UNITED
NATIONS

TD

United Nations
Conference
on Trade and
Development

Distr.
GENERAL

TD/B/COM.2/55
24 November 2003

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and
Related Financial Issues
Eighth session
Geneva, 26-30 January 2004
Item 3 of the provisional agenda

FDI AND DEVELOPMENT: POLICY ISSUES RELATED TO THE GROWTH OF FDI IN SERVICES

Note by the UNCTAD secretariat[*]

Executive summary

In light of recent trends in foreign direct investment (FDI) and international production, this note highlights the changing sectoral composition of FDI and discusses the implications of the increased role of services. Special attention is paid to two forms of FDI in services: FDI related to privatization of services, and FDI in service production for exports. In both instances, FDI can contribute to the competitiveness of the productive sectors of host countries.

[*] The late submission of this document is due to the fact that it is partly based on feedback from the UNCTAD Expert Meeting held on 29–31 October 2003.

GE.03-53457

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INTRODUCTION

1. In line with the decision of the Commission on Investment, Technology and Related Financial Issues at its seventh session in January 2003, the UNCTAD secretariat has prepared this note to help identify policy issues for discussion by the Commission at its eighth session. The note draws in part on the analysis in the *World Investment Report 2003: FDI Policies for Development: National and International Perspectives (WIR03)* and on two Expert Meetings: on the Effectiveness of FDI Policy (25–27 June 2003) and on FDI and Development (29–31 October 2003).

I. THE GLOBAL FDI ENVIRONMENT

2. As is reported in *WIR03*, global FDI inflows, already down by over 40 per cent in 2001, fell by another 21 per cent in 2002 to $651 billion.[1] The decline was broad-based, with 108 of 195 economies receiving smaller FDI inflows in 2002 than in 2001. Outflows were also down in almost half of all source countries, although FDI outflows from the United States expanded by 15 per cent from 2001.

3. The FDI downturn was uneven in four ways. (a) The geographic impact was uneven. The slump in the developed world (22%) was concentrated in the United States and the United Kingdom, which together accounted for 54 per cent of the drop in the countries with reduced inflows. The decline in the developing world (23%), which faced even sharper cuts in other private external capital flows, was steepest in Africa (41%) and in Latin America and the Caribbean (33%). Flows to the world's most populous region, Asia and the Pacific, fell minimally, thanks to record high flows to China. (b) In terms of sectors, both manufacturing and services were hard hit, while FDI in the primary sector rose. (c) While investment flows fell in all three financial components of FDI – equity capital, reinvested earnings and intra-company loans – the decline in intra-company loans last year exceeded that in equity flows. (d) Most of the decline in FDI was related to one mode of entry, cross-border mergers and acquisitions, which fell from $1.1 trillion in 2000 to $594 billion in 2001 and $370 billion in 2002. The number of "megadeals" (worth over $1 billion) fell from 175 in 2000 to 113 in 2001 and only 81 in 2002, the lowest figure since 1998.

4. Notwithstanding the decline in FDI flows, international production continued to expand in 2002, albeit at a slower pace. FDI stock, the basis of international production by the 64,000 or so transnational corporations (TNCs) that now control 870,000 foreign affiliates, reached almost $7 trillion in 2002, compared with $6.3 trillion in 2001, and it was up more than 14 times compared to 1980 figures. Other indicators, too, rose in 2002 compared with 2001. The estimated value added of foreign affiliates of TNCs amounts to $3.4 trillion. Sales by foreign affiliates were about $18 trillion, compared with global exports of $8 trillion. Employment by foreign affiliates reached an estimated 53 million workers in 2002, which was 6 per cent higher than in 2001 and three times the number in 1982.

5. While the slowdown in economic growth has led to a decline in market-seeking FDI into the developed economies, many developing countries have experienced inflows of efficiency-seeking FDI as TNCs try to find ways to cut costs and improve their competitiveness. Interestingly, such efficiency-seeking investment is occurring not only in manufacturing activities but increasingly also in services.

6. The fall in FDI flows has led countries to intensify efforts to improve their investment environment and use better targeting methods to attract FDI. After the record number of favourable changes in national FDI legislation in 2001, 2002 saw another record: of 248 changes in legislation in 70 countries, 236 were favourable to FDI, with a third related to promotional measures. Competition for FDI has intensified, including through the use of incentives.

[1] Throughout, the term "dollar" ($) refers to US dollars, unless otherwise stated.

7. Against this background, the Expert Meeting organized by UNCTAD on 25–27 June 2003 on the Effectiveness of FDI Policy was timely. Its outcome included four main elements. (a) There is increasing uniformity among countries in terms of their investment frameworks governing FDI (i.e. rules and regulations governing entry and admission of foreign investors, and standards of treatment of foreign affiliates). (b) The general regulatory environment that affects all businesses, including FDI, is important. This includes the fiscal regime, land and labour laws, competition policy, residence permits and intellectual property rights. (c) Proactive measures can help augment a country's dynamic locational determinants. However, such measures tend to be effective only when supported by a sound investment and regulatory environment. (d) The combination of home country measures and proactive host country measures can be a powerful tool for attracting FDI in developing countries.

II. THE GROWING ROLE OF SERVICES IN GLOBAL FDI

8. In the global expansion of TNC activities over the past decade, one of the most striking features has been the growing importance of the services sector. Its share in the world FDI stock now amounts to some 60 per cent, compared to less than 50 per cent a decade ago.2 The overall rise of FDI in services applies to both developed and developing countries and is mirrored by a decline in the share of both the manufacturing and primary sectors (figure 1).

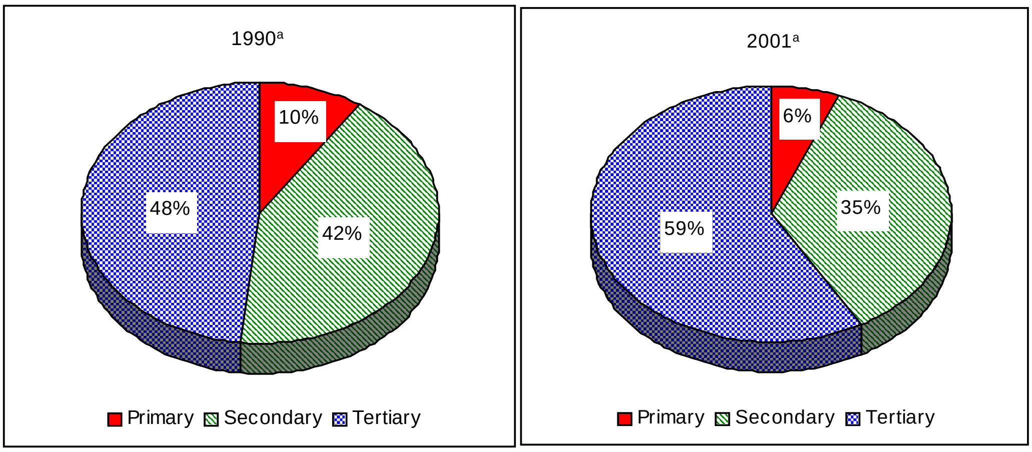
9. For many years, finance- and trade-related activities dominated the FDI stock in services of most home and host countries. This was partly owing to the early international expansion of banks and trading companies, but even more to FDI in wholesale and marketing affiliates by petroleum and manufacturing TNCs and in finance-related foreign affiliates by TNCs from all sectors (Mallampally and Zimny 2000). With the liberalization of FDI in services, a new industry pattern for services FDI has emerged. Trading and financial services remain large industries for services FDI, but they are no longer the most dynamic ones (table 1). Opening of utilities to FDI through privatization programmes triggered unprecedented increases in FDI in telecommunications and power generation and distribution. Another large and dynamic category is business services. As a result, the share of finance and trading decreased from 65 per cent of the inward stock of FDI in services in 1990 to 45 per cent in 2001, whereas that of new FDI service industries – notably power generation and distribution, telecommunications and business services – surged from 17 per cent to 44 per cent.

10. As was observed at the UNCTAD Expert Meeting on FDI and Development (29–31 October 2003), TNCs can affect the provision of services in host countries in various ways. They can provide capital and foreign exchange, develop critical support activities and introduce best practices as well as technology with important demonstration and other spillover effects on local enterprises. This can result in better and cheaper services as well as introduce services not available from domestic suppliers. Through privatization, FDI can also help restructure ailing state-owned enterprises, bring in necessary capital and know-how, and increase government's budget revenues. Such benefits are not automatic, however, and there may also be costs. There are concerns that FDI may (e.g. in the retail sector) crowd out local companies and have adverse socio-cultural effects. Moreover, lack of investment in local skills development, along with formation of linkages overseas rather than locally, may reduce positive spillovers. In connection with privatization, concerns related to employment effects and the risk of formerly public monopolies' being converted into private foreign ones are sometimes voiced.

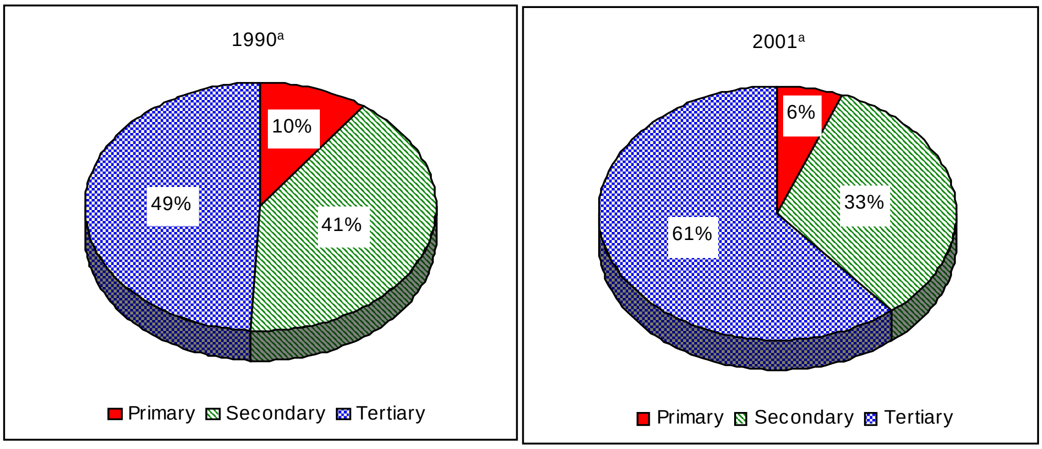
[2] See UNCTAD press release "New FDI Pattern Emerging, Says UNCTAD, Reshaped by Services Economy, New Industries", UNCTAD/PRESS/PR/2003/105.

Figure 1. Inward FDI stock, by sector, 1990 and 2001

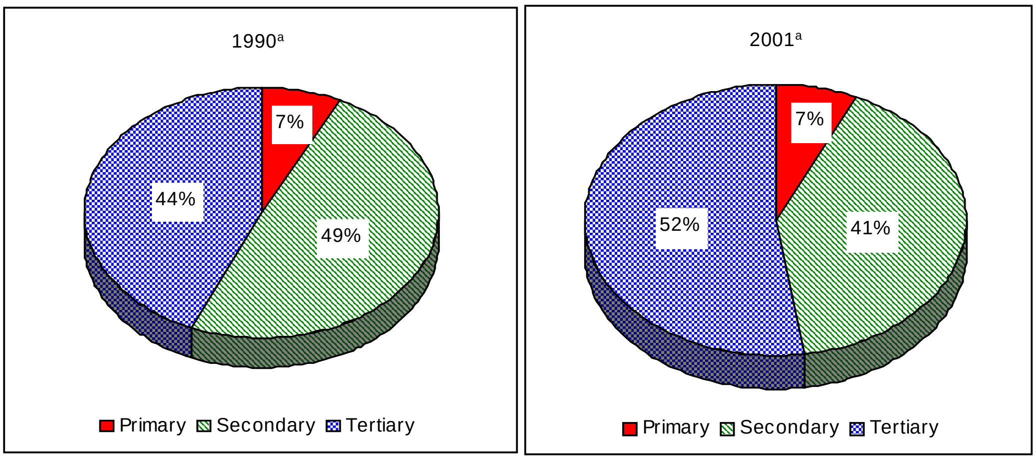
World



Developed countries



Developing economies



[a] Or latest year available.
Source: UNCTAD, FDI database.

Table 1. Inward FDI stock in the services sector, 1990 and 2001

(millions of dollars)

Sector/industry	1990[a] Developed countries	1990[a] Developing economies	1990[a] World	2001[a] Developed countries	2001[a] Developing economies	2001[a] Central & Eastern Europe	2001[a] World
Total	1 221 921	246 848	1 468 769	3 473 090	1 618 209	71 953	5 163 252
Primary	121 428	17 527	138 955	199 002	107 033	3 825	309 860
Secondary	495 801	119 997	615 798	1 140 606	630 473	25 809	1 796 888
Tertiary	597 695	106 585	704 280	2 106 788	815 896	40 889	2 963 573
Electricity, gas & water	5 347	2 324	7 671	55 381	40 247	2 789	98 417
Construction	13 292	3 595	16 887	22 415	25 712	927	49 054
Trade	159 309	14 747	174 056	425 262	97 818	9 830	532 910
Hotels & restaurants	16 899	2 177	19 076	33 560	15 044	601	49 206
Transport, storage & communications	12 702	8 594	21 296	232 008	66 299	11 642	309 949
Finance	220 498	60 472	280 970	656 593	139 928	9 460	805 981
Business activities	89 460	3 943	93 403	481 656	386 119	4 927	872 702[b]
Public administration & defence	-	-	-	-	54	4	58
Education	75	-	75	323	1	12	337
Health & social services	795	-	795	6 210	3 360	18	9 588
Other & unspecifed services	79 318	10 734	90 052	193 380	41 313	678	235 371
Unspecified	6 997	2 738	9 735	26 695	64 806	1 429	92 930

Note: Data cover 48 economies in 1990 and 60 economies in 2001. They account for over four-fifths of world inward stock in 1990 and 2001. Approval data were used for Sri Lanka in 1990 and Malaysia in 2001. In the case of Cambodia, China, Indonesia, the Lao People's Democratic Republic, Mongolia, Myanmar, Nepal, Taiwan Province of China and Viet Nam, the actual data were estimated by applying the implementation ratio of realized FDI to approved FDI to the latter (33% in 1994 for Cambodia, 68% in 2001 for China, 45% in 2001 for Indonesia, 10% in 1990 and 7% in 1999 for the Lao People's Democratic Republic, 15% in 1990 and 44% in 2001 for Mongolia, 39% in 1990 and 55% in 2001 for Myanmar, 41% in 1990 and 47% in 1999 for Nepal, 74% in 1990 and 65% in 2001 for Taiwan Province of China and 15% in 1990 for Viet Nam). The world total in 1990 does not include the countries of Central and Eastern Europe. Data are as of 24 September 2003. The data therefore do not necessarily correspond to those reported in other UNCTAD documents.

[a] Or latest year available.
[b] A considerable share of investment in this industry is in Hong Kong (China), accounting for 60% of developing economies and 27% of the world total. Hong Kong (China) data include investment holding companies.

Source: UNCTAD, FDI database.

III. PRIVATIZATION-RELATED FDI IN SERVICES AND POLICY ISSUES

11. Privatization activity in developing countries accounted for very large inflows of FDI into services during the 1990s, but, since peaking in 1998, it has declined. The largest transactions so far have taken place in Latin America, followed by Central and Eastern Europe. In terms of industrial composition, the most deals have been undertaken in telecommunications, followed by electricity, transport and banking. Asset sales (mostly involving FDI) have been the preferred mode of privatization.[3]

12. In terms of impact, the privatization of services to foreign investors has sometimes aroused popular resistance and concerns that it implies a “selling of the family silver” and unnecessary job losses. Still, research shows that, in the majority of cases, privatization leads to improved firm performance and the provision of more competitive services (Megginson and Netter 2001). Obviously, increased firm performance is not synonymous with increased efficiency of the economy as a whole, especially if firms are operating in an uncompetitive environment. Nor does it mean that all societal objectives are met. With regard to the labour impact, for example, most (but not all) studies conclude that employment in privatized firms usually falls. However, reduction of a usually inflated workforce is typically a key condition for improved firm performance. Moreover, although the employment effect is often negative in the short run, it tends to be positive in the medium to long term (Sheshinski and López-Calva 2003).

13. The high involvement of foreign companies in the privatization programmes of many developing countries and economies in transition makes it important to consider the role of *policies* in maximizing the positive impact of such transactions. The design and implementation of the privatization processes are key in this context. Privatization programmes need a clear formulation of objectives related to what development goals Governments expect to reach, and why foreign (instead of local) investors should be invited. For each situation, all alternatives should be considered. In light of significant differences between industries, no “one-size-fits all” solution is available. At the same time, some dilemmas are common to most privatizations of services. One is related to the trade-off between maximization of budget revenues and other development objectives, such as competitiveness, preservation of employment and universal provision of services.

14. The issue of regulation of a privatized service industry is particularly important when the industry is a natural monopoly. In these cases, policy makers and regulators often have to balance conflicting goals of ensuring efficient provision of services while at the same time making sure that the services provided are accessible at affordable prices to the poor. At the UNCTAD Expert Meeting, there was general agreement that privatization in these industries should ideally be preceded by the establishment of an appropriate regulatory framework and, if possible, by the breaking up of monopolies. The need to have regulatory bodies as independent and adequately resourced institutions overseeing the privatization and the post-

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[3] In developed countries, share offerings have tended to dominate. In addition to outright privatizations, public-private partnerships, concession agreements, "build-operate-transfer" schemes, project finance and other methods have been used to involve the private sector in various service industries.

privatization phase was undisputed. Weak regulation often implies higher returns to private monopolies and an increased risk of regulatory capture.

15. At the end of the Expert Meeting, experts debated issues related to the justifications for privatization; its political feasibility and how to facilitate political and public acceptance; competition and regulation; and social implications and mechanisms of privatization. The following issues were perceived to be the most important when considering privatization: the role of privatization policy in a country's overall development strategy; the objectives of privatization; the importance of the regulatory framework and of strong and independent supervisory and privatization institutions; the level of domestic political support for privatization; and the identification of possible social costs of privatization and how to minimize them. The Commission may wish to discuss these issues further.[4]

[4] See also the Chairman's Summary of the Expert Meeting (TD/B/COM.2/57 – TD/B/COM.2/EM.14/3).

IV. EXPORT-ORIENTED FDI IN SERVICES AND POLICY IMPLICATIONS

16. An important characteristic of many services is that they are not storable and must be produced when and where they are consumed. Consequently, only a small part of the production of services (less than one tenth in 2001)[5] enters international trade, compared with over half of the production of goods. However, this situation is changing rapidly as the tradability of information-related services, cutting across all sectors, increases as a result of advances in information and communication technologies (ICT) (Sauvant 1990). Both services- and goods-producing TNCs are increasingly splitting up the production processes of services or their components along the value chains and relocating them to countries where they can be produced more cheaply. This process resembles the changes that took place in labour-intensive manufacturing 20–30 years ago (Zimny and Mallampally 2002). Relocation of services is greatly facilitated by the rapidly declining costs of telecommunications services. Services functions can be relocated internationally at arm's length to an independent (locally or foreign-owned) service provider, or through FDI to a foreign affiliate of the same company.[6] This represents significant potential for developing and transition economies in terms of new jobs, FDI and exports.

17. The relocation began in the 1980s, but the real take-off occurred in the 1990s, after the commercial breakthrough of the Internet. The global economic slowdown in recent years, with increased competitive pressures on companies in many industries, added further momentum to the process as companies sought ways to reduce their costs and increase efficiency. The nature of the services work that is relocated internationally has changed over time. At the initial stages, the work transferred to lower-income countries was low-end, IT-enabled services such as data entry and basic software programming. Both required only basic levels of computer literacy and skills and limited interaction between customers and suppliers. Back-office services, including claims processing, call centres, product design, logistics management and customer services, have been gradually added to the list of relocated activities, and these days more and more sophisticated tasks are being shifted to cheaper locations. Anecdotal evidence suggests that functions such as computer-aided medical analysis, financial equity analysis, accounting, computer programming and chip design are increasingly being performed abroad for final use in the United States and Europe.[7] Examples of internationally relocated business processes are provided in box 1.

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[5] Calculated as a ratio of services exports to services output from World Bank (2003).

[6] In business literature, such relocation is referred to as *offshoring* or (when it is done at arm's length) *outsourcing offshore.*

[7] See "Service Industries Go Global: How High-Wage Professional Jobs Are Migrating to Low-Cost Countries", *Financial Times,* 20 August 2003; "As It Tries to Cut Costs, Wall Street Looks to India", *nytimes.com,* 8 October 2003.

Box 1. Industry examples of international relocation of business processes

Insurance: New York Life has conducted part of its insurance payments processing in Ireland (UNCTAD 1996: 107). Royal & Sun Alliance announced in September 2003 that it would cut its United Kingdom workforce and shift the activity to India.[a] In Ghana, the American company ACS processes data for various US insurance companies.[b]

Airlines: In 1993 Swissair transferred its revenue accounting to India; American Airlines has established an affiliate in Barbados for processing its accounts material and ticket coupons (UNCTAD 1996: 107). British Airways opened an offshore processing centre in India in 1996 to handle work from the airline's operations. Customer relations were the first two major tasks moved. After some time, British Airways' centre in Mumbai also began servicing other airlines (IBM Business Consulting Services 2002). In 2003 Delta chose to outsource activities to Wipro Spectramind in India.[c] Moreover, Swiss International Airlines, Austrian Airlines and Scandinavian Airlines System (SAS) have outsourced revenue accounting, traffic accounting, billing services and/or navigation support to Indian suppliers.[d]

Telecommunications and call centres: The Spanish company Telefónica has established call centres near Rabat and Tangiers in Morocco, employing more than 2,000 Moroccans to talk with Spanish and French consumers (Zimny and Mallampally 2002: 93). In the call centre industry, specialized TNCs such as Convergys, Sitel and Sykes have expanded fast internationally (especially in India) to take care of other companies' outsourced services.

Banking and financial services: Hong Kong and Shanghai Bank Corporation (HSBC) opened a processing centre in Guangzhou, China, in 1996 and started moving back-office functions to India in 2000. It now operates three processing centres in India – two in Hyderabad and one in Bangalore. The company planned to employ 8,000 people in India, China and Malaysia for back-office functions by the end of 2003.[e] In October 2003, Lloyds Bank said that it would close a call centre in Newcastle, which employs 986 people, and shift the jobs to its new centre in Hyderabad.[f] American Express located finance and customer services with its affiliate in India (Zimny and Mallampally 2002: 93). Large financial firms, including Goldman Sachs, Merrill Lynch and J. P. Morgan, have recently established offices, mainly in India, to do investment banking, brokerage, equity research and asset management.[g]

Computer and information technology services: Many of the world's top IT companies have established development centres in India, including Texas Instruments (developing third-generation mobile phone chips), Microsoft and Hewlett Packard. Cisco Systems also operates a global software R&D lab in Bangalore, and Intel has entered into a joint venture with Infosys Technology in the form of an R&D lab in Hyderabad. According to NASSCOM, the Indian business association for the software industry, every fourth TNC now outsources software production to India.[h]

[a] "Insurance Firm to Cut 1,000 Jobs", *Ananova*, 4 September 2003.
[b] "In Ghana, Hope Arrives via Satellite", *International Herald Tribune*, 4 May 2001.
[c] "Outsourcing Call Centers Pay Off for Delta", *Information Week*, 17 June 2003.
[d] "On Runway, Will Take Off? Airlines BPO Has Contributed $30 Million to the Total Earnings of WNS", *Indian Business Insight*, 31 August 2003; "Scandinavian Airlines Outsources Parts of Revenue Information", press release, 3 September 2003, *www.Scandinavian.net.*
[e] "India Graduates from the Back Office", *International Herald Tribune*, 7 August 2003.
[f] "Lloyds under Fire as Jobs Go to India", *Guardian*, 31 October 2003.
[g] "As It Tries to Cut Costs, Wall Street Looks to India", *nytimes.com*, 8 October 2003.
[h] See *http://www.nasscom.org/newsline/jul03/ites_update.asp*.

18. India has clearly been the main beneficiary of the increased relocation of services. The country's total exports of IT services, chip design, call centre services and business back-office functions generated $10 billion in 2001 and are expected to reach as much as $57 billion by 2008.[8] In the more narrowly defined business process outsourcing industry, India accounts for an estimated two-thirds of the global market.[9] The share of software and services exports in total Indian exports has climbed from 2 per cent in the mid-1990s to more than 16 per cent today (UNCTAD 2002b). Foreign affiliates that export significant amounts of software from India include IBM Global Services, Cognizant Technology Solutions and Oracle India. Obviously, however, India's success is not linked only to inflows of FDI. A number of Indian companies have become global players in this industry. Some of the most important are Tata Consultancy Services, Infosys Technologies, Wipro Technologies, Satyam Computer Services and HCL Technologies. Whereas these and other domestic companies account for the bulk of software exports from India, FDI has played a critical role in the growth of other business process services exports.[10]

19. Outside of India, a range of developing countries have developed export capabilities in the area of business services. The Philippines, Malaysia, Singapore and China are among the most prominent cases in Asia. In the Philippines, for example, more than 8,000 foreign companies source accounting services, software writing, architectural services and telemarketing from nine IT parks with state-of-the-art IT infrastructure. In Africa, Ghana, Mauritius and South Africa have attracted investment mainly in call centres. Brazil, Costa Rica, Mexico and a number of Caribbean countries have similarly attracted investment in business processing and call centres. Central and Eastern Europe, too, has seen service-related inflows of FDI. For example, in 2002, General Electric spent $4.6 million on a Budapest office that will employ 500 people in its customer service and back-office operations to support other parts of the company across Western Europe.

20. Estimates suggest that the process of shifting services work abroad is still at an early stage. A recent study predicted that, from the United States alone, some 3.3 million white-collar jobs would have been relocated to lower-cost countries by 2015. Most of the increase should be related to various types of office support, computer-related and business services.[11] In the financial sector itself, some 850,000 jobs from North America, 730,000 positions from Europe and 400,000 from developed economies in Asia are expected to be relocated by 2008.[12]

21. Beyond the impact on employment and exports, this process offers some scope for technological and skills upgrading. While routine and unsophisticated labour-intensive activities still dominate the picture, more and more advanced service functions are entering the process. For example, Indian radiologists are now involved in the analysis of x-rays of US patients, and US financial companies are relocating financial analyses to India. Even call

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[8] See "NASSCOM-McKinsey Report Predicts Robust Growth for Indian IT Services and IT Enabled Services Industry", *http://www.nasscom.org/articleprint.asp?art_id=1435*.
[9] See "Gartner: Offshore BPO Market to Grow 38% in 2003", *http://searchcio.techtarget.com/originalContent/0,289142,sid19_gci914221,00.html*.
[10] See *http://www.mckinsey.com/knowledge/mgi/newhorizons/reports/IT_BPO.asp*.
[11] This figure has been arrived at by Forrester Research Inc., see *Business Week Online*, 3 February 2003.
[12] "Service industries go global: How high-wage professional jobs are migrating to low-cost countries", *Financial Times*, 20 August 2003.

centre services can be relatively sophisticated if they involve technical support and marketing functions.

22. That does not mean, however, that this type of services job is without critics. For example, some observers argue that work conditions in call centres are often unsatisfactory, with high stress levels, short-term contracts and a low level of unionization.[13] Others question the potential for upgrading and spillovers to other parts of the economy. Moreover, some commentators predict that call centres will create new forms of social division.[14]

23. A priority among countries – whether rich or poor – is to sustain and upgrade exports so that they contribute more to development. Just as firms are forced to make their production systems more competitive, countries have to figure out how to move, in any industry, into higher-value-added activities. Traditionally, most attention has been paid to exports of goods. As was noted above, however, for many countries it may be relevant to consider services, too. Since cross-border supply of information-related services does not face transportation constraints, even remote, land-locked or island countries are potential candidates for this kind of export. The main infrastructure requirement is competitive telecommunication facilities.

24. In this context, it may be useful for the Commission to consider what *policy measures* are needed to attract, as well as to reap maximum benefits from, an influx of FDI in services for export. In terms of desired impacts, such investment may contribute to the creation of employment opportunities as well as tax and export revenues. Moreover, it may result in the transfer of knowledge and technology. The scope for such benefits, however, depends on both the nature of the investment and the absorptive capacity of the domestic enterprise sector.

25. In pursuing, designing and implementing policies to attract and benefit from export-oriented FDI in services, countries need to take into consideration the factors driving the relocation of services to lower-cost locations. Developing an effective targeted strategy requires an informed analysis of the underlying corporate locational strategies in order to match the needs of investors with the specific strengths and weaknesses of each location. Obviously, the factors affecting the choice of location differ depending on the activity. It is nevertheless possible to identify common areas to which countries should pay attention if they wish to attract export-oriented FDI in services. Generally speaking, these areas are related to the cost and quality of *infrastructure,* the cost and quality of *labour,* the *regulatory framework,* and *investment promotion strategies.*[15]

26. High-quality telecommunication *infrastructure* is a prerequisite for any operation based on handling phone and data transmissions. The provision of telecommunication services needs to be reliable and stable, and the cost of transmission acceptable. In some situations, the infrastructure issue may be taken care of by the private investor itself. In India,

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[13] See e.g. www.union-networks.org.
[14] See e.g. "Progress on Hold", *The Guardian,* 24 October 2003.
[15] This part draws on a presentation by Mr. Philip Cohen at the UNCTAD Expert Meeting on FDI and Development. In addition to the above-mentioned factors, the geography of the location is still often important, especially for the location of call centres. For example, the outsourcing of a service may be undertaken to enable work around the clock, with similar work being done in *different* time zones. In other situations, the offshore service production has to be in the *same* time zone as that of the home country.

for example, low labour costs made it viable for some TNCs to bring in their own telecommunications technology for large call centre operations. However, for smaller countries, insufficient infrastructure would have a clearly negative effect on potential investors. A reliable energy supply is also important, as is its cost. An uninterrupted electricity supply is necessary in order to base international business on IT systems. Moreover, an investor will assess the cost and quality of available office space, including air-conditioned buildings wired and equipped for phone and data transmission.

27. The *labour* factor is always important in the case of service production. For a host country to be attractive, a sufficient supply of labour with the appropriate qualifications at competitive costs is a key asset. The skills profile required will depend on the activity. For call centre operations, relevant language skills, an appropriate level of IT literacy, and oral communication skills are important elements. Some companies prefer to set up their call centres in countries that have a cultural affinity with the market to be served. For accounting, financial analysis, software development and other activities, an adequate supply of relevant technical skills is required. When considering labour issues, investors also want to know the availability of, and conditions for, first- and second-line management. In smaller developing countries in particular, this can constitute a considerable challenge. On the other hand, in some cases, companies may prefer to invest in locations that are less well known to the investor community, if this implies less competition for skills in the labour market or a lower risk of staff turnover.[16] Since one of the main reasons for relocating services is to reduce costs, the total cost of human resources is obviously important, too.

28. As in the case of all FDI projects, the *regulatory framework* plays a key role. In the context of production for cross-border supply of services, data protection can be very important. Moreover, where a contract is concluded at a distance – by phone, fax, Internet or e-mail – it is important to know what legislation will govern it. Many countries do not permit data exchange with countries that lack adequate legislation for protecting data. This fact has been used by some developed-country organizations as an argument against outsourcing services. Labour legislation – terms of contract, rules on hiring and firing staff and bringing in expatriates, and so on – can also be a factor in the investment decision. Taxes and incentives are another area that needs to be considered. Many countries offer tax breaks, grants and other financial benefits to inward FDI related to services exports. Such incentives mostly come in three broad forms: subsidy of initial capital outlay, including salaries; government support for training programmes; and reduced tax on profits during a specified number of initial years. Incentives are almost never the main reason for selecting a location, but they may tilt the balance between two otherwise similar locations. It should be noted that subsidies are generally not prohibited by the General Agreement on Trade in Services (GATS) (UNCTAD 2002a: 210).

29. Finally, there is a need for *investment promotion* to market existing opportunities to potential investors. To date, India, the Philippines and a few other locations have been the main beneficiaries of the trend towards shifting services jobs abroad from the developed

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[16] In countries like Ireland and India, which have been very successful in attracting call centres, the problem of high staff turnover has been recognized. According to some industry experts in India, for example, high attrition levels have led to a 20 per cent increase in wage costs in just one year ("India's Phone Call Centers Face Rising Turnover Rates", *Wall Street Journal Europe*, 31 October – 2 November 2003).

countries. This does not mean, however, that other countries cannot attract export-oriented FDI in services. In fact, many countries can offer competitive conditions (e.g. for hosting a call centre). Better provision of information can sometimes help overcome information failures limiting the inflow of FDI. An investment promotion agency (IPA) can help create awareness among investors about existing opportunities, as well as ensure an efficient handling of inquiries. To the extent that the IPA engages in targeted proactive marketing, an honest assessment of a host country's strengths and weaknesses coupled with an understanding of the requirements for attracting different kinds of services FDI are important starting points.[17]

30. The policy challenge goes beyond attracting export-oriented FDI in services. There is also a need to find ways to facilitate upgrading of established activities. As was noted above, even countries that have successfully attracted TNCs to invest in call centres, business services functions or software development face competition from other locations. The principal policy tool for facilitating upgrading is to promote skills development, including through on-the-job training. Very important are efforts to improve IT literacy and IT education – for example, by increasing course offerings in technical and engineering fields and encouraging specialized training (UNCTAD 2002b: 242). Some countries provide specific incentives to firms engaging in human resource development.[18] Other policy measures to consider include reducing duties on imports of IT-related products; encouraging competition in the telecommunication sector; setting up technology parks compatible with world-class infrastructure; and adopting e-government practices, especially in the procurement of IT services (UNCTAD 2002b: 242).

31. In addition to host country policies, actions by home countries can also affect the ability of developing countries to attract this type of FDI and benefit from it. Trade unions are concerned that international relocation of services is resulting in too many lost jobs. In the United States, several states have considered legislation to stop the movement of government-controlled jobs overseas. In the United Kingdom, a parliamentary committee has announced that it will investigate the issue, and the Government has added software services to the Shortage Occupation List, which specifies that employers must make good-faith efforts to employ individuals from the United Kingdom before employing foreign professionals.[19] In France, a group called MUNCI (Mouvement pour une union nationale des consultants en informatique) is lobbying for restrictions on outsourcing of IT work. The group is critical of the Government of France for favouring and even funding outsourcing of software development work.[20]

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[17] For a fuller discussion on targeting FDI, see UNCTAD (2002a), chapter VIII.

[18] The Republic of Korea gives tax incentives to large firms (domestic as well as foreign) as partial compensation for expenditures on human resource development in small and medium-size enterprises. Some countries provide financial support to firms that send workers for training or incur training expenses. Malaysia, Singapore and South Africa have established skills development funds (UNCTAD 2001 and 2003b), and Thailand grants a 150 per cent tax deduction for certain training expenses (Brimble 2001).

[19] See "Protectionism Hits the Outsourcing Industry", *IDG News Service*, www.idg.net, 15 April 2003.

[20] Ibid.

CONCLUSION

32. In conclusion, access to efficient and high-quality services has become increasingly important for the productivity and competitiveness of firms and industries as well as for the living standards of people in an economy. In an increasingly knowledge-based world economy, access to competitive services in key areas is a necessary (but not sufficient) condition for developing the supply capacity that developing countries need to take advantage of trade liberalization and to integrate into the international production system involving both goods and services. Recent developments open new opportunities for developing countries to benefit from globalization.

33. Services are important as *intermediate inputs* as well as *exported* products. Services as intermediate inputs to the production of goods and other services affect competitiveness in domestic and international markets. Poorly developed service industries, therefore, can be an effective barrier to fostering internationally competitive productive capacity. Power failures, breakdowns of telecommunication networks, inefficient transportation systems, the lack of an adequate financial infrastructure and similar factors hamper the development of domestic enterprise capabilities as well as the scope for FDI into productive industries. Moreover, thanks to ICT developments, services can have an increasingly important direct impact on a country's export performance.

34. Against this background, the Commission may wish to discuss which national policies are most important for increasing the benefits from FDI in services, whether as indirect or direct inputs into a country's export performance. It may also wish to consider the impact of recent trends in some developed countries towards relocating services to lower-cost locations. Finally, the Commission may wish to explore how national policies in this area interact with international agreements.

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