infrastructure through grants for upgrading infrastructure, R&D in advance telecommunications and to encourage the development of enhanced capacities and innovative services, are interesting examples of state intervention. Also, the cases of Malaysia, with the development of the "Multi-media corridor", and Indonesia with the Nusantara-21 Project are another examples of initiatives launched for upgrading telecommunications infrastructure and connectivity. Measures aimed at closing the "digital divide" by supporting the use of IT services by firms, in particular SMEs, and the population at large, constituting demand-driving measures, is an example of measures aiming at increasing the utilization of these services by households and firms

There is a growing trend among developing countries towards the supporting of the development of more dynamic high-tech activities, including services, *inter alia*, R&D services, information technology services and software companies. In most cases this support is geared towards pioneer industries deemed important in the light of their expected positive externalities, potentially benefiting the overall economy on the grounds of "infant industry" considerations, and with the view of enhancing services exports. State support for strengthening domestic services capacities varies across countries, but the observed tendency is to implement comprehensive packages addressing human resource development, infrastructure development, enhancing telecommunication capabilities and software industry's development. These packages, although differing between countries, incorporate a variety of measures. The measures utilized include, among others, the following: (i) establishment of "technology parks" providing certain benefits to firms establishing in them; direct grants; tax holidays, investment incentives both for domestic and foreign capital; duty free imports; (ii) allowances for human resources development; (iii) R&D state support; (iv) access to telecommunications under preferential rates; (v) access to concessionary credit and, (vi) in some cases the granting of EFZ or offshore treatment to IT services.⁶⁸ State support to software exports is also rapidly spreading in all

⁶⁶ UNCTAD (2003) Investment and Technology Policies for Competitiveness: Review of successful country experiences.

⁶⁷ OECD (2001) "The Development of Broadband Access in OECD Countries", DSTI/ICCP/TISP/2001Final, October Paris.

⁶⁸ The cases of Pakistan and India highlight the comprehensive approach undertaken to develop information technology and software services. In Pakistan, the information technology policy in this country include the following measures: (i) 15 years income tax holidays for computer training and exports of software; (ii) exemptions from sales tax; (iii) subsidized rental allowance for space facilities in Software Technology Parks; (iv) concessionary export finance; (v) foreign exchange retention facilities; and, (vi) exemption from minimum tax of 0.5 per cent on remittances from software exports (WTO (2002) S/WPGR/W/25/Add.3) The case of India also provides another example of a comprehensive policy to develop IT services in particular software. The government has created software technology parks, providing state-of-the-art high

of the regions of the world, as countries implement different measures to enhance the competitiveness of their domestic firms in order to allow them competing both in the domestic and international market.⁶⁹ The inclusion of services under the treatment of Export Free Zones in many developing countries constitute a measure directly aiming to promote the exports of services, in particular through offshoring,⁷⁰

The potential for developing countries to enter the offshoring business will depend to a large extent on the appropriateness and efficacy of the supporting measures they implement. In this regard the institutional capabilities of different countries to put in place "industrial policies" might be a determining factor of success. It should be noted that institutional capabilities are very unevenly distributed among developing countries, and that institution-building is a process requiring significant resources, and that it can not realistically be achieved in the short-term. The lack of a comprehensive national policy to effectively participate in the new wave of globalization, and the institutional limitations to implement adequate and timely policies might impede many developing countries to benefit from the offshoring possibilities that may be available in the future.

Incentives for attracting FDI are wildly popular public policies in developing countries. Investment incentives have been defined, alternatively, as any measurable advantage accorded to specific enterprises, or categories of enterprises by the state in order to encourage them to behave in a certain manner;⁷¹ or as those instruments which provide direct economic benefits to investors and are reasonably proximate to the investment decision.⁷² Investment incentives have sprung all over, while restrictions to FDI progressively have been significantly lowered in developing countries. During the period 1990 to 1998 over 135 countries reduced restrictions to FDI.⁷³ Since 1998 more than a hundred developing countries have offered special tax concessions and other benefits to foreign companies.⁷⁴ Many developing countries are offering substantial investment

speed data communication facilities, infrastructure facilities, and benefits such as the exemption from payment of income tax for a period of ten years, and exemption from payment of excise taxes and import duties (WTO 2002: S/WPGR/W/25/Add.3).

⁶⁹ An example, is the case of India where software developers are now permitted, under Section 35 of the Income Tax Act allowing for deduction of scientific research expenditure from taxable income regardless of whether such expenses are classified as capital or revenue in treatment, to book expenses incurred in the development of software package as deduction against taxable income in the year of incurring of such expense. As software was not considered in the law as scientific research, only companies falling under Section 10A fulfilling the criteria of an export-oriented unit (EOU) had been eligible for this benefit before. This decision has extended the benefit to all software developers, eliminating the export specificity of the original regime. *The Economics Times*, New Delhi; 14 May 2003. This was a decision of the Tax Appellate Tribunal.

⁷⁰ Refer to the case of panama, among others many

⁷¹ UNCTAD (2000). Tax Incentives and Direct Foreign Investment, UNCTAD/ITE/IPC/Misc 3.

⁷² OECD (2003) Andrew Charlton; Incentive Bidding for Mobile Investment: Economic Consequences and Potential Responses, OECD Development Centre Technical Papers No 203.

⁷³ UNCTAD (1999) World Investment Report: Foreign Direct Investment and the Challenge of Development, New York and Geneva, UN.

⁷⁴ Avi-Yonah RS (1999) "Globalization, tax competition and the fiscal crisis of the welfare state" (mimeo) Cambridge, MA, Harvard University, quoted by Hanson (2001); Should Countries Promote Foreign Direct

incentives to lure offshoring activity into their territories. [Malaysia case as example] Investment-incentive packages usually incorporate a mix of a number of financial, fiscal and foreign exchange rate privileges.⁷⁵ The main objective of any package of investment incentives is to influence an investment decision either by directly affecting profit streams accruing to that potential investment or reducing the risks attached to it. Investment incentives to FDI are justified in economic literature on the basis of being a market failure offsetting measure providing positive outcomes to the host country. But as it has been correctly highlighted, for FDI to merit special treatment, there needs to be market failure that is specific to foreign firms⁷⁶. It is not the purpose of this note to discuss the overall effect on host countries of FDI investment incentives. This issue has been widely discussed in the literature, albeit no definite conclusions have been reached. On the one hand, incentives are commonly criticized as an ineffective and harmful policy tool, and as a typical example of socially sub optimal behavior from the point of view of the world as a whole.⁷⁷ On the other hand the positive externalities associated with FDI, among others technology gains and enhanced trade flows, benefiting the host country are stressed as favorable outcomes generated by this type of policies.

A relevant question for our purpose is the extent to which investment incentives may affect the geographical distribution of offshoring among developing countries, and its effect on competition in the host country. Regarding the effect of investment incentives on the direction of investment flows, a study found, for example, that in certain industries in ASEAN countries, in particular some services such as banking and high technology services there was strong relation between incentives and capital investments.⁷⁸ Other studies have shown that export oriented activities are more responsive to host country incentive packages. In general, most analysts tend to agree that FDI investment incentives may distort the allocation of investment, even if in some cases only influencing business decision at the margin. In particular FDI incentives would distort investment flows between countries with similar economic conditions and factor endowments. Recent empirical research carried out both in developed and in developing countries has shown that the bulk of competition on FDI incentives takes place among very similar countries/regions/towns; a subsidy influences the final localization once the main decision on investment has been taken.⁷⁹ From the review of different studies an author concludes

Investment? G-24 Discussion Paper, series, No 9, February. UNCTAD and Center for international Development, Harvard University.

⁷⁵ For a discussion of investment incentives refer to: UNCTAD (2004) Incentives. UNCTAD Series on issues in international investment agreements.

⁷⁶ Gordon H Hanson (2001), Should Countries Promote Foreign Direct Investment? G-24 Discussion Paper Series; No 9, February. UNCTAD and Center for International Development, Harvard University.

⁷⁷ Globally harmful conducts on the part of both public and private agents are variously analysed by game theory under various denominations, *inter alia*, as the tragedy of the commons, prisoners' dilemma, and beggar-my-neighbour strategies.

⁷⁸ Agarwal, J.P (1986) "Home country incentives and FDI in ASEAN economies", Kiel Working Paper No 258, cited in Chalk (2001)

⁷⁹ See Oman C (2000); Policy competition for foreign Direct Investment: A study of Competition Among Governments to attract FDI, OECD, Paris; and Charlton A (2003); Incentive Bidding for Mobile Investment, OECD Development Centre, Technical Paper No 203. Also, World Bank (2001) Foreign

that empirical evidence from incentives in investment decisions is quite mixed, but there seems to be more evidence that in the developing country context incentives can matter.⁸⁰ FDI incentives, besides affecting the direction of investment flows, can also affect competition in the domestic market of the host country if treatment discriminates between foreign services companies. This situation could arise, for example, due to the existence of discretionary, usually "hidden" incentives incorporated in investor-state contracts. Also, discrimination might occur, and frequently occurs, against domestic companies that do not receive the same incentives.

Investment incentives have the potential to affect the location of offshoring activity among developing countries, and also the type of offshoring that would take place in the host country. To the extent that captive offshoring, through FDI, might receive a more favorable treatment than that accorded to domestic companies able to provide similar competitive services, incentives would promote this type of firm behavior. The future geographical distribution of offshoring could be reflecting more the size and scope of the competing incentives offered by different countries. In such a race developing countries with the financial and institutional capacity to offer and monitor the programs would surely be the main beneficiaries. The existence of a significant number of stakeholders in those countries already benefiting from offshoring would more probably generate a higher domestic political pressure for those programs to be continued or enhanced as needed. Most investment incentives seem to do little to increase the aggregated level of investment, and their main result might be to provoke a race to the bottom among countries, unleashing "bidding wars". The outcome of bidding wars in terms of the impact on global welfare is largely undetermined. If competition improves distribution by allocating investment to the location in which they are anyway more profitable welfare might be increased; if competition leads to unnecessary shifting of investments or distorts allocation of projects to locations where they would be less profitable in the absence of incentives then competition might be wasteful and welfare will be reduced.⁸¹ Even in a global welfare-maximizing situation a country could be over-subsiding FDI in offshoring activities. In any case, the extent of incentives being provided to FDI in these activities makes, in the best case, their current and future fiscal contribution in developing countries very limited.

As there are some elements that led us to believe that the current concentration of offshoring activity in few developing countries will more probably continue in the future, there are also some forces and conditions that could be working for allowing a further, even though limited, spreading of the phenomenon. One element that is promoting the spread of offshoring activity among developing countries is the internationalization of firms from the first comers to the offshoring market. There seem to be two main drivers of this process. On the one hand, there is already some evidence in this regard that developing countries, as India for example, are relocating some of the activity they were undertaking in offshored services to other developing countries as domestic wages

investment Advisory Service Occasional Paper; No FIAS 15, by Wells I, Allen N, Morisset J and Pirnia, N, January.

⁸⁰ Chalk (2001)

⁸¹ Charlton A (2003)

increase due to pressure on the demand for labour. This relocation is taking place mainly to neighboring countries that count with an untapped supply of adequate personnel and lower labour-costs while providing the minimum context requirements, in line with the issues discussed above, for these activities to be undertaken from that location. Also, the spreading of offshoring is taking place as firms from successful developing countries move abroad to tap offshoring opportunities that may arise in other locations in order to preempt the emergence of competitors in those countries. Also, the existence of location-specific advantages, and advantages emerging from language and cultural affinities have been pointed out as elements that could provide, pending the right environment and policies, opportunities to a wider number of countries to develop specialized niche markets in the offshoring business. In the case of location-specific advantages the issue of the potential of "nearshoring" - the location is in the same of similar time zone and which can be reached in short-haul flight from the outsourcer's site- for some new entrants from developing countries has been pointed out.⁸²

There are still a number of questions to be address in order to assess how the developmental benefits of offshoring might be distributed among developing countries in the future. A highly probable outcome is however that only few developing countries will be significant players on trade of these ICT-enabled services and they will concentrate most of the developmental gains. A troubling trend is that the developing countries that are emerging as competitive exporters of these services tend to be the same ones that have been able also to reap benefits from trade in goods, and are the ones concentrating the bulk of the inflows of FDI. We might be confronting a situation of few winners in the development race, while the rest of developing countries might be missing all the opportunities offered by globalization. The success stories point out to the crucial role played by public policies in supporting the development of the offshoring activity. Further work is needed to elucidate the potential niche markets that can be developed by countries currently marginalized from the offshoring phenomena, and the more appropriate policies to turn the potential into concrete realities.

3.3 Offshoring: How sustainable development gains might be? [Section to be developed further]

Offshoring is thought to be a process that is here to stay and that can not be rolled back. Probably that is the case. Nevertheless, there are a number of issues that need to be assess in order to evaluate how sustainable the development gains for participating countries would be. A central issue in this regard is the future growth prospects of the process world wide. Most of the forecasts, produced mainly by private consulting companies, rest in assuming that the impressive rates of growth observed until now can be sustained in the medium and long-term. There are indications however that the process might be already leveling off and that lower rates of growth in offshoring could be expected in the future. Some consulting firms have revised their very optimistic forecasts

⁸² Abbot, Pamela and Mathew Jones, "The Importance of Being Nearest: Nearshore Software Outsourcing and Globalization Discourse", mimeo.

and are accepting the possibility of a more moderate expansion of offshoring in the near future. Growth of offshoring in time will determine the potential gains for developing countries with the caveats discussed in the preceding sections of this paper.

This section addresses some issues that have emerged in the literature and attain to the sustainability of the process in offshoring destinations. It focuses on the following issues: (i) the possible impact of new technological developments and business practices on offshoring; (ii) the effect of competition and increasing number of entrants striving to participate in the market; (iii) emerging supply-side constraints that might undermine the relative position of a country as offshoring destination limiting the benefits for the host economy; and, (iv) the vulnerability of developing countries to shifts in the location of activity, and to consumers reactions.

Technology and Business Practices

Offshoring has been made possible by technological developments. In the same vein new developments in technology might be conspiring against developing countries reaping benefits from offshoring. The growing sophistication of voice recognition and voice to data technology are already mechanizing many jobs in the ITE-BOP services segment of the offshoring market (UNCTAD WIR 2005). Some even argue that these developments could render a significant share of the industry obsolete in a few years time. This trend is already evident in some activities where offshoring locations are losing jobs that have been displaced by mechanization. This is happening in the medical transcription industry in India, for example, that has experienced a nine percent revenue loss per annum in recent years. (Suri 2005) In this case is not only the jobs in the existing offshoring location that would disappear but there will be an absolute loss of jobs worldwide.

Labour displacing technology is not a new phenomenon, it has been a constant since the industrial revolution. What we might be witnessing is an impressive shortening of the time frame during which the impact of new technological developments are felt in this regard. The extent of mechanization of ITE-BOP services would have a significant impact on offshoring countries. This is the market segment that is expected to provide the higher benefits in terms of jobs and income to developing countries and where more countries could have found a possibility in niche markets to enter the industry. The potential effect of voice recognition technology could be enormous. A study by the research firm Nelson Hall (2004) points to the fact that nearly 60 percent of work done offshore is customer management services, and that 64 percent of all offshore work is voice based, with 85 percent of customer management services being voice based. Of course not all these jobs could be mechanized, but a significant share of them is highly vulnerable to new technological developments.

Innovative business practices, seeking more efficiency and better response to market demands, are also having an impact on the offshoring of services. There is increasing customer involvement in the provision of many services that tend to eliminate some of the back office processes that are being offshored by developed and developing

countries firms. That is for example the increasing reliance on electronic ticketing in the airline industry and self service in the banking industry. This has significantly reduced the need to outsource data encoding, for example, among other back office processes. This has affected already some Caribbean countries that develop the data entry industry to serve the airline and banking companies. The call centre industry could be challenged by the increasing reliance of firms in "virtual call centres", where the service is provided from the home of the employee. Already, some companies as Home Depot in the US are shifting from conventional call centres to virtual ones.

A relevant question, requiring further assessment, is to what extent offshoring of basic back office processes is a temporary bubble that will be superseded to a large extent, sooner or latter, by new technological innovations and novel business methods and practices. Furthermore, another open question concerns the capabilities of most developing countries to keep pace with technological developments in the SS and ODPS segments of the offshoring markets. For this being possible developing countries would need to have strong domestic innovation capabilities and situate themselves in a leading position in the technology race. Confronting the enormous amounts of state subsidies provided by developed countries for R&D, estimated at US\$ 250 billion a year adding subsidies in the US, the EU and Japan, the possibilities of this happening and that be sustained in time seem fairly remote.⁸³ An issue related to innovation concerns the extent to which developed country firms will retain their current share of the offshoring market and if they will enlarge it in the SS and ODPS segments of the industry based on their capabilities and support for R&D. What is sure is that they will not see their business slipping away without any reaction.

Increasing competition and new entrants

The problems emerging from the "fallacy of composition" has been analyzed with emphasis in labour-intensive manufactures. The fallacy of composition proposes that what is viable for one or few exporters, acting in relative isolation, might not be viable for a larger group of exporters acting at the same time: if all, in particular large, developing countries try to substantially increase exports of labour-intense manufactures there will be the risk that they encounter rising protectionist resistance in importing markets, and the terms of trade declining to such an extent that benefits of any increased volume of exports is more than offset by losses due top lower prices.⁸⁴ Increased international competition coupled with productivity improvements in exporting countries can lead to what has been called "immiserizing growth". Kaplinski (2000; 2001) warns about the "race to the bottom" as developing countries compete with each other to offer foreign companies the lowest operating costs. The analysis of the possible effects on labour intensive manufacturing exports can be safely extrapolated to the case of labour-intensive services as ITE-BOPs.

⁸³ Abugattas, Luis (2005) op.cit

⁸⁴ Jörg Mayer (2003) "The Fallacy of Composition: A Review of the Literature", UNCTAD Discussion Papers. No 166.

Jaffee (2004) already has suggested the fallacy of composition effect generating immiserizing growth in exporting countries as a possibility on trade in services through offshoring. The growing protectionist trend in the mayor offshoring countries, in particular the US, is well documented in the literature and we will not dwell with that issue in this paper. There is real possibility, and there are already some partial indicators, that increased competition by developing countries to access the main markets for offshore services might be generating a strong downward pressure on prices and firm's profitability. As more developing countries try to take part of the market, even if they are not successful on the long-term, they would be exerting additional competitive pressure on prices, and therefore on domestic wages in the industry limiting the beneficial income effects of employment in the offshoring industry in the host country. Depending on the competitive pressure's effects on prices some offshoring locations having higher wages and overall costs, and more rigid labour markets, might be price out of the market.

Supply-side constraints

Most of the analysis of offshoring assumes an almost unlimited supply of adequately qualified labour in the insourcing location. Therefore, a country can benefit of increasing volumes of exports for a significant period of time, while expanding domestic employment generating better paid occupations than those in the traditional economic sectors. The case of India, a country with a large educated population and a significant output of skill labour, at all levels, entering the market every year, is already giving some indications that the assumption of unlimited supply of labour might not necessarily hold. Wages in the offshoring industry in India have been significantly rising in recent years indicating an increasing shortage of the right type of labour for the industry. Some estimates suggest that wages have been rising in some segments of the industry by almost 30 percent a year. A country confronting labour shortages that put upward pressure on wages can cost itself out of the offshoring business.

Most estimates by private consulting firms situate the costs savings for the offshoring firms between 10 and 30 percent of what it would cost to undertake the task in house or outsourcing it in the domestic market. Therefore, there is a certain margin to internalize higher labour costs, but it is not unlimited. Higher domestic wages can prompt firms to relocate their activities in lower cost countries, as is already happening in the case of India in some segments of the industry. The firms might be able to maintain or even enlarge their market share, but the domestic economy will lose the gains from offshoring.

Vulnerability of the offshoring business

Anecdotic evidence highlights the fact that the offshoring industry in developing countries might be highly vulnerable to offshoring firms' behavior and to market signals. Captive offshoring entails reduced sunken costs and therefore has a tendency of being "foot-loose" investment. Contrary to other type of FDI that has a long-term vocation of remaining in the host country in view of significant sunken costs, investment in offshoring presents high propensity to suddenly move searching for more adequate

locations when conditions change in the host country increasing risk or affecting profitability. Also, the industry is highly sensitive to market signals. This has become manifest in the call centre segment where due to customer resistance firms have relocated their activities to the home country or to other locations that do not generate that type of market response. This was, for example, the case of call centres established in Senegal to cater to the French consumer. Also, in the case of the UK, one out of seven companies that established call centers abroad relocated their activities in the light of negative consumer reaction.

In the case of offshoring services provided by third parties abroad there is a high sensitivity to the perceived quality of the service provided and the reliability of the supplier. The country's brand value could rapidly be affected by below expectations performance of some suppliers, leading to a rapid lost of business for the whole industry. Finally, the provision of offshored services requires the temporary movement of natural persons service providers (GATS Mode 4) to make the business possible. Suri (2005) analyses the importance of inter-modal linkages allowing for the success of offshoring in the case of India. The conditions for entry into the offshoring country territory can suddenly shift in response to security or other considerations. The barriers that could be erected on trans-border mobility of personnel of insourcing firms, or of contractual services suppliers working for them, can seriously affect the prospects of services exports.

3.5 Spillover effects in the host country: How positive? [Section to be developed further]

A crucial issue to assess the potential development gains brought by offshoring is the positive spillovers that may be generated in the economy of the host country. Unfortunately, there are very few studies analyzing this issue. Most of conventional wisdom derives from extrapolating some of the conclusions arising in general from the analysis of the impact on FDI in the host country, or from some studies addressing this issue in the case of India, with emphasis in the SS segment of the market. It is not an easy task generalizing with respect to the developmental impact of offshoring on the host country. The potential impact will depend, *inter alia*, on the segment of the business - ITE-BOP, SS or ODPS, and on the business model through which the activity is undertaken -captive-offshoring or outsourcing from a third party abroad. This section presents a brief review of the potential impact of offshoring in the host country discussing the main issues highlighted in the literature.

Technology and Knowledge Spillovers

A main benefit that is expected for the host countries are the technology and knowledge spillovers generated by the offshoring industry, both intra-industry benefiting domestic companies, and also through out the economy contributing with overall systemic efficiency. These effects are expected to derive from the presence of FDI in the business, being therefore proprietary of captive-offshoring. The higher technology

segments of the market, SS and ODPS, would have a higher propensity to generate this positive outcome. In the case of ITE-BOPs being low-technology intensive activities the potential spillovers would necessarily be much more limited. In the case of India, in the SS segment, it has been found that it might have generated very little knowledge spill over for the domestic economy. Most export oriented activities operate as "export-enclaves" with limited linkages with the domestic economy. (D'Costa 2003⁸⁵; Kumar and Josepf 2005; UNCTAD WIR 2005) There is also evidence that the scope for linkages between foreign affiliates and local firms is especially small in the area of software development (Kumar 2001).⁸⁶ Most of the software developed is highly customized with little application elsewhere. The high export concentration of the industry in India might also have conspired with the diffusion of ICT technology in the domestic economy imposing a high cost to the rest of economic activities. Knowledge spillover might also take place through the movement of skill personnel from the high-technology export firms to domestic companies in the same sector or other sectors. However, evidence from the case of India will suggest the opposite is taking place where the export activity is luring skill personnel from domestic companies from different sectors of the economy.

Nevertheless, knowledge spillovers can also take place in a more diffuse manner, difficult to empirically assess, through the repeated and frequent interactions of domestic with foreign firms, and by the direct presence of foreign firms in the domestic economy. The extent to which offshoring generates positive technology and knowledge spillovers in the host country is an area that requires much further in depth analysis covering a wider sample of country cases and also other segments of the industry.

Upgrading of Human Capital

The impact of offshoring activity in enhancing human capital is widely mentioned in the literature as one of the positive effects of this activity on the host country. The higher the skill level required by the activity higher would be the drive for enhancing human capital. Different type of avenues through which this effect takes place has been discussed. Upgrading of skills takes place to the extent that firms engaged in offshoring undertake substantial in-house training, and also if the workplace encourages learning by doing as has been the case, for example, of Singapore and the Philippines.⁸⁷ Even in the ITE-BOP segment, it has been found that there is skill upgrading. Many jobs in the low-skill segment of the industry constitute the market entry for new people, and these jobs stimulate updating of skills (Richardson R, 1999).⁸⁸ Many of the offshoring host countries provide fiscal incentives for investment in training in order to promote in house training by companies involved in the offshoring business.

⁸⁵ D'Costa, A.P; (2003) "Uneven and Combined Development: understanding India's software exports", World Development, vol 31, No 1.

⁸⁶ Kumar Nagesh (2001) "Indian Software Industry Development: International and national perspective", Economic and political Weekly, No 36 (45).

⁸⁷ ILO (2003) Employment and Social policy in Respect to Export Processing Zones (EPZs), Geneva.

⁸⁸ Richardson R (1999) "Call centers and the Prospects of Export-oriented work in the Developing World: Evidence from Western Europe" in, Europe and Developing Countries in the Globalized Information Economy, INTECH UNU Press.

Offshoring might have a wider systemic impact on the development of human capital in the host economy, besides the upgrading of skills of workers directly employed in the industry. It could be a driver providing incentives for improvement of national education systems. This effect could emerge from the demand side by increasing the returns to educations moving individuals to seek better training and qualifications and making investment in learning profitable, putting pressure on the education institutions. From the supply side this effect could take place by means of the business sector demands on the State and on the education institutions to upgrade programs and adjust them to its needs. These effects will materialize, however, to the extent that public policies in the education are adequately implemented, thus requiring a certain critical mass of offshoring interests to be able to influence policy decisions. The successful offshoring cases highlight the fact that there were significant investments in education and coordination with the industry to adjust supply to the particular demands of the firms in order aiming at sustaining the activity and increasing productivity. To the extent that this effect takes place it would generate significant long-term benefits to the host economy spreading beyond the offshoring industry.

Limiting "brain drain"

By providing adequate remunerated domestic job opportunities to highly educated individuals offshoring is reputed as contributing to retain skills in the host country. There are no empirical studies testing the extent to which this is actually happening in developing countries actively engaged in offshoring. However, data tend to show that the incentives to migrate remain and countries successful in this area still confront significant brain drain problems. Studies on migration demonstrate that income opportunities are only one of the variables explaining the decision to migrate. One of the effects of offshoring has been however to lure expatriates to return to their home country to set up business. This has been the case in India (Kumar 2001) and also this trend has been found in Ireland (Sands 2005)⁸⁹ Large Diaspora populations have facilitated connections between the export firms and their product markets, creating a natural inflow of expertise when expatriates return working with companies abroad (Kaqpur, D and McHale, J 2005; Lateef 1997; Arora et al 2000)⁹⁰. What could be a positive effect of offshoring is that it is making "brain circulation" possible between the offshoring and the insourcing countries allowing workers to upgrade skills abroad and them applying knowledge in their home country.

⁸⁹ Sands, Anita (2005) *The Irish Software Industry*, in Arora and Gambarela (eds) op.cit. The author found that two-thirds of the founders of software firms in their sample of Irish firms had worked in another country.

⁹⁰ Kaqpur, D and McHale, J 2005, "Sojourns and Software: International Mobile Human Capital and the Software Industry", in, *From Underdogs to Tigers: The Rise and Growth of the Software Industry in Brazil, China, India, Ireland and Israel*, Arora Ashish and Alonso Gambarella (eds) Oxford University Press.

Other effects

A number of other positive effects of offshoring on the host economy are commonly pointed out in the literature. Among them: (i) improvement of the quality of services available to consumers and other economic activities in the domestic economy. However, this effect is potentially limited by the predominance of captive offshoring and the low articulation of these activities with the host economy. A relevant policy issue in this regard is how to enhance linkages of export-oriented offshoring with other economic activities and the domestic realm in general; (ii) fostering local entrepreneurship: due to the low initial start-up costs, and the fact that economy of scale are not very relevant in some market niches, it is stated that offshoring provides opportunities to local entrepreneurs, and qualified professionals to engage in business; and, (iii) Gender empowerment: the industry, in particular the ITE-BOP segment employs a significant share of women of its total labor force, in some cases above 60 percent. These activities allow women with low skills in developing countries entering the labour market, receiving a higher wage than in other opportunities available, and learning a trade improving skills which enhances their overall employability.

Some of the potential negative impacts of offshoring on the host country are also discussed in the literature. Among them the following: (i) upward pressure on wages of skill labour and professionals affecting the competitiveness of other sectors of the economy, in particular in small countries with a limited supply of qualified labour; (ii) impact on inequality: by enlarging the income gap between skill and unskilled labour, with potential social and political implications. Antras and Garicano (2005)⁹¹ modeling offshoring find in this regard that it always increases within-worker wage inequality in the south; (iii) Social costs associated with offshoring. Many jobs are stressful intensive and tedious. Repetitive tasks performed in high pressure environment has lead, for example, to high turnover rates in the call centre industry in India emerging as one of the most significant challenges to the industry (Taylor and Bain 2004)⁹² The issue of labor conditions that might conflict with international labor standards in the offshoring industry has raised some concerns (Belt 2002).⁹³ Also, the issue of employment of women under certain conditions, like night-shifts, clashing with traditions has been identified as an issue generating certain tensions in some host countries, as well as the overall tensions created by the new role of women in traditional societies. This last issue was also present, for example, in the case of the "maquila" industry in Mexico.

⁹¹ Antras Pol and Garicano Luis (2005) "Offshoring in a Knowledge Economy", NBER Working Paper Series, Working paper 11094, January.

⁹² Taylor, P and Bain (2004) "Call Centres in Scotland and Outsourced Competition from India, Scottish Enterprise, University of Stirling

⁹³ Belt Vicki (2002) A Female Ghetto? Women's careers in call centres, Human Resource Management Journal, Vol 12:4 (51-56)

Concluding Remarks

Emerging conventional wisdom might be overstating the potential development gains for all developing countries. The trend offer opportunities to these countries but those may be limited in terms of its overall dimension and also in terms of number of possible beneficiaries. Incumbents will enjoy significant advantages and may concentrate the bulk of development gains. There are market niches that could be exploited by new entrants. There are a number of questions concerning the sustainability of gains which require further analysis. Establishing a business-friendly environment is not sufficient to be successful in the offshoring trend. Public policies have played, and more certainly will continue playing, a crucial role in fostering the competitiveness of domestic firms and assuring developmental gains for developing countries. The extent and nature of the spillovers in the host economies suggest that not all are as positive as expected. However, this is another area demanding further in depth analysis to allow reaching some general conclusions.