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SERVICES: A NEW FRONTIER FOR SUSTAINABLE DEVELOPMENT  
服务业：可持续发展的新领域

**BACKGROUND NOTE**

# HIGH-LEVEL SESSION 3

## BUILDING SUPPLY AND EXPORT CAPACITY: THE CASE OF OUTSOURCING SERVICES

**28 MAY 2013; 14.30–17.30**

DRAFT FOR DISCUSSION



## Introduction

This paper aims to provide perspectives to a discussion on building supply and export capacity in offshored services.

This paper begins by defining the conceptual framework of offshoring, to underscore the development importance of this topic. Then, it reviews its origin and evolution, its determinants and recent trends. Finally, the paper identifies key policy challenges for developing countries to maximize development gains from trade and action spheres to build supply and export capacity in offshored services.

## I. Conceptual Framework to Understand Outsourcing and Offshoring

### A. Defining Outsourcing and Offshoring

Outsourcing means that companies, source out non-core activities to other companies. When the source of this supply is located in a country that is different from the home country of the outsourcing company, this is called offshoring. Offshoring can be achieved, internally, by moving production from the parent company to its foreign affiliates<sup>1</sup> or, externally, by outsourcing services to a third party services provider abroad.

**Table 1:** Offshoring and Outsourcing

Location	Internationalized production	Externalized production (outsourcing)
Domestic	Production kept in house at home	Production outsourced to third party services provider at home
Foreign (offshoring)	Production by own foreign affiliate "captive offshoring"	Offshore outsourcing to third party provider abroad

*Source: UNCTAD, Information Economy Report 2009*

The spread of international outsourcing of services has been a major force shaping the services trade and investment landscape during the last two decades.

### B. Categories of Services Affected by Offshoring

To analyse the scope of services activities that are affected by offshoring, it is common to make a distinction between IT services and IT-enabled services.

<sup>1</sup> Often referred to as "captive offshoring"

**Table 2:** Categories of Services Affected by Offshoring

Services Category	Example of services activities
IT services	Programming, systems integration, application testing, IT infrastructure management and maintenance, IT consulting, software development and implementation services, data processing and database services, IT support services, data warehousing and content management and development
IT-enabled services 1. Front office services (Business Processing outsourcing - BPO) 2. Back office services (BPO) 3. Knowledge Process Outsourcing (KPO <sup>2</sup> )	1. Call centres and customer contact centres (inbound and outbound) 2. Data entry, human resources, payroll, finance and accounting, procurement, transcription 3. Financial analysis data mining, engineering, research and development, insurance claims processing, architectural design, remote education and publishing, medical diagnostics, journalism

Source: UNCTAD, IER 2009

### C. Origins and Evolution of this Phenomenon

The trend towards globalisation of services first emerged in the early 1990s and rapidly gained momentum. Two main factors were decisive in promoting services offshoring and increased trade in IT and IT-enabled services. The first one was advancements in Information and Communication Technology (ICT) and the second was the transnationalization of corporate service functions by Transnational Corporations (TNCs).

Increased broadband connectivity and increased acceptance of standardised software platforms introduced a degree of tradability in services that did not previously exist. It made unnecessary for providers and users to be close to one another and “fragmented” services into smaller components that could be internationalized, to take advantage of differences in cost and quality between countries, and to reap economies of scale. These ICT advancements facilitated shifting part of the production process and services to other countries.

The trend towards tradability in services coincided with greater competitiveness and cost cutting pressures in key sectors of the economy, which led to the practice of subcontracting work to third parties, with the view to (i) reduce costs and (ii) enhance efficiency, by allowing companies to concentrate on their core activities.

<sup>2</sup> KPO activities - such as business consulting, business analysis, market intelligence and legal services - are particularly human-capital intensive, as they are performed by highly educated professionals holding master degrees or PhDs, and thus belong to the highest segment of the IT-enabled value chain

The software sector was among the first to relocate a significant amount of functions to overseas destinations. Such functions included applications management, applications development and help-desk support. Gradually the scope of outsourced functions expanded, offloading entire business functions, such as human resources, logistics, procurement, engineering, marketing, sales, facility operations and management, legal services, finance and accounting.

Large companies in the US were pioneers in outsourcing. They began by outsourcing their non-core IT services to large companies domestically, preferring to obtain these services securely and reliably from the outside. The initial strategy consisted in relocating their centres from large metropolitan cities to smaller Midwestern towns, in order to take advantage of lower wage and property costs, in places where accents were neutral, education was adequate and the workforce less troublesome.

While large firms may have been the pioneers, increasingly Small and Medium Enterprises (SMEs) in developed countries chose outsourcing as a business policy to obtain quality services flexibly and a low cost, rather than setting up internal departments to perform the services. The US offshored functions to Canada and Ireland, because of availability of a highly qualified workforce and greater cultural affinity.

Later on, the savings linked to low wage labour were a major incentive to consider outsourcing to developing countries. Large providers of IT and IT-enabled services and intermediaries in developed countries (such as Accenture, Cap Gemini, Deloitte, Ernst and Young, IBM Global Services, Price Waterhouse Coopers) played a key role linking the developed and developing world. Global and regional clients in the US and EU progressively built and acquired delivery companies in developing countries and collaborated with them.

India and the Philippines were amongst the first developing countries to test the waters of offshoring. Others have followed suit, including China, Malaysia, Vietnam, South Africa, Ghana, Senegal, Kenya, Hungary, the Czech Republic, Mexico, Jamaica, Barbados and others.

#### **D. Drivers and Determinants**

The cost and availability of appropriate skills primarily determine the choice of location. However, outsourcing decisions depend on a variety of factors related to (i) the outsourcing company, (ii) the nature of the outsourced functions, (iii) the characteristics of the market of the services provider and (iv) the characteristics of the services provider.

For companies, the key driver is the search for improved competitiveness – through cost reduction and/or improved quality. To provide an order of magnitude of those cost savings, the banking industry in the United States saved up to 8 billion USD during 1999-2002 by offshoring services to India. During that same period, offshoring call centres to India was estimated to be 30-40% less expensive than setting these in the United States<sup>3</sup>.

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<sup>3</sup> UNCTAD. World Investment Report 2004

Different studies show that cost savings derived from offshoring can be substantial, often between 20 and 40%<sup>4</sup>. Savings can be achieved by not only seeking out lower cost locations but also by consolidating operations and reducing the cost of infrastructure, training and management.

The quality gains many companies have observed because of offshoring are even more interesting. When the "back-office services" of one firm become the "front-office services" of a specialized service provider, the latter often pays more attention to quality while the principal can focus scarce resources on its core activities. Relocating some functions offshore may also be a way to cope with excess demand.

The decision to offshore services functions is also dependant on the risk management strategy of the outsourcing company: i.e. how it weighs the potential benefits and costs of externalizing business functions. Such costs could relate, for example, to managing relationships with partners on a continuous basis, including flows of knowledge, goods and services; communication and information flows and monitoring control and compliance with contractual obligations. It may also entail increased exposure to business uncertainties (derived from managing cross-border operations in economically, politically, culturally and socially diverse environments), giving up part of the profits generated along the chain and losing control over parts of the value chain.<sup>5</sup>

The nature of the outsourced functions also influences where a service will be offshored. Requirements in this respect may differ across companies. Infrastructure requirements are particularly strict for certain types of IT services. For example for remote IT infrastructure management, only locations with very reliable infrastructure can be considered. For companies processing large quantities of data, the extent of bandwidth is important and there might be an interest, in certain situations, in relying on satellite connections. In the case of voice-based services, a reliable internet connection and low connectivity costs are required. In this case, fibre optic links might be more interesting than satellite technology.

Many BPO services involve basic back-office functions consisting primarily of data entry, data transfer or data conversion tasks, tasks such as moving data from a document or database to a general ledger and billing services. These tasks require basic clerical skills.

The skills required depend on the level of complexity of the outsourced business functions. For the provision of IT-enabled services that involve high interaction with customers, for example contact centres and customer services, having a presence in different time zones and different language areas is important. BPO service providers working with clients worldwide must have not only excellent communication skills but also knowledge of the clients' mind-set and native industry. In the case of service providers offering consulting or advisory services, complex specialized business skills and relationship-building skills are required.

Offshoring decisions are also function of the characteristics of the market of the services provider. Although the quality and affordability of ICT infrastructure is

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<sup>4</sup> Fredriksson, Torbjörn (2008) "Offshoring of Services: a Win-Win Proposition"

<sup>5</sup> UNCTAD. World Investment Report 2011.

necessary, today it is not a sufficient condition to attract export-oriented services projects in IT and IT-enabled services. Other important variables include the sector specific environment, the overall business environment, geographic location and cultural affinity.

The characteristics of the services provider also play an important role. Services promotion and marketing is about selling a promise of trust and confidence. Two factors are thus critical, the level of knowledge, skills and expertise and proving the capacity to understand the clients' instructions. Adaptability, flexibility and a competitive cost structure are also important factors.

**Box 1: Drivers and Determinants for Offshoring Services to Central and Eastern European Countries**

The offshore services industry started developing in Central and Eastern European countries since the mid-2000s. Nowadays, the Czech Republic, Hungary, Poland, Russia, Romania, Slovakia, Slovenia and the Baltic countries have gained some footing in services GVCs. Although low wages and low operating costs play an important role in the level of attractiveness of these offshoring destinations, other factors come into play as well.

A qualified workforce, with a relatively high level of university education, explains why, in addition to back office tasks (such as transaction processing, document management, data entry and processing), Hungary was able to capture offshoring activities related to corporate functions (such as human resources and quality management) and advanced services functions (such as program and project management).

Language capabilities and geographical and cultural proximity with Western Europe play an important role in the attractiveness of Poland and Hungary as services offshoring destinations. Poland capabilities in several European languages (English, French, German and others) and Hungary's German capabilities and linguistic proximity to minorities in neighbouring countries were key factors to develop BPOs and shared service sector activities.

Enabling economic policies and pro-business economic culture is also an important determinant. In this regard, the Czech Republic is well recognized for its well-established legal framework and for its investment incentives. In 2009, it was ranked as the third most attractive offshore jurisdiction by the Economist Intelligence Unit and the seventh in terms of investment attractiveness by Ernest and Young respectively. During the period 2007-2011, the Czech Republic attracted the highest level of cumulative FDI in the region. For Poland, the level of IPR protection was an important factor to develop successfully offshoring in Research and Development services.

*UNCTAD (2013, forthcoming) Trade in Services and GVCs*

## **II. Trends**

The global offshoring business is poised to grow, as more and more companies, in a growing number of industries and countries are embracing the opportunities created

by ICT for the specialization and internationalization of services. In addition, the scope of services affected by offshoring is continuously evolving, which means that countries should carefully assess in what areas they represented a competitive export location. The following sections zoom in on the recent evolution in terms of services sectors, countries and regions.

### A. Trends Regarding the Evolution of Different Services Sectors

Today, enterprises are choosing to offshore services in multiple sectors as well as in processes with higher levels of complexity. Table 3 presents a categorization of the dynamism of some services sectors based on their level of maturity, which is associated with differentiated market features.

**Table 3:** Exposure of Different Services to Offshoring

Level of maturity	Example of services	Features
Already reaching maturity	IT services, such as programming and applications development and maintenance	<ul style="list-style-type: none"> <li>▪ Decelerating adoption rates, but continued growth in scope.</li> <li>▪ Clearly established players and locations</li> <li>▪ Accepted business models and standards</li> </ul>
Emerging and rapid growth	<ul style="list-style-type: none"> <li>▪ Customer contacts</li> <li>▪ Infrastructure management</li> <li>▪ Finance and accounting</li> <li>▪ Human resources</li> <li>▪ Remote infrastructure monitoring</li> <li>▪ Knowledge services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Accelerating adoption rates and increased scope and scale penetration</li> <li>▪ Suppliers becoming established</li> <li>▪ Market consolidation</li> <li>▪ Location options with varying characteristics increasing</li> <li>▪ Fewer, better established models leading to lower risk in choosing appropriate design</li> </ul>
Pioneer stage	<ul style="list-style-type: none"> <li>▪ Procurement</li> <li>▪ Legal process</li> </ul>	<ul style="list-style-type: none"> <li>▪ Untapped value proposition, early but few adopters</li> </ul>

	offshoring	<ul style="list-style-type: none"> <li>▪ Limited number of suppliers in few locations</li> <li>▪ Multiple business models and unclear standards</li> </ul>
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*Source: UNCTAD, IER 2009 (based on information by Everest Research Institute, April 2009)*

Traditional IT services are approaching a high level of maturity, which means that companies considering offshoring these services can choose among many suppliers and locations and the growth in adoption rates has started to taper off. In contrast, business process services are experiencing fast growth.

Offshored IT-enabled services are at a lower stage of maturity and present better prospects for growth and revenues. In fact, the scope of industries and business functions that become subject to offshoring is expected to expand in the longer term. A recent assessment of the long-term prospects of the offshoring industry<sup>6</sup> suggests that as much as 80 per cent of its incremental revenue until 2020 is expected to come from new industries (such as the public sector, health care media and utilities), customers (specially SMEs) and countries.

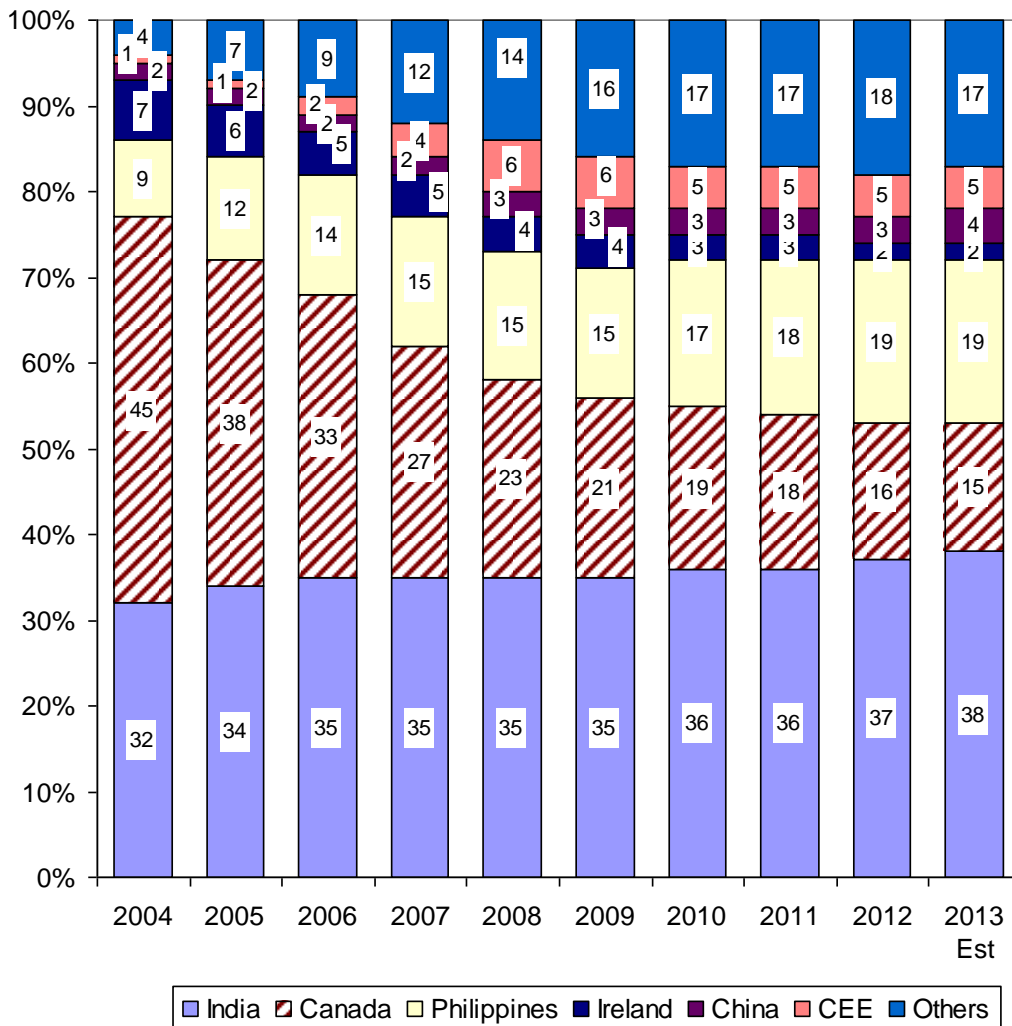
This situation implies an opportunity for developing countries to (i) develop a sizeable export-oriented services industry, if they can meet companies' needs for complementary assets in terms of skills and time zones and (ii) exploit higher value-niches, if they are able to develop a competitive position.

## **B. Trends Regarding Specific Countries or Regions**

When the exporting IT and IT-enabled services first started to take off, four countries quickly emerged as key players. These front-runners were Canada and Ireland, among developed countries, and India and the Philippines, among developing countries. These front-runners are still present in the offshoring landscape today. The figure below shows how the shares of these front-runners have evolved during the last decade, with respect to IT-enabled services.

<sup>6</sup> Nasscom and Mc. Kinsey 2009, cited in IER 2009



**Figure 1: Share of the Offshore BPO Market by Location**

Source Everest Research Group (2013)

The graph shows that, India has long been, and remains, the preferred location in the area of IT and IT-enabled services. The graph also shows that, although the early movers remain global leading destinations for offshoring, other destinations are gaining ground for the offshoring of IT-enabled services.

Indeed, the landscape of offshoring shows a trend towards geographical diversification. A new geography of offshoring has emerged in the past few years. New dynamic exporters encompass countries from the developed and developing world. In this new geography, the most dynamic exporters of IT and IT-enabled services appear to be concentrated in selected countries in Asia, the EU, some transition economies and the Russian Federation.

In the developing world, a number of countries in Africa, Asia and Latin America and the Caribbean are reporting important export shares gains, revealing their increased attractiveness for the provision of various business services. This evolution may relate to the fact that global services providers today seek to offer flexible solutions to their clients by tapping into different knowledge pools, language skills and time zones.

This trend is particularly visible in the case of voice-based services, where companies seeking to offshore functions are looking for new locations to ensure flexible services delivery around the clock. In this context, the Latin American region, due to its closeness to the US, language capabilities, human capital and technology hubs is showing particular dynamism.

Table 4 below identifies who are the dynamic newcomers in the global offshoring market.

**Table 4:** The Changing Landscape of Offshoring: the Newcomers

Category	Source, period and data used	Who are the dynamic newcomers?
<ul style="list-style-type: none"> <li>▪ IT and IT-enabled services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Balance of payments data</li> <li>▪ 2000-2007</li> <li>▪ Exports of certain categories of services</li> </ul>	<ul style="list-style-type: none"> <li>✓ Top performers = India and Ireland</li> <li>✓ Gaining ground: <ul style="list-style-type: none"> <li>▪ <b>Argentina, China, Kuwait, the Russian Federation and Singapore</b></li> </ul> </li> <li>✗ Losing ground: <ul style="list-style-type: none"> <li>▪ Developed countries: US, followed by Japan, France and Canada.</li> <li>▪ Developing countries: Egypt, Hong-Kong, Malaysia, Mexico, Saudi Arabia, Taiwan (Province of China) and Turkey.</li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>▪ IT-enabled services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Data of FDI projects related to selected ICT-enabled services</li> <li>▪ 2003-2008</li> <li>▪ Business processes (Customer contact services) - proxy for front office services</li> <li>▪ Shared services centres - proxy for back-office services</li> </ul>	<ul style="list-style-type: none"> <li>✓ Top performers: US and the <b>UK</b></li> <li>✓ Other excellent performers (dominated by developed countries): <ul style="list-style-type: none"> <li>▪ Customer Contact Centres: Canada, <b>France, Germany</b> and Ireland</li> <li>▪ Shared services centres: <b>Czech Republic, Hungary</b>, Ireland and <b>Poland</b></li> </ul> </li> <li>✓ Dynamic developing countries <ul style="list-style-type: none"> <li>▪ Asia: India and Philippines (2/3)</li> </ul> </li> </ul>

		of the South) <ul style="list-style-type: none"> <li>▪ Africa: <b>Morocco</b>, followed by <b>South Africa</b> and <b>Egypt</b></li> <li>▪ Latin America: <b>Costa Rica</b>, <b>Argentina</b> and <b>Brazil</b></li> </ul>
IT-enabled services	<ul style="list-style-type: none"> <li>▪ Market analysis data</li> <li>▪ 2003-2008</li> </ul>	<ul style="list-style-type: none"> <li>▪ In 2004, Canada, India, <b>China</b> Ireland and the Philippines accounted for 95% of the market. By 2013, their combined share accounts for 78%.</li> <li>▪ Dynamic emerging countries include: <b>Malaysia</b>, and <b>Singapore</b> (Asia), <b>Czech Republic</b>, <b>Hungary</b>, <b>Poland</b> and <b>Romania</b> (EU), and <b>Argentina</b>, <b>Brazil</b> and <b>Mexico</b> (Latin America)</li> </ul>
IT services	<ul style="list-style-type: none"> <li>▪ Market analysis data</li> <li>▪ 2003-2008</li> </ul>	India, Canada and <b>new EU members</b>

*Source: Elaboration, based on information contained in IER 2009 and on information provided by Everest Research Group (2013)*

### III. Benefits and Challenges Related to Participation in the Global Offshoring Market

#### A. Benefits for Developing Countries

Understanding the phenomenon of outsourcing and offshoring functions is important for Governments and businesses because of the opportunities and challenges it entails.

Governments perceive outsourcing and offshoring can lead, in the case of the country importing offshored services to increased economic efficiency. In the case of importers, offshoring can contribute to economic efficiency. For instance, it can generate efficiency gains from international specialization and trade. Importing companies and countries can access services at a lower cost and focus where they enjoy a comparative advantage.

From the perspective of exporters, it can lead to increased exports, employment and poverty alleviation and can contribute to structural transformation and improved competitiveness. For exporting countries, successful participation in the offshoring services market can improve chances of being better connected with the global economy, facilitating integration into the global trading system through participation in Global Value Chains (GVCs). It can also lead to the creation of attractive employment opportunities and to a new source of export revenues, influencing positively poverty alleviation and consumption.

Exporters can also benefit from spillover effects in terms of structural change and enhanced competitiveness. For example, providing offshored services to TNCs in knowledge intensive activities, can contribute to build productive capacity and economic upgrading, by (i) disseminating technology and managerial knowledge (ii) enhancing skills and (iii) providing impetus to restructure inefficient enterprises.

Offshoring can also be an avenue to explore diversification efforts. Indeed, offshoring provides an occasion to generate exports by focusing on fewer tasks within an industry value chain, as opposed to developing an entire industry.

From the business exporters' perspective, offshoring holds promises with respect to enterprise development. For example, it can lead to develop new business activities, increase the integration of SMEs in global and regional value chains, increase efficiency by externalizing non-core business functions and generate economies of scale through internationalization.

### **Box 2: India's Success Story with Offshoring IT and IT-Enabled Services.**

From a development perspective, outsourcing has demonstrated its visibility and success in India. India's boom as an offshore destination began in the mid-1990s. The country benefitted from the "first mover" advantage. In addition, low labour costs, a sizeable skilled English-speaking workforce with demonstrated capacities in the field of software development; an appropriate ICT environment; a time zone that was convenient for developed countries and agglomeration advantages also explain the attractiveness of the Indian market for offshoring during that period.

For India, offshoring led to an exponential increase in exports, revenues and employment. Between 1994 and 2004, exports of software and IT-enabled services grew from less than 0.5 million USD to some 12 million to 12 billion USD in 2003-2004. By 2008, India's offshore services industry employed 2.2 million professionals and generated almost 60 billion USD, out of which 46 billion (corresponding to over 5% of the country's GDP) was exported.

In terms of structural change and increased competitiveness, India developed efficient infrastructure and infrastructure services, for example in financial and telecom services, to support supply and export capacity in IT and enabled-services. This benefitted the overall economy. India also developed its competitiveness at the firm-level, by upgrading its supplier capabilities and continuously expanding the range of exported services. The fact that India maintained during the last decade its share in the (rapidly evolving and highly competitive) global offshoring market of IT-enabled services (see Figure 1 in section I.F.2 on trends per country and regions) demonstrates this.

TNCs played a crucial role in terms of business development in IT-enabled services in India at the beginning of the 2000s. Initially, TNCs provided capital, knowledge expertise, new infrastructure and access to markets and fostered the formation of new companies. India was, later on, able to build on this *acquis* and developed local suppliers' capabilities for offshored activities delinked from operations of TNCs, evolving from a model of intra-firm captive offshoring to a model of outsourcing to third party external providers abroad. India was also able to move up the value chain of IT-enabled services, to provide services related to more complex corporate

functions. The development and increased capabilities of India's businesses also translated in investments and in Indian companies venturing abroad. For example, in the mid-2000s, India invested heavily in developed countries (US and Western Europe) in software and related services and Indian call centres and BPOs set foreign affiliates in the Philippines and Mexico.

*Elaboration based on various sources<sup>7</sup>*

## **B. Challenges for Developing Countries**

Governments and businesses face challenges in the path to maximize development gains from outsourcing and offshoring of services. These are summarized in the following points.

### *1. Getting the Clients*

The first challenge is about entering the global offshoring market and hence, about entering GVCs and linking with TNCs. TNCs play an important role in ensuring countries can enter the global services offshoring market. This importance is demonstrated with foreign affiliates figures related to exports, employment and FDI. For instance, in 2008, in a mature location such as the Philippines, foreign companies accounted for the 90% of IT-enabled services exports. Foreign companies also dominated with respect to employment. For example, in 2008, they generated half of the employment related to offshored services exports in South Africa, to 59 per cent in Honduras, 63 per cent in Saint Vincent and the Grenadines and 90 per cent in El Salvador<sup>8</sup>. In addition, more than 60% of global FDI stock is allocated to services activities, a significant part of which is linked to GVCs.<sup>9</sup>

Although FDI could be an important avenue for developing countries to gain access to GVCs and for their participation in GVCs, services outsourcing appears to fit more into the prevalent trend of Non-Equity Modes (NEMs) of international production. NEMs are contractual arrangements that coordinate the activities in the host-country firms, without owning a stake in those firms.

The challenge of establishing offshoring relationships with potential partners lies in promoting trust in services providers by raising awareness on their knowhow and domain knowledge. The regulatory and policy framework plays a key role in promoting this trust and awareness.

### *2. Maximizing Potential Positive Effects and Minimizing Potential Negative Effects*

Ensuring development gains is about maximizing potential positive effects and minimizing potential negative effects. In this sense, services offshoring can yield significant development benefits in terms of employment, export earnings, knowledge transfer, technology dissemination and upgrading productive capacities. However, not all of these benefits are automatic. The extent to which they materialize will depend

<sup>7</sup> UNCTAD, World Investment Report 2004; Suri, Navdeep (2005), UNCTAD (2013, forthcoming) and UNCTAD, IER 2009

<sup>8</sup> UNCTAD. Information Economy Report 2009

<sup>9</sup> UNCTAD (2013). Global Value Chains and development

on the capabilities of local firms and on the balance of power between them and the partner TNC, as well as the general policy framework of host countries.

Minimizing potential negative effects relates to different challenges. First, local companies may have the little bargaining power to negotiate terms and conditions of their contractual arrangement with TNCs. The following table identifies aspects of NEMs that represent levers and sources of bargaining power for the TNC in the case of services outsourcing.

**Table 5:** TNCs Contractual Levers and Sources of Bargaining Power

Mode	Contractual levers of TNC control over host country firms	Sources of TNC bargaining power
Services outsourcing	<ul style="list-style-type: none"> <li>• Specifications for process, service and quality</li> <li>• Commercial terms and capital expenditure obligations/assurance</li> <li>• Obligations regarding the TNC Corporate Social Responsibility practices</li> </ul>	<ul style="list-style-type: none"> <li>• Access to TNC internal market and guaranteed sales</li> <li>• Access to TNC know how supply of inputs, logistics network</li> <li>• Existence of many potential contract suppliers</li> </ul>

*Source: UNCTAD, World Investment Report 2011*

Maintaining the presence of offshored services providers is another challenge aspect related to minimizing potential negative effects. The location of offshored tasks and activities can easily shift around the international production networks of multinational firms, given that it is determined by dynamic factors, such as relative labour productivity and cost. In addition, the global offshoring market is becoming increasingly competitive, witnessing a rise in labour costs in the most popular locations, competitive pressures, pressures to improve host-country environments and a broadening of the geographic scope of locations for services offshoring. This situation puts developing countries in a vulnerability situation in case TNCs decide to shift their services activities. This dependency not only refers to access to markets but also, in certain cases, to access to technology

Avoiding the low-value added trap is a third challenge related to minimizing potential negative effects of services offshoring. When participating in the global offshoring market, developing countries can remain locked in relatively low value added activities. As the value of the service increases, profit margins may significantly increase as well. Moving up the value chain to provide higher value-added services brings opportunities in terms of knowledge transfer, skills upgrade and development, infrastructure development and competitiveness.

Services offshoring can generate potential social negative effects. Focused on reduction of production costs, offshoring could be prone to weak employment conditions and violation of national and international labour rights. For example, complaints on BPO-related work in India encompassed health concerns (because of

night shifts and sleep deprivation), concerns related to social life (due to night- sleep routine) and dilution of cultural values.

Taking advantage of favourable external conditions and coping with potential challenges require a policy mix tailored to the specific circumstances of each country and to the specificity of the sector

## **IV. Action Spheres to Build Supply and Export Capacity**

UNCTAD research shows that governments have a fundamental role to play, to ensure companies in developing countries benefit from the existing opportunities in outsourcing and offshoring markets. The following section explores policy spheres that are important to develop supply and export capacity in IT and IT-enabled services.

### **A. Building Supply Side Capacity**

Governments wishing to support the development of the IT and IT-enabled services sector for offshoring may, as a matter of policy, address four areas that are key to build domestic capacity: infrastructure, human and business skills, the policy framework and the regulatory framework.

#### *1. Infrastructure*

A sound telecommunications infrastructure, along with skilled work force, is an imperative for establishing successful IT-enabled services sectors. Countries that have been able to set up international gateways that provided competitively priced high-speed internet connectivity lines have a much higher probability to succeed. Key issues to address in this regard include quality and costs of broadband.

#### **Box 3: Policy and regulatory frameworks to overcome the infrastructure deficit**

Broadband networks are critically important to facilitate trade in services by electronic means, and thus for developing an offshored services industry. Despite positive developments in narrowing the digital divide, wide gaps between high-income and low-income countries remain in the area of broadband connectivity. These gaps can potentially delay the transition to next generation networks and thus using these as platforms to support an emerging industry of offshored services adequately.

Policies to facilitate broadband rollout range from taxation and fiscal incentives to market liberalization, and may include universal access and market stimulation. In adapting the policy and regulatory environment, operators should be encouraged to share state-of-the-art backbone infrastructure to avoid duplicative and fragmented low bandwidth networks. At the same time, a critical ingredient for ensuring sufficient broadband supply at reasonable prices is to expose operators to competition.

Governments can make use of universal access service funds (UASFs) to respond to the challenge of increasing deployment of broadband backbones and access networks in remote and less densely populated areas. Another way to enhance broadband access is through the promotion of public Internet access points or telecentres.

In the case of international broadband connections, countries have to connect with undersea cable projects and, in the case of landlocked countries, build out fibre links to connect with submarine cable landing stations in other countries.

*Source: UNCTAD IER 2009*

## 2. *Developing Human and Business Skills*

The IT and IT-enabled services sectors depend heavily on the availability of skilled labour at a relatively low cost. The types of skills, knowledge and expertise needed by IT-enabled services providers depend on the complexity and type of functions being offered to the client, and on the type of business. In many cases, the "skills bottleneck" does not lie in lack of training institutions or study programmes but rather on a mismatch between skills provided in these training programmes and the needs of the market. Thus, a first step towards overcoming the skills challenge is to assess and define the scope of the skills gap.

Countries that seek to take advantage of the opportunities available in these sectors, must develop a set of policies to ensure that they can (i) produce a sufficient number of professionals with the skills needed, (ii) establish a standard to certify the quality of skills provided and (iii) attract people to get them certified and deployed in this sector

To develop the requisite skills, several spheres of action are possible, as summarized in the table below.

**Table 6:** Spheres for Action to Develop Skills for IT-Enabled Services Sectors

Skill	Objective	Sphere of action
English and computer literacy	Improving these skills	Primary or secondary education
Basic customer orientation and behaviour	Improving these skills	Secondary higher education
Specific knowledge related to the IT-enabled services function	<ul style="list-style-type: none"> <li>▪ Improving domain awareness on issues specific to the sector</li> <li>▪ Familiarizing graduates with foreign language capabilities relevant to the IT-enabled services function</li> </ul>	Tertiary level. <ul style="list-style-type: none"> <li>▪ Examples: Including modules on international standards for financial and accounting targeting accounting, finance and commerce undergraduates</li> <li>▪ Possibility of undertaking one or more courses that are directly related to BPO functions in English (or another relevant language)</li> <li>▪ Cultural exchanges programmes with countries that have successfully</li> </ul>



	functions	developed an IT-enabled sector
Specific knowledge related to the IT-enabled services function	Improving domain awareness on issues specific to the sector	<ul style="list-style-type: none"> <li>▪ On the job training</li> <li>▪ Example: In-house or on-site training programmes</li> </ul>
Skills that enable to undertake more sophisticated tasks	<ul style="list-style-type: none"> <li>▪ Upgrading services offer to more sophisticated IT-enabled services functions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Post-graduate level</li> <li>▪ Example: requesting inputs from industry leaders to develop academic programmes in careers related to R&amp;D (such as engineering, computer-related subjects, IT and mathematics)</li> </ul>

*Elaboration, based on Suri, Navdeep (2005). "Outsourcing and development"*

In addition to the skills that are specific to IT-enabled services functions, certain horizontal skills are also important to integrate successfully local businesses in GVCs, through NEMs for services outsourcing. These skills include general managerial competencies, e.g. financial, marketing and management knowledge. They are critical to allow entrepreneurs manage their business efficiently and to ensure local firms develop absorptive capacities, to benefit from skills and technology derived from their participation in the GVC.

A good way to develop these entrepreneurship skills is to embed training on financial literacy and business strategy for start-ups into the formal system at all levels, including schools universities and private sector bodies. Vocational training can also contribute to develop these skills, as it enhances the capabilities of local companies to engage to a specific occupation without requiring a formal academic involvement.

Problem-solving and communication skills are important in the case of IT-enabled services requiring a frequent interaction with the client or the clients' customers. Communication plays a key role in defining, communicating, understanding and measuring project requirements and success criteria, particularly considering that services offshoring activities often take place, through electronic means, in contexts with differences in language, culture and work style.

Local companies may also need to develop skills to negotiate NEMs. Local entrepreneurs can benefit greatly from advice on how to negotiate a NEM contract. This includes economic aspects (distribution of business risks), financial considerations (e.g. taxation) and legal elements (implications of the contract). In most cases, it is not the lack of an adequate legal framework, but the lack of carefully drafted contracts, that lies at the root of subsequent problems and failures. Governments can play a role, for instance, by developing and publishing negotiating guidelines, checklists of issues to be considered in negotiations, codes of conduct, model contracts (including for contract farming) or benchmark prices for the respective product or service. Promoting a "contract culture", i.e. a better understanding of the merits of entering into formal contracts, is also vital. Finally,

supporting collective bargaining, including the formation of domestic producer associations, can help to create a better counterweight to TNCs' negotiating power.

A strategy to strengthen skills needed to develop offshored services would benefit from including the following objectives:

- i. *Creating awareness of opportunities in the sector*, through industry or professional associations and career counselling at high schools, colleges and universities.
- ii. *Strengthening collaboration between businesses, academic sector and policy makers to meet the human resource requirements to develop the sector*. For example: (i) to set up vocational training that can interact with apprenticeship systems or (ii) to establish entrepreneurship centres to serve as hubs to coordinate activities across business and educational institutions.

An area of collaboration between public and private sector can consist of fiscal incentives for private sector players that provide basic and domain-specific training for IT-enabled services sectors. Such a scheme was used, for example, to develop BPO-related skills in India.

- iii. *Certifying skill levels*. Ensuring appropriate levels of quality can be a problem faced by new entrants to the IT-enabled services sector. To overcome this problem, the government could work with industry in introducing a standard test that certifies the basic skills required in the sector, including fluency in the relevant language, customer service orientation and teamwork ability. An annual review mechanism could be built into the certification to keep it current with the needs of a rapidly evolving industry.
- iv. *Promoting quality awareness*. As IT-enabled services have evolved in complexity, quality has emerged as a key issue in the success of IT-enabled operations: it helps services providers differentiate themselves and claim an edge over competitors in major global contracts. Quality certifications serve as a road map for sustained improvement in processes, adding value and strengthening relationships between vendors and clients. They also provide parameters for appraising the performance of services providers in a consistent and comparable manner, allowing clients to separate high performance vendors from those with a more ordinary record.

When considering the creation of a BPO business, companies in developing countries could consider building quality levels, by starting with operations involving basic skills (such as data entry) and then expanding to include more complex business processes. Starting at a lower skill level reduces the cost and risk, allowing time for a learning curve until quality implementation is achieved. Beginning with low-risk projects and paying special attention to the transition is what really matters. Equally important is to focus on a few projects to provide high-quality services and thereby learn the business mentality of BPO clients, build confidence and successfully promote endogenous capacities.

**Box 4: India's Strategy to Build Quality Awareness and Improve their Services Offer**

Analysts consider the conscious drive undertaken by India's IT industry towards internationally recognised certifications as an important factor in raising the comfort level of clients, moving up the value chain and sustaining the industry high growth trajectory. The industry has moved through three distinct phases in its quest for high-level certification.

In the first phase, the emphasis was on creation of basic processes to handle all activities related to order fulfilment. The European ISO9000 standard served as a useful benchmark for this purpose. In the second phase, the focus shifted to more sophisticated software engineering and IT companies attempting to align their quality management systems with the CMM system, submitting their systems to one or more assessments at increasing levels of maturity.

In the third phase, the focus shifted to instituting processes, metrics and a framework for improvement in all areas of activity, ranging from billing, collection and sales to HRD and after sales support. Companies have attempted to achieve this by aligning their internal practices with the People CMM framework and by using the Six Sigma methodology to reduce quality variations and by putting in place systems that ensure quality in all company operations.

*Source: Suri, Navdeep (2005). "Outsourcing and Development"*

### 3. *An Enabling Policy Framework*

To ensure that services offshoring can contribute achieving development objectives, strategies aimed at the promotion of such services should be embedded in the broader development strategy. Supporting services offshoring can relate to different policy spheres, for example investment, technology and innovation and industrial policies. In order to maximize benefits, these policy spheres should reinforce each other and be coherent with the overall development strategy. To achieve this National government support at the highest level is also important, to create an enabling environment for opportunities, encourage policy reforms and build a climate of trust among relevant stakeholders.

Government support measures can help ensure that benefits of developing an IT-enabled services industry actually materialize. Active policies consisting of fiscal and tax incentives and cluster development programmes have proven successful to develop supply capacity and maximize development gains of offshored services. These policies seek to improve the location advantages of the "potential winners", once these and the niches (in which they can compete most effectively) are identified.

#### *i. Fiscal Incentives and Financial Support*

Offering tax incentives and financial backing can be an important part of a strategy to develop a local services industry for the global offshoring market. Fiscal incentives can lure investors into the production of ICT enabled services and attract foreign affiliates. Generous financial incentive packages were, for example, determinant to attract leading TNCs such as IBM, DHL, Motorola, ExxonMobil and Honeywell to offshore services centres in the Czech Republic. India used tax breaks and other

financial support measures to encourage foreign-based companies to outsource part of their business or to develop and own businesses in India.

**Box 5: Fiscal Incentives to Develop Offshore Services in Uruguay**

Uruguay has emerged as an attractive offshoring destination in Latin America. Most companies involved in offshoring benefit from either of two incentive schemes: Duty Free Zones (DFZs) or special incentives for the ICT and audiovisual services industries. Under both schemes, companies can enjoy fiscal exemptions from domestic taxes (value added and rental taxes) and the elimination of import tariffs (on inputs and investment goods and equipment). Under the special sectoral regimes, fiscal incentives apply only to export sales. Foreign affiliates dominate in DFZs and domestic companies are the main beneficiaries of the special incentives for the ICT and audiovisual services. In general, foreign affiliates are more export-oriented than domestic firms.

*Source: UNCTAD IER 2009*

Subsidies can also contribute to domestic capacity building. For example, the availability of support, from EU structural funds and from the central government, was important to develop offshoring of services performing BPO, Shared Services Centres and R&D tasks in Poland.

It is important to adapt incentive schemes to the nature of IT-enabled offshored services projects, which means emphasizing more costs related to human resources than capital investments. At the same time, countries should be cautious not to be too generous to when offering incentives as it may fuel a race to the bottom among potential destinations.

*ii. Cluster Development Policies*

The development of an offshoring industry often is characterized by reduced backward and forward linkages with other economic sectors, leading to little spillover effects for the local economy. Many countries also face difficulties to ensure that offshoring activities translate into concrete opportunities for SMEs and to less favoured areas.

These aspects can also be considered part of the sphere of policy action to maximize potential positive effects of offshoring. They can be addressed through the creation of productive clusters. Clusters are organized collaborations between a diverse number of public and private sector actors, such as firms, government agencies, and academic institutions, with a view to improve the competitiveness of one of several business sectors.

Such intra-firm cooperation contributed to the development of services associated with the goods production in Economic Processing Zones (EPZs). Originally, services activities were limited to warehousing and trade facilitation, and then, around the 2000s, EPZs gradually attracted other services (including call centres, medical diagnosis and business, architectural, engineering and financial services). Technology parks were also introduced to provide well-developed technological support and

infrastructure, and were used successfully by India, Dubai and Jamaica to increase their attractiveness as services hubs for offshoring.

Other cluster initiatives seek to promote SMEs by providing venture capital to support start-ups, incubators<sup>10</sup> and generating opportunities to link with bigger national, regional and foreign companies. For example, Mauritius used incubator schemes to finance enterprises in IT and IT-enabled services. Mauritius also developed technology and free trade zones<sup>11</sup>. Such initiatives contributed decisively to the evolution of the outsourcing industry witnessed during the period 2009-2013: from basic data services tasks, Mauritius developed supply and export capacity in increasingly KPO complex processes. This country is today being recognized as a centre of excellence in the areas of finance, accounting and IT.

Clusters have proven effective to develop capacities in services influencing production or management efficiency. They contribute to innovation processes in services and create local backward linkages. They also reduce the risk of TNCs shifting production to other locations, because of the benefits TNCs gain from cooperation with firms in such agglomeration.

#### 4. *An Enabling Regulatory Framework*

Promoting and facilitating services offshoring and ensuring development gains from services offshoring depends on clear and stable rules on a number of regulatory issues.

- i. *Business facilitation.* Facilitating business activities and avoiding cumbersome administrative laws contribute to attract NEMs. Examples include simplification of administrative steps to set up new business. This can be done through one-stop shops initiatives that concentrate registration procedures in a single agency, which can reduce the time and costs needed to set up a company. Communication campaigns on existing regulations on media and websites can also contribute to business facilitation.
- ii. *A strong and stable commercial contract law,* as NEMs are essential a contract-based form of TNC engagement in the host economy. NEM parties need to know, for example, what domestic rules govern their contract; the extent to which these regulations constrain their contractual discretion; whether and to what extent they have the right to choose the law of a third country to apply to the contract; the consequences of a breach of contract and what procedures apply in the event of a dispute.
- iii. *Protection of private data.* The growing concern over privacy issues and fear of sensitive personal information falling into unauthorised hands could have a disproportionate effect on offshoring of data and services. In an environment marked with periodic attacks on data by computer viruses and hackers, the issue of information security and data privacy is increasingly important to assure the companies in IT-enabled services and their customers of the safety of their data.

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<sup>10</sup> Schemes where SMEs receive direct services from Government to business in strategic sectors. ICT incubators are specially designed to extend networks, facilitate exchange of ideas, information and knowledge and assisting management and technological development.

<sup>11</sup> Convoy, Martin (2012). "Mauritius: The Thinking Mans' ICT-BPO Island"

- iv. *Protection of intellectual property* is an important factor considering that NEMs are in essence a transfer of intellectual property to a host-country firm under the protection of a contract. IP protection can contribute to the acquisition of knowledge and to move gradually towards more sophisticated services production, especially in areas that are R&D-intensive.
- v. *Labour policies and regulation*. Governments have an important role influencing working conditions and defining, communicating and enforcing labour legislation.
- vi. *Competition*. If TNCs engaged in NEMs acquire dominant positions, they may be able to abuse their market power to the detriment of their competitors (domestic and foreign) and their own trading partners. Therefore, policies to promote NEMs need to go hand in hand with policies to safeguard competition

## **B. Promoting Exports**

### *i. Marketing*

Promoting exports of offshored services is mainly about marketing. Key areas for action in this regard relate to effective promotion of existing opportunities to potential investors, public relations and building partnerships and reputation of local services providers to be able to capture offshoring opportunities. Investment and export promotion agencies play a key role in this respect, providing information, developing brand awareness and recognition in export markets and facilitating projects.

Their activities regarding information-sharing range from undertaking market research, business partner searches and individual market visit programs, as well as participating in international fairs and organizing special marketing missions. Branding creating an image that is recognizable in terms of quality of services provided The facilitation of projects in the area of services offshoring involve business matchmaking, i.e. establishing partnerships between foreign and local companies

#### **Box 6: Peru Export Promotion Strategies for Offshored Services**

PROMPERU is the export and investment promotion agency of Peru. In recent years, it has actively engaging in efforts to develop an export offer of services in Peru and in developing sectors with a view to capture greater offshoring opportunities in high value-added segments.

Although there is little available information regarding the effectiveness of these promotion efforts, they have certainly contributed to create a positive framework to develop export potential. Examples of this contribution include creating and promoting brands to identify services Peru's offer abroad; creating partnerships and clusters among local companies; ensuring participation of local companies in industry international events, developing informative brochures to highlight the achievements of the services sectors. Their services have specially favoured SMEs.

The software sector in particular has been continuously supported by PROMPERU. In fact, the agency was instrumental in the creation of its business association. As part

of their initiatives to support the sector, PROMPERU provides commercial intelligence services to identify export opportunities, promotes the participation of the Peruvian businesses in a variety of commercial missions and in domestic and international fairs to make the Peruvian offer known by potential clients in target markets.

*Source: UNCTAD (2013) Services Policy Review of Peru (forthcoming)*

## *ii. Services Offshoring and Trade*

Advances in telecommunications technology and evolution of business models in recent years have created strong interdependencies and linkages between the individual modes of trade in services. Offshoring is usually viewed as mode 1. However, there is a view that it should be considered as consumption abroad and should fall in mode 2.

From a business perspective, particularly in the IT-enabled services sector, modes 1, 3 and 4 are closely intertwined. To provide a concrete example, in Peru<sup>12</sup>, companies in the engineering consulting sector export such services using least modes 1, 3 and 4 of supply. Mode 3 services exports of engineering consulting services have become increasingly linked to mode 4 in Peru. Peruvian companies are setting up branches and offices in several Latin American countries to seek business opportunities and then create specialized project teams with local companies for works in the region or are opening of offices in foreign markets with Peruvian personnel and gradually including local personnel.

Over the last few years, a clearly discernible pattern of the web of linkages between modes 1 and 4 has emerged. When skilled professionals such as doctors, investment bankers or software programmers from developing countries successfully deliver high quality services in the host country, the brand equity built by them for their country helps in attracting offshored services under Mode 1. This has been particularly true in the case of India and the Philippines.

There are indications that the rapid growth of the Mode 1 model of offshored services can also act to a certain extent as a substitute for Mode 4. Since many of the internationally traded services tend to be labour and/or knowledge intensive, cross-border supply of these services can reduce the need for individuals to traverse the physical distance to provide the service.

It becomes imperative for national policy makers and stakeholders involved in services trade promotion and services trade negotiations to take a holistic view of these linkages. Any commitments made on a particular mode without taking into account the impact that it may have on the other modes could have a significant impact on the welfare gains expected from an increased trade in services. The same applies to identifying and addressing barriers to trade in offshored services.

<sup>12</sup> UNCTAD (2013) Services Policy Review of Peru (forthcoming)

## C. CONCLUSIONS

There are two main challenges affecting countries who desire to embark of capturing greater opportunities from the global services offshoring market. The first one is related to getting the clients; the second one is about maximizing potential positive effects and minimizing potential negative effects. UNCTAD research shows that governments have a fundamental role to play, to ensure companies in developing countries benefit from the existing opportunities in outsourcing and offshoring markets.

To ensure that services offshoring can contribute achieving development objectives, strategies aimed at the promotion of such services should be embedded in the broader development strategy. Supporting services offshoring can relate to different policy spheres, for example investment, technology and innovation and industrial policies. In order to maximize benefits, these policy spheres should be coherent.

Four policy areas are crucial to build domestic capacity in offshored services: infrastructure, human and business skills, the policy framework and the regulatory framework, to achieve the following objectives:

- Access to competitively priced high-speed internet connectivity lines
- Promoting requisite skills to develop the sector, establishing a standard to certify the quality of skills provided and attracting people to be certified and deployed in the sector. At the personal level, these skills may include English, computer literacy, basic customer orientation and behaviour, knowledge that is specific to the IT-enabled services function and skills that enable to undertake tasks that are more sophisticated. At the business level, such skills may refer to entrepreneurship and managerial competencies, problem-solving and communication skills and legal skills to negotiate offshoring services contracts.
- Implementing support measures can help ensure that benefits of developing an IT-enabled services industry actually materialize. Such support measures may include: fiscal incentives and financial support or cluster development policies
- An enabling regulatory framework that facilitates business operations; ensures contract stability, protection of private data, protection of intellectual property; defines and enforces labour standards and promote competition.

Promoting exports of offshored services is mainly about marketing. Key areas for action to capture offshoring opportunities relate to promotion of existing opportunities to potential investors, building business partnerships and developing awareness of the offer of local services providers. In promoting these exports through offshoring, recognition of increased interlinkages among modes of supplying services is necessary. This aspect is also of relevance for trade negotiations strategies and for identification of barriers to trade in these services and for addressing them effectively.



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