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## CHAPTER V

# NATIONAL POLICIES

## A. Host-country policies on services are key to development gains

National policy-making in services affects the ability of a country to attract desired types of FDI and to extract benefits from it. Most FDI in services is market-seeking in nature, but as services become more tradable, the scope for efficiency-seeking FDI – and thus for associated policies – is expanding. A general challenge facing policy-makers is to strike the right balance between economic efficiency and other policy concerns. Whereas a case can often be made on efficiency grounds for liberalizing FDI in services, market failures as well as broader developmental objectives often justify restrictions or national regulations on the provision of various services. At the same time, in areas in which countries seek to promote a stronger presence of FDI, proactive measures may be necessary, for example, through privatization programmes or investment promotion. Given the intensity of the use of human resources in services production, skills development and education policies are key to attracting and leveraging inward FDI in this sector.

### 1. Countries are opening up to FDI in services

Mirroring the overall tendency among countries to liberalize the entry of foreign firms in the primary and manufacturing sectors, the liberalization of services has also come a long way. While FDI in services remains more restricted, both developed and developing countries have taken steps to open up their service industries. In fact, starting from a higher level of restrictiveness, developing countries may have liberalized their service industries at an even more rapid pace than developed countries over the past decade.

Whereas comprehensive data on restrictions to FDI in services do not exist, it is possible to draw some deductions from reservation lists in various international agreements that deal with investment. Non-

conforming measures listed in such agreements – especially those with a negative list of reservations – provide one useful proxy of areas that host countries deem particularly sensitive or of strategic importance.<sup>1</sup> Beyond lists of non-conforming measures, some information can also be obtained from national sources. The subsequent discussion is based on studies that have drawn on both international and national sources.

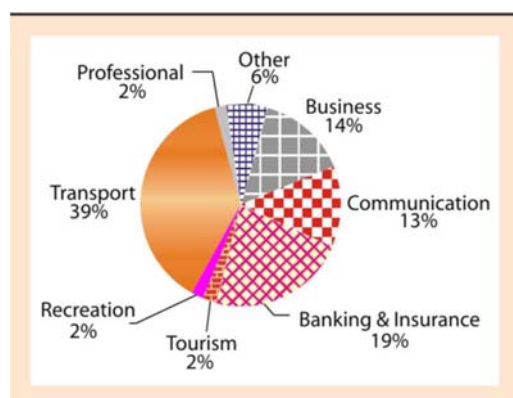
Based on the lists of a total of 4,886 non-conforming measures included in seven IIAs, 71% were related to investment in services, 15% to horizontal restrictions that apply to all sectors and 14% concerned investment in the primary and manufacturing sectors (figure V.1).<sup>2</sup> Within the services sector, four industries – transportation, banking and insurance, business services and communications – accounted for 85% of all non-conforming measures (figure V.2).<sup>3</sup> A study of restrictions in the OECD area concluded that most countries are today quite open to FDI in hotels and restaurants, construction and business services, whereas the level of restrictiveness rises considerably in the transportation, telecom and electricity industries (Golub 2003).<sup>4</sup>

In general, developed countries are more open than developing countries to FDI in services (OECD 2003, p. 23); however, there is great variation across industries and countries. A detailed analysis suggests a rather complex pattern. For example, even liberal and mature economies such as the United States, open to FDI in most activities, retain entry restrictions on services such as media and air transportation. Moreover, whereas low- and middle-income economies *on average* are more protected than high-income economies in distribution industries, Belgium, France, Italy and Switzerland were among the most restrictive in a sample of countries, while Singapore, South Africa and Uruguay were among the most liberal (Kalirajan 2000). In a study related to telecommunications, Argentina, Brazil and Chile were among the least restrictive countries, while Burkina Faso, Costa Rica, Ethiopia, Malta, the Syrian Arab Republic and Tunisia were the most restrictive (Warren

2000; McGuire 2002). Similarly, other research shows that the most open economies in maritime services included a mix of developed and developing countries, while countries as diverse as Brazil, Chile, India and the United States had the highest barriers to foreign service providers (McGuire et al. 2000).

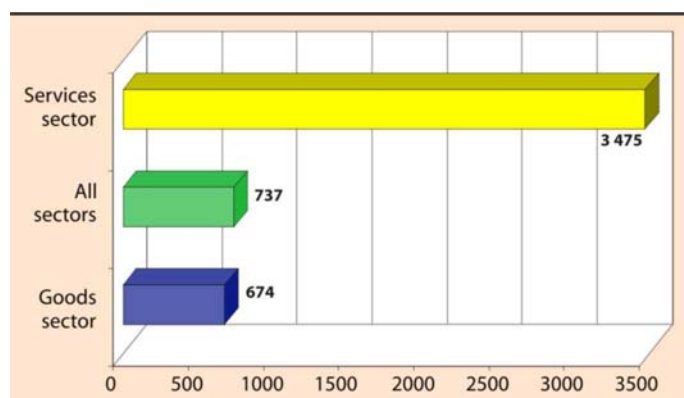
Various measures are used to restrict FDI in services. Restrictions can be formal (e.g. legislations and decisions) or informal; specific (applying at the level of firms or industries at large) or general (e.g. economic needs test and national interest criteria). They may seek to influence the allocation of capital between countries, between foreign and domestic investment and between direct and portfolio investment. Some measures apply at the point of entry, stretching from mere notification requirements to outright prohibition of FDI; others target the operations of firms; while a third category is related to restrictions in the area of ownership and control. The nature of restrictions and the purpose for which they are introduced varies by industry. In distribution services, restrictions are often used to maintain health and safety standards and limit urban sprawl (Kalirajan 2000). Common examples include performance requirements, zoning regulations, operating hours and advertising restrictions. In professional services, they are mainly introduced to ensure standards and the quality level of services, as well as the integrity of service providers (Nguyen-Hong 2000). Examples include nationality and residence requirements, limitations on business forms accepted and lack of recognition of foreign qualifications. In telecom, licensing requirements, limits on foreign equity participation and price regulating are frequent.

**Figure V.2. Reservations on investment in services, by industry, selected IIAs**



Source: UNCTAD.

**Figure V.1. Reservations by sector in selected IIAs**



Source: UNCTAD.

A further liberalization of services involves potential advantages and disadvantages. Benefits can stem from increased competition, lower prices and better quality of services (McGuire 2002; OECD 2003 for a review). Moreover, a larger number of suppliers of services furthermore enhances consumer choice. Finally, allowing foreign companies to establish a presence in services that are key inputs to other productive activities may help improve the systemic competitiveness of an economy.

But there are several reasons why developing countries, on average, remain more restrictive on FDI in services than developed ones. It is partly due to the particular nature of services. Apart from the sensitivity of services with cultural, social, distributional or strategic significance, there are economic concerns. First, countries restrict FDI to avoid the risk of foreign investors killing off fledgling domestic enterprises (i.e. the infant-industry argument).<sup>5</sup> Second, entry by large service TNCs involves competition policy considerations, and many host countries may not feel ready to deal with the technical and legal issues involved. Industries that are characterized by a lack of competition are also likely to be subject to more regulations. Third, services FDI that involves the sale of public utilities to foreign firms raises complex issues related to privatization and the regulation of natural monopolies. Countries without the necessary regulatory framework may lose by rushing into liberalization, particularly when a reversal of the liberalization is hard to achieve or when liberalization has “systemic implications”, as in the case of the financial industry. Fourth, some services may not appear to offer significant technical skill creation, linkages or other benefits (reflecting partly a lack

of understanding of the indirect impact of services on productivity), and governments may wonder why they should promote entry by TNCs. Finally, since a number of services are closed to foreign investors, are monopolies and, in any event, need to be regulated, it is frequently difficult to predict as well as to assess the effects of an opening up to FDI (e.g. on prices); and getting the right regulation in place is a challenge.

These concerns are often valid, and there are trade-offs involved in liberalizing FDI entry. Where local enterprises are capable but are threatened by the TNCs' size, resources or links, a case can be made for gradual liberalization and for measures to ensure that local enterprises receive support and do not face anti-competitive practices. Governments need to tailor their policies to the specific conditions prevailing in their countries and in each activity. The complex pattern of liberalization to date in countries at varying levels of development indicates that "the more liberalization the better" is too simple a policy prescription. Rather, it is preferable to find an appropriate balance between possible efficiency gains from opening up and other broader development objectives: "In practice, liberalization is likely to be a step-by-step, industry-by-industry endeavour.... The selection of industries in the context of a programme of gradual liberalization requires that policy-makers be able to evaluate how particular industries will perform when their environment is liberalized.... Adaptation takes time, thus providing the basis for an argument for a gradual liberalization of services" (UNCTAD and World Bank 1994, p. 58). The need for appropriate regulation when liberalizing is well illustrated by the financial industry (box V.1).

The liberalization of services has contributed to the boom in FDI (chapter III). Much of the impetus for liberalization has come from developing and transition economies seeking to improve the efficiency of their services, reduce the financial burden of State-owned services by selling them to foreign investors, and boost exports by attracting FDI related to services offshoring. As many services are essential inputs for manufactures, and since many restrictions to trade in manufactures have been removed, the liberalization of services has also become more important. Unless countries offer internationally competitive service inputs locally, they may not be able to retain manufacturing activities that use these services. Moreover, international rules and pressures have

reinforced the liberalization trend, but the appropriate scope, speed and nature of further liberalization continues to be debated.

In open and contestable markets, there is generally little reason to fear that greater competition will lead to a deterioration in the quality of services, but only so long as the competition and regulatory framework is strong and effective. In many services, conditions imposed on FDI can be seen as an integral part of such a framework. Services with built-in monopoly elements (power, water, telecoms) need strong legal and regulatory systems to ensure efficient pricing, investment and delivery. Policies may also need to reflect the possibly different effects from FDI depending on whether it takes the form of acquisitions or greenfield investment (Mattoo et al. 2001). Services that are widespread or raise particular governance or stability concerns (like finance) need appropriate regulatory systems to ensure that they conform to social interests. Similarly, the entry of FDI via privatization raises complex issues (discussed below). In services with implications for the labour market (e.g. employment conditions in call centres) or the environment (e.g. tourism), governments need to define socially acceptable norms of behaviour. There is also a crucial role for competition policies in ensuring the benefits of FDI in services (WIR97). However, many of these policies are not specific to FDI, but apply generally to all forms of investment.

In view of the complex nature of services and the variation in national priorities and values (whether economic, social and environmental concerns, consumer interests or other development considerations), there is a need for policy space in regulating service industries to allow governments the flexibility necessary to implement their national objectives – an issue taken up in the next chapter.

## 2. Benefits from FDI in infrastructure-related services: the case of privatization

Basic infrastructure services are key to economic and social development. At the same time, they are capital-intensive, often characterized by natural monopoly and difficult to regulate. As indicated in chapter III, the opening up of various infrastructure services through privatization programmes triggered unprecedented increases in FDI, especially in

telecommunications and electricity. Given the pressing need for capital to meet the projected demand for infrastructure investment, coupled with low savings rates in many developing countries, as well as poorly developed local capital markets, FDI is likely to continue to play a major role in the financing of projects related

to telecommunications, electricity, water, railroads and other utilities. In order to mobilize foreign investment into these highly capital-intensive industries, developing-country governments will need to pay attention to how their policy, legal and regulatory frameworks affect investment risk and how barriers to

### Box V.1. Prudential regulation of the entry of foreign banks

The extent to which countries have chosen to allow foreign banks to enter differs considerably (chapter III). Opening up to foreign banks entails benefits and risks, which implies the need for appropriate government regulation. This usually means not simply deregulation, but also the replacement of existing regulations with more market-friendly ones, and that focus on prudential objectives.

Due to the high incidence of market failure, notably imperfect and asymmetric information, regulation is essential in financial services (Stiglitz 1994). Imperfect information can lead to adverse selection and moral hazard, making it difficult for banks successfully to allocate financing to good investments. Weak regulation can exacerbate the problem, potentially leading to inadequate capital positions, fraudulent behaviour, excessive credit growth and risk-taking at individual banks. Any of these can undermine an institution's health, perhaps even the health of the banking system, and possibly induce wider financial instability.<sup>a</sup>

Even the most developed regulation and supervision cannot always prevent banking distress in the case of major economic shocks (Calomiris 1992). On the other hand, a well-designed framework (with supporting legal, accounting, disclosure and auditing infrastructure), including appropriate prudential regulations, well trained and experienced supervisors and proper enforcement, can discourage imprudent behaviour by weak banks without unduly constraining the operations of strong banks (Rojas-Suarez and Weisbrod 1996). It can also make a banking system more resilient to volatility and economic shocks and promote financial stability.<sup>b</sup>

The entry of foreign banks into developing countries and transition economies raises concerns

that regulators in these countries may find it difficult to supervise properly foreign "large complex banking organizations" operating in their markets (Mathieson and Roldos 2001). There are worries that foreign banks ignore domestic borrowers, and be less prone to respond to domestic credit needs; that regulatory authorities are not able to exercise adequate control over these banks; and that domestic banks are unable to compete (Peek and Rosengren 2000).

On the other hand, the entry of foreign banks can contribute to the development of domestic regulation, to the extent that they abide by international regulatory standards (Mathieson and Roldos 2001). Foreign branches of a foreign bank are supervised on a consolidated basis by the parent bank's regulator. Thus, their presence in a country with weak regulatory structures may contribute indirectly to promoting harmonization of its regulatory standards with those in more developed markets. However, it does not absolve domestic authorities from responsibility for regulating and monitoring the activities of banks, whether they be banks with minority foreign stakes, joint ventures between domestic and foreign investors, or domestic banks that adopt more sophisticated financial instruments in a liberalized financial system.

Countries must decide to what extent regulation and supervision must be developed before undertaking financial liberalization – including opening up to FDI – or whether these measures can be adequately addressed in parallel. The issue of the appropriate sequencing, speed and breadth of financial liberalization – and indeed the *desirability* of external financial liberalization – remains controversial, and needs careful consideration by national authorities.

Source: UNCTAD.

<sup>a</sup> Poor regulation has been found to be one of the leading causes of banking crises in both developed and developing banking markets (Caprio and Klingebiel 1997). See also Goldstein and Turner 1996; Basel Committee on Banking Supervision 2004.

<sup>b</sup> In fact, the development of an adequate regulatory and supervisory framework can be seen as a necessary condition for both domestic and external financial liberalization (Goldstein and Turner 1996; Mishkin 1997).

international investment can be lowered in a development-enhancing way.

Involving foreign companies in infrastructure services can bring important benefits, especially in terms of inflows of capital, enhanced supply of services and increased efficiency. However, benefits are not automatic and various costs can arise (chapter III). Adequate policies are needed to address concerns related to market failures, the risk of crowding out local players and potential job losses. Some services such as the distribution of electricity and water, are particularly sensitive, since they have traditionally been run as public monopolies and may be of strategic importance – not only from an economic but also social, national security or cultural perspectives. FDI in services through privatization poses a special challenge in terms of regulation and governance. The outcome of such FDI is affected by the way in which privatizations are undertaken, the nature of competition in privatized industries and the quality of the national regulatory framework and institutions.

To the extent that governments do decide to open up services to foreign investors, a number of factors need to be considered (box V.2 provides a checklist; see also Odle 1993). Governments first need to establish clear objectives for involving FDI in privatization and determine whether those objectives could be achieved by domestic investors; they then need to prioritize these and other objectives not well served by FDI, and adapt the privatization method accordingly. Typical objectives include raising government revenue, expanding the supply of services and improving the efficiency of service provision. While certain objectives can be well served through sale to a specific “strategic” foreign buyer, others may be better met through initial public offerings in the domestic and foreign stock markets, sale to employees of the firm to be privatized or liquidation and subsequent sale of assets. For example, in addition to firm-specific objectives of privatization involving FDI (such as enhancing its competitiveness), governments might seek to achieve economy-wide objectives, such as macroeconomic stabilization (focusing on the revenue aspect) or capital market development, for which an initial public offering may be a stronger candidate.

The situation of the State as a seller of assets confers a special responsibility on policy-

makers in negotiating individual privatization transactions. It is particularly important to strike a balance between budgetary and other considerations. Policy-makers also have to balance the need to allow the service producer to be profitable with the need to supply services at affordable prices to the poor and/or in sparsely populated areas. Budgetary considerations may prompt governments to negotiate the highest price possible and use the revenues for social purposes, neglecting the competitiveness aspect. Other considerations, such as employment preservation or regional policy concerns, may call for the negotiation of specific commitments by investors. Similarly, if governments focus too much on the sale price of a State-owned company to maximize revenues, neglecting the regulatory framework and institutions needed to maintain or improve the efficiency of natural-monopoly-type industries, privatization may have an adverse impact on the host country. Controversies surrounding the privatization of electricity and water are a case in point (Lamech and Saeed 2003; Ugaz and Waddams Price 2003).

Given the political and sensitive nature of large privatizations, it is also important to build an appropriate institutional environment that guarantees policy consistency, coherence and efficiency. A privatization programme involving FDI presents specific problems. TNCs are legally and financially powerful private institutions. Transactions and related contracts tend to be technical in nature and involve the imposition and monitoring of numerous post-privatization obligations. Most countries that have sought FDI in this context have opted for specialized privatization agencies. This can help provide a one-stop shop for investors, facilitate the recruitment of adequate expertise, limit the possibility of buyers capturing sellers and regulators, and maintain independence from governments and vested interests in State-owned enterprises. The agency should also be accountable to parliament and adequately audited.

From the perspective of optimizing the benefits from the sale of a State-owned enterprise, pricing of the assets is critical. A major risk for a host country is that, if an enterprise is sold at a price below its “correct” (social) price, there is a loss to the budget and the economy. And, under certain conditions – for example, when equity markets are underdeveloped or economic systems are in transition – it may be difficult to price assets correctly. The possibility of undervaluation

### Box V.2. Check-list for privatizing services through FDI

#### *Economic justification for privatizing services*

- What is the underlying reason for privatization: is it symbolic (the retreat of the State), for raising funds for the budget, or for improving the cost, quality or availability of services? Only the last is a valid economic reason.
- Are the reasons for privatization clearly stated and are they realistic?
- Does the privatization authority have the information, skills and independence to negotiate effectively?
- What is the experience of other countries (at similar levels of development) in privatizing the same services? (The experience would have to be in the same services, as conditions and impacts would differ.)
- Is there only one bidder for the project or can several be attracted?
- Should the government target a strategic investor? If so, what effect will this have on the price and the bargaining power of the government?
- What conditions (performance requirements) should be set on the buyer? Given the difficulties sometimes associated with monitoring and enforcing performance requirements, should they be imposed at all? If so, what is the trade-off with the price offered?
- Has the government considered alternatives to privatization (such as management contracts or concessions)?
- Are subsidies involved? Are they justified? Are they affordable in terms of the budget? If not, can they be financed by aid or other means?
- What is the prevailing market structure before privatization? Is the industry potentially contestable and competitive?
- Are appropriate regulatory mechanisms, institutions and skills in place, if market mechanisms are insufficient to yield socially efficient prices and quality of product? If not, privatization may lead to a private monopoly with a "licence to print money".
- Do the regulatory mechanisms have provisions for subsequent expansion, upgrading and modernization?

#### *Political feasibility of privatization*

- Does privatization have broad political support?
- If there is significant opposition, is the motivation for the opponents primarily ideological, social, political or economic?
- Are there particular social sensitivities involved, for example, as regards water or the media?

- Should the government retain a "golden share" in the privatized company? If so, has the trade-off vis-à-vis economic efficiency been considered?

#### *Form of privatization*

- What form should the privatization take: asset sale, public share offering or partial sale to foreign interests?
- Which technique for selling to foreign interests is best (for example, auction, direct negotiations)?
- Should the asset be restructured before privatization to raise its price? To what extent?
- Should the privatization take place all at once or in tranches?
- Is the bidding process transparent and accountable?
- What role should foreign consultants and advisers play in the privatization process? How can their impartiality and competence be assured?

#### *Regulatory considerations*

- If the regulatory framework exists, is it consistent with the long-term contractual arrangements of the privatization?
- How are legitimate consumer interests (prices, availability, quality) taken into account?
- What is the appropriate scope of regulation in terms of prices, delivery, investment and technical efficiency?
- How will the regulatory authority be staffed and funded? What is its role in the government hierarchy or is it autonomous?
- How is the operational independence of the regulator ensured? What safeguards are in place to prevent it from being captured by large firms?
- Can competition be introduced into parts of the privatized service? If so, how?
- How is corporate governance enforced? Are minority shareholders protected? Are accounts audited in accordance with international norms?

#### *Social issues*

- How can the provision of services to remote and/or poor areas of the country best be ensured?
- Is there a social safety net for staff made redundant on efficiency grounds? Who finances and administers the safety net?
- Is there a case for seeking job protection guarantees? What would be the cost of such guarantees in terms of the price of sale or the cost of services to the consumer?
- Have environmental issues been taken into account? Who will finance safeguards, if needed?

Source: UNCTAD, based on Megginson forthcoming.

increases if the negotiating position of a host country vis-à-vis foreign investors is weak, or if a host country does not make potential investors compete through a bidding process. The economic and political setting can also influence pricing. Broadly speaking, a clear political commitment to strong rules of the game may result in higher prices.

The privatization process itself also affects the sales price. One approach is to get a large number of competitive bids from a variety of (domestic and foreign) firms and, if foreign firms are the only contenders, from well-reputed TNCs. Where the objective is to get a strategic partner with specific technological or other assets, there may be a need for a trade-off between the upfront price and other conditions.<sup>6</sup> An important institutional requirement in this context is the establishment of a competitive selection process. It is only by ensuring the participation of a maximum number of foreign investors in the bidding that a government will obtain a competitive price for its assets and secure the highest level of post-privatization commitment by the buyer. It is also important to make the rules and selection criteria clearly known in advance to potential bidders.

In some industries (such as electricity and water), the number of potential investors may be too small to secure a sufficient number of bidders. This puts governments in a weak bargaining position and lowers the chances of getting a good price. The situation is aggravated by greater perceptions of regulatory risks related to FDI in utilities in a number of countries, most significantly in Latin America (CMCG 2003). It may become necessary to find ways of encouraging an expansion of the pool of strategic investors, with special efforts to attract investors in these industries not only from Europe and the United States, but also from other developed and developing countries. One possibility might be to focus on local and regional TNCs that have appropriate technical or managerial cooperation agreements with qualified utilities or their affiliates.

The regulation of privatized services is another challenging task. While foreign investors are often attracted to assets that enjoy monopolistic or oligopolistic rents, it is in the interest of host countries to minimize those rents, for example by regulating the relevant industries. Difficult questions arising in this context relate to the degree to which a temporary monopoly can

be tolerated in exchange for the modernization of technology and equipment, what techniques should be used to circumscribe monopolies, how to decide on an adequate time frame, the sequencing of regulation and privatization and the relationship between competition authorities and sectoral regulations.

A well-designed regulatory regime, aimed at ensuring the quality, scope and availability of a given service, contributes to improvements expected from FDI, just as it contributes to improvements under local (public or private) owners. A country's ability to enforce laws and contracts and honour commitments it has entered into are perceived by investors in infrastructure to be key elements of an attractive and stable investment environment (Lamech and Saeed 2003). The transparency of the decision-making process is an associated aspect. In Colombia, for example, regulatory decisions are made public on the Internet; this, in turn, reduces corruption and leaves the door open to other interested parties such as consumer associations (Jamash 2002, p. 49).

In network industries, clear principles for tariff setting are important elements of regulatory policy. In a survey of power sector international equity investors, 65% of the respondents considered the tariff level as critical for the success or failure of their investments (*ibid.*, pp. 9-10). Inadequate policies in this area can lead to unwanted consequences,<sup>7</sup> especially when policies are affected by political opportunism and corruption. Opposition to tariff adjustments is compounded in countries where basic services have been provided at unsustainably low tariffs. Successful tariff reforms have often been gradual, with proposed changes taking place according to a reasonable time schedule. Household income surveys can also help to identify groups in a society that need special attention, as well as the levels of electricity consumption needed by such households and at affordable tariff levels.

The regulatory framework also needs to address the ability of investors to collect payment for the services they provide.<sup>8</sup> In some countries, service providers do not have the right to deny services to those who do not pay their electricity bills.<sup>9</sup> Transferring assets into the hands of foreign investors may create a stronger incentive to the provider to ensure payment, but it is not sufficient to improve discipline with payments. If FDI in utilities is to be sustainable, a solution that is acceptable to the Government, customers



and investors is needed concerning the tariff regime and enforcing the collection of payment. In this context, the situation of those who do not have the means to pay for basic services has to be addressed, for example, through social policies

and special provisions related to universal access to services (box V.3).<sup>10</sup>

In the telecom industry, regulators also have to deal with the international dimension of services such as international agreements fixing

### Box V.3. Policies to promote universal access to services in telecommunications

An important objective in any national telecom policy is to make services available to a greater proportion of the population. The problem of access is particularly acute in many developing countries, where large regions may have little or no basic telephone infrastructure. Similar situations arise also in other services, such as provision of electricity or Internet connections. The issue is important when private companies are responsible for the provision of the service, since the servicing of regions with low population densities, low purchasing power or difficult terrain tends to be unprofitable. Some of the policies that have been used by developing countries to address the question of universal provision of telecommunication services are discussed below.

*Government-managed funds for universal service.* Universal service funds can be used to subsidize a commercial provider's expansion into certain regions. The resources needed for such funds can be raised through taxes on the telecom industry (e.g. Ghana, Peru and the United States), from general tax funds (e.g. Chile and El Salvador), or from a one-time sale of resources, as occurs when a carrier is privatized (as in Guatemala) (Peha 1999). For example, Chile established a temporary fund in 1994 to extend access to rural and low-income regions through a series of auctions. Regulators selected a set of regions for universal service auctions in which operators had to bid for subsidies. Concessions are awarded to the company offering the largest reduction to the maximum allowable subsidy. State contributions are justified by the fact that the projects identified have positive social returns. As a result of this programme, about 80% of the rural population had gained access to public telephony by 2002 (Estache et al. 2002, p. 34).

It is important that universal service funds "augment market mechanisms" rather than replace them (ITU 2003). In this context, policy-makers and regulators have to make a series of choices. Should the financial resources come only from the government, or also from the private sector? If the private sector contributes, should all telecom/

IT service providers contribute, or only some of them? Who should administer the fund? Should it be a separate agency, the national telecom regulatory authority or some other entity? How should universal service projects be identified and what services should be funded?

*Rural cooperatives* can be an important source of network development. In Poland, for example, the Government mobilized the reserves of local communities through cooperatives to raise funds for building rural networks. These cooperatives operate under the equivalent of a build-operate-transfer (BOT) agreement, that would ultimately return control to the monopoly undertaking, but providing for compensation. Nearly 60% of the new main lines in rural areas were developed according to this type of arrangement (Hudson 1997; Prössdorf 1997; Kubasik 1997; Petrazinni 1995).

*"Franchising" by a monopoly undertaking* is an option applied in wireless services when local entrepreneurs buy and operate mobile phones for a village. In Bangladesh, for example, a company sells airtime at wholesale rates to a non-profit organization that helps rural women entrepreneurs establish village pay phones and obtain financing from micro-credit banks to purchase cellular handsets. A pilot programme has shown that women net an average \$2 a day or \$700 a year from the village pay-phone operations – more than twice the country's average annual per capita income (World Bank Operation Evaluation Department 2002).

*Funding consumers, not carriers.* One problem of universal service provision, once a network is built, is income-related. Households can make their own decisions about spending priorities. Vouchers for telephone services – whether they are used for prepaid calling cards or home phones – provide greater consumer choice, and they eliminate the distortion from pricing local services below cost to make them affordable. The problem is to identify the poor and the cost of implementing targeting mechanisms.

Source: UNCTAD, based on Peha 1999, World Bank Operation Evaluation Department 2002 and World Bank 2001.

the prices of international calls or international cross-subsidies. The more international the operators become, the greater the need for cross-border cooperation between regulators. However, as far as international arrangements are concerned, regulators with regional mandates are rare, the EU being an important exception. In utilities, the establishment of independent regulatory agencies helps to secure benefits from privatization. If possible, a relatively independent status helps to minimize regulatory risk and makes implementation more predictable. The regulatory authority needs to have adequate financial and human resources to protect consumer interests. Independent agencies are also often better positioned to attract qualified professionals (Krishnaswamy and Stuggins 2003, p. 10).<sup>11</sup>

At the same time, as most developing countries suffer from a shortage of adequate human resources, expertise and financial resources, it may be difficult to establish and maintain such strong regulatory agencies to oversee the generation of services, regulate networks and award concessions and licenses. One way to address scarcities in qualified personnel and limited financial resources is to establish regulatory agencies that oversee several infrastructure industries such as electricity, gas, telecommunications and transportation. Such multi-utility regulators have been set up by, e.g. Botswana, Chile, Colombia and Mexico (Samarajiva et al. 2002; World Bank 2001). International organizations can play an important role by sponsoring cooperation, training and the exchange of experience among regulators (Jamasb 2002).

A difficult issue relates to the extent to which countries should require specific commitments from investors when privatizing services. One of the most important considerations in an FDI privatization is investors' continuing engagement in a country in terms of investment, employment, etc. Some governments have specified future investment levels and even mandated contractually certain investments at specific times (see e.g. Odle 1993).<sup>12</sup> Performance requirements (or obligations) may be needed to ensure the universal provision of services to remote areas or to the poor (box V.3). There is typically a trade-off between the amount of commitments attached and the sales price of the company to be privatized. In the case of network/infrastructure industries, commitments built into

a regulatory framework may be preferable to negotiating specific performance requirements and including them in privatization covenants. Chile and Peru, for example, built detailed requirements into their electricity regulatory framework (Nestor and Mahboobi 2000).

A proper regulatory framework should be complemented by an appropriate policy to encourage competition. The only credible threat of potential competition to large TNC incumbents comes from other TNCs. In a developing-country context, foreign investors often achieve (or consolidate) a dominant position more quickly and more forcefully than in developed economies. As already noted, sometimes there are few TNCs with the expertise to compete globally. In other cases, such as the telecom market in Latin America, the development of regional hegemony in some markets may reduce the scope for competition in national markets (box II.14). In the electricity sector, for example, it has been suggested, as a rule of thumb, that no single entity should operate or control more than 20-25% of generation or distribution (Krishnaswamy and Stuggins 2003).

One way to further consumer welfare and the public interest in this context is a competitive restructuring of the relevant industry *before* privatization. In the telecom industry, undertaking privatization before introducing competition tends to affect adversely the number of mainlines created (Fink et al. 2002). The purpose of pre-privatization competitive restructuring is to introduce competition in the upstream/downstream segments through the break-up of vertically integrated firms. In the Chilean electricity industry, for example, the two main companies – Endesa and Chilectra – were broken up into seven generating and eight distribution companies, which were privatized separately (Nestor and Mahboobi 2000). In Bolivia, the Government broke up its main generation company into separate parts and sold them to different foreign investors (box V.4). Alternatively, competitive restructuring can be initiated through horizontal break-up along geographical and functional lines, as was done in Brazil with Telebras. There, the Government split the incumbent holding into three geographical markets/companies, one long-distance operator and eight cellular operators (ECLAC 2001).

The procedures for dispute settlement also have an impact on the regulatory framework

as they can help mitigate perceived levels of risks. In Bolivia, for example, a new authority was established specifically to resolve disputes between regulatory agencies and companies (Jamasp 2002, p. 46). Sometimes disputes concerning major contracts related to FDI in infrastructure services have been referred to litigation at the international level. In Argentina, in particular, a number of disputes between foreign investors and the Government have recently emerged. As of early 2004, 28 proceedings against Argentina were pending under the International Convention for Settlement of Investment Dispute (ICSID Convention). The vast majority of them were initiated in the months following the December 2001 devaluation of the Argentine peso. Most of the disputes concern

public utilities and related services (water and sewer services, electricity generation and distribution, telecommunications) or the extractive sector (oil and gas concessions).

### 3. Promotion of FDI in services

#### a. Investment promotion agencies increasingly target services

Apart from opening up to FDI and inviting foreign investors to participate in the privatization of certain services, a growing number of countries actively promote FDI in services. Effective promotion can be essential to attract high quality investors. TNCs aiming at domestic markets or buying State-owned

#### Box V.4. FDI-related privatization and electricity reform in Bolivia

Bolivia pursued an innovative approach to privatization: the “capitalization” method. Its distinguishing feature is that the sale proceeds stayed within the privatized company to finance future investment and improve efficiency. Another feature of the approach was that the Government’s 50% ownership of the shares in the privatized companies was transferred to a national pension fund.

Bolivian electricity reform involved the privatization of transmission and distribution, while public-private co-ownership through capitalization was chosen for the generation segment. To encourage competition, the generation capacity of the State utility, ENDE, was split into three separate companies and the assets were capitalized in 1995. Strategic foreign investors (Dominion Energy, Constellation Energy, GPU International – all based in the United States) invested approximately \$1.6 billion. This capital was earmarked for modernization and further efficiency improvements of the industry. The management of the companies was transferred to the private investors. Another important element of the Bolivian strategy was the establishment of an independent but accountable regulator. This helped improve the coverage, quality and productivity of electricity. Moreover, allowing the electricity generating TNCs to compete kept the wholesale price of electricity down.

The Bolivian model of privatization appears to have generated a number of positive effects.

Fiscal revenues from the power sector (sales and profit taxes) increased from \$17 million in 1994 to approximately \$42 million in 1997, and the servicing of ENDE’s debt of approximately \$61 million was transferred to the private companies. FDI in the electricity industry rose from \$2.2 million in 1995 to a peak of \$51.9 million in 1998. Subsequently, however, it fell to \$1.4 million in 2001, following the completion of the capitalization process. Moreover, competition among the four post-reform generating companies caused the spot price of electricity to fall by 22% between 1996 and 2000, and consumers gained better access to the power companies through new consumer offices to resolve grievances. While the average consumption price has increased somewhat (ranging from \$5.55-\$6.67 per kWh in 1994 to \$5.82-\$7.88 in 2001) ([www.superele.gov.bo](http://www.superele.gov.bo)), electricity coverage has improved: by 2001, urban electrification had reached 78% and rural electrification had grown from 11.8% in 1992 to 25.5 % ([www.ine.gov.bo](http://www.ine.gov.bo)).

In order to promote rural electrification, the Bolivian Electricity Law encourages distribution utilities to expand coverage by allowing for the inclusion of the immediate 100 meters surrounding the lines to companies’ concession areas. In addition, the proceeds from the award of concessions to distribution utilities are used for expanding the electrification of rural areas.

Source: UNCTAD, based on Jamasp 2002 and World Bank 2000, 2003b.

utilities may not need persuasion to enter, but they may lack information on economic and other conditions in the host country. Those aiming at export markets have more locations to choose from and are therefore particularly demanding. Effective FDI promotion requires a capacity to assess national strengths, global investment trends and the strategies of potential investors – and then match all three. They should be able to target activities, countries and investors and gear their promotion to these, rather than mount diffuse publicity campaigns.<sup>13</sup> Successful investment promotion involves not just selling the existing advantages of a country but also *creating* new advantages.<sup>14</sup>

What are investment promotion agencies (IPAs) targeting in the area of services? In a survey conducted by UNCTAD in January-April 2004, 61 national IPAs responded to this question. All respondents reported that they target FDI in some industry and/or activity, but prime attention was given to services that can help generate export revenues. The service *industries* that are most often targeted by IPAs are computer and related services, tourism, and hotels and restaurants. The least common service industries targeted are retail and wholesale trade, water and insurance (table V.1). However, there are notable regional differences. IPAs in developed countries and in CEE most often target FDI in computer services, but a few of them target FDI in tourism. Conversely, almost 80% of all IPAs in Africa and

Latin America target tourism-related FDI. In Asia and the Pacific, greater importance is given to FDI in transport and water services than by IPAs elsewhere.

The increased tradability of services (chapter IV) makes it possible for companies in all sectors to relocate various service *functions* abroad. In order to assess the extent to which investment promotion activities reflect the new opportunities in this area, IPAs were asked whether they target certain corporate service functions. Indeed, IT and call centre services are the most sought-after service functions in all regions (table V.2). For example, more than half of all IPAs in Africa are already actively seeking FDI in these areas. In developed countries and CEE, R&D activities, call centres, shared service centres and regional headquarters functions are also targeted by at least 50% of the IPAs. In contrast, less than 20% of the IPAs in developing countries seek to attract FDI in R&D.

The general principles for promoting services FDI are similar to those in manufacturing.<sup>15</sup> However, some services are a relatively new to FDI promotion. IPAs have therefore to learn their particular characteristics, corporate strategies, intellectual property implications, value chain organization and market leaders, to be effective. Moreover, while it may be relatively easy to identify the target companies in service industries, targeting service functions that can be offshored by firms from all sectors

**Table V.1. Service industries targeted by IPAs, 2004**  
(Per cent; number of responses)

Service industry	All countries	Developed countries	CEE	Developing countries	Africa	Latin America	Asia-Pacific
Computer and related services	72	100	80	65	58	62	82
Hotels and restaurants	57	13	50	67	63	77	64
Tourism	57	25	30	70	79	77	45
Transport	39	25	40	42	42	23	64
Energy	34	25	20	40	58	23	27
Health and social services	30	25	-	37	47	15	45
Other business services	28	38	60	19	11	15	36
Banking	26	25	20	28	42	8	27
Construction	26	-	10	35	42	31	27
Education	26	25	10	30	42	8	36
Real estate	20	13	30	19	26	15	9
Water	18	-	10	23	32	15	18
Wholesale trade	16	13	20	16	16	-	36
Insurance	15	13	-	19	26	8	18
Retail trade	13	-	10	16	16	8	27
Others	30	25	20	33	26	38	36
<i>No. of responses</i>	61	8	10	43	19	13	11

Source: UNCTAD survey of IPAs, conducted January-April 2004.

**Table V.2. Services functions targeted by IPAs, 2004**  
(Percentage; number of responses)

Service function	All countries	Developed countries	CEE	Developing countries	Africa	Latin America	Asia-Pacific
IT services	75	100	80	70	63	77	73
Call centers	61	75	70	56	53	62	55
Shared services centers	43	63	60	35	26	38	45
Regional headquarters	38	63	50	30	21	38	36
R&D	33	75	60	19	26	8	18
Offshore banking	15	-	-	21	26	23	9
Others	21	25	30	19	26	8	18
<i>No. of responses</i>	<i>61</i>	<i>8</i>	<i>8</i>	<i>43</i>	<i>19</i>	<i>13</i>	<i>11</i>

Source: UNCTAD survey of IPAs conducted January-April 2004.

is a real challenge. UNCTAD's survey of IPAs showed that various tools are used to promote FDI in services. General promotion (e.g. missions, seminars, websites) and tax incentives are widely applied through the range of services. For export-oriented FDI related to tourism, call centres (see box V.5 for an example), computer-related services, health and social services, regional headquarters and R&D and different forms of free zone incentives (free trade zone, export processing zone, free economic zone) are used. A few IPAs also mentioned direct grants.

As with attracting FDI into other sectors, a generally favourable investment climate is important. This implies a welcoming regime for private investors, stable and transparent policies, competitive tax rates and low transaction costs (*WIR02*, Part III). Attracting export-oriented FDI generally requires a higher quality of relevant production factors. In services, locational determinants may be related to a more narrow range of factors than in manufacturing.<sup>16</sup> In particular, skill and infrastructure must meet the needs of TNCs and match those offered by competing locations. Countries seeking to attract high value services FDI such as R&D, architectural design, medical testing or regional headquarters functions have to match carefully their locational assets with the specific needs and strategies of investors. (Boxes V.6 and V.7 explain the strategies of Singapore and the Republic of Korea, respectively, in attracting headquarters and other high-value-added service functions.)

An important area of investment promotion that generally remains poorly developed is after-care services. This promotional activity may be particularly relevant in the

context of the offshoring of services. As many as 40% of the largest European TNCs stated that factors beyond pure benchmarking affect their offshoring decisions, including internal lobbying by their own foreign affiliates (UNCTAD and RBSC 2004). Many foreign investors feel that IPAs focus on attracting new investors, but not enough on taking care of existing ones (IBM and Oxford Intelligence 2004).

Having discussed the need for an appropriate investment environment, the following sections focus on the role of incentives, export processing zones, infrastructure and skills development and, finally, the protection of data and intellectual property rights, in promoting locations for FDI in services.

### **b. The role of incentives**

As part of their investment promotion efforts, many countries use various fiscal, financial and other incentives to attract foreign investors,<sup>17</sup> in manufacturing, and increasingly so in services. A recent analysis of WTO Trade Policy Reviews showed that both developed and developing countries apply a wide range of subsidies to either attract (or retain) the production of services or to influence the behaviour of companies in certain industries (WTO 2004b).<sup>18</sup>

Subsidies are used in the whole range of service industries, but are most common in tourism, transport and financial services. Many WTO members also provide subsidies in the telecom industry, often in the form of grants to fulfil universal service obligations. A significant number of members allow duty-free inputs and provide subsidies linked to special zones of

various kinds (table V.3). Tax incentives are more common than direct grants, but there are certain differences between countries at different levels of development: developed countries rely more on direct grants than on tax incentives, and they rarely allow duty-free inputs and free zone incentives.

Incentives in service industries are provided for various purposes. They are often

granted to induce domestic or foreign investment into service industries that are important for boosting systemic competitiveness and economic growth, such as infrastructure or other strategic industries. For example, in Sri Lanka, income tax holidays for 5-10 years are offered for pioneering investments in energy, transportation and water services; the Thai Board of Investment grants import-duty exemptions on certain machinery and an 8-year tax holiday to industries

#### **Box V.5. New Brunswick: an early mover in attracting call centres**

The Canadian province of New Brunswick has attracted customer contact centres since the beginning of the 1990s. Aliant Inc., the regional telecom provider, was an early investor in fibre-optics and digital switching technologies. Aliant's early entrance was driven by the need to create network-based solutions for distributed centres. It succeeded in rapid implementation of an advanced province-wide telecom infrastructure. This infrastructure, together with the province's business investment strategy, a skilled labour force, the province's bilingualism, proximity to the United States, political stability and a favourable currency exchange rate, were identified as location assets by the local government.

The development strategy was, and remains, successful. By 2004, more than 100 contact centres had been established in New Brunswick, employing an estimated 18,000 workers, equivalent to 4.6% of the provincial labour force. Initially, the investors were mainly of Canadian origin, although companies from the United States were subsequently targeted. Fibre-optic backbone connections to major United States telecom networks made possible a seamless integration of New Brunswick operations for international companies.

During the 1990s, educational initiatives were sought to support the industry. Computer literacy became mandatory for high school graduates, and both public and private institutions began to offer contact centre and IT training programmes. This training has evolved to include technical assistance/helpdesk operations as well as business-to-business sales, applications development and sophisticated customer service courses. Diversification into other back-office functions such as accounts receivables, human resource management and accounts management has also occurred, and the workforce continues to be trained in the skills and

technologies required to handle effectively skilled transactional work.

Career websites, electronic job fairs, toll-free numbers and electronic databases have been established to gather information on people with the skills and interests to work in the industry. There have also been efforts to draw on non-traditional labour pools, such as students, disabled persons and seniors, made possible in part by a targeted wage/training subsidy programme. Finally, so-called "virtual contact centres" – where people can work from smaller satellite operations or from home – have been tested and are operating in the province.

The provincial government continues to support the contact centre strategy as part of its "Prosperity Plan", while other partners have also become more visible. Partnerships with local economic development agencies, federal and municipal governments, chambers of commerce, industry organizations and educational facilities are now in place. An industry association shares best practices and addresses broader concerns such as quality standards, industry image and training to ensure a continued supply of qualified workers.

The customer contact centre industry remains a growing facet of the New Brunswick economy. From its early start in traditional telemarketing, the industry has grown to include web-based customer care (e-government) and advanced training technologies (e-learning) – the fastest growing subclusters of the province's knowledge industry. The industry now encompasses companies providing Internet solutions (e-business); software development; systems integration and support services; and consulting services, including knowledge-based services, engineering, environmental, architectural, ocean technologies and remote monitoring services.

*Source:* UNCTAD, based on information provided by Business New Brunswick.

### Box V.6. Singapore: going for headquarters

The Economic Development Board (EDB) seeks to establish Singapore as a premier international hub for all types of headquarters (HQs) – big and small, from all industries and geographic regions. Its goal is to attract 500 world-class regional and international HQs by 2010 that will receive the prestigious EDB HQ award.

The HQ Programme started in 1986 with the launch of the Operational Headquarters Programme award to firms that provide management and other HQ-related services to foreign affiliates or related companies in other countries. The Programme has evolved over time to include the Business Headquarters Programme, Manufacturing Headquarters Programme and Global Headquarters Programme awards.

In January 2003, the HQ Programme was streamlined and enhanced. A new scheme, the Regional Headquarters award, was introduced for companies conducting exploratory forays into the Asia-Pacific using Singapore as a base. Companies under this scheme enjoy a preferential tax rate of 15% for a period of three years if they meet certain investment and operational commitments. In this case, the EDB leverages external partners, such as the accounting, legal and business associations based in Singapore, to take the lead in promoting the award.

In parallel, EDB announced that it would be stepping up its initiatives to promote companies in areas such as lifestyle, retail and hospitality, and international business-related organizations and foundations, to create an HQ “eco-system” of small, medium and large HQs from all over the world, collectively building depth and diversity into economic activity in Singapore. By end-2003, around 280 companies had been granted HQ status.

*Source:* UNCTAD, based on information provided by the EDB.

EDB estimates that over 4,000 of the 7,000 TNCs in Singapore have some form of regional mandate.

In its budget for 2004, the Government announced enhancements to the Regional HQ Award. Effective from February 2004, the maximum number of years for the Award was increased from 3 to 5 years and it was opened up to all companies in Singapore.

HQs established under the Programme represent various industries, most of which concern electronics and precision engineering and various services (box table V.6.1). In terms of home countries, 38% of the HQs are controlled from North America, 33% from Europe and 29% from Asia, New Zealand or Australia. According to the EDB, the HQ Award has helped create 1,600 new high-skilled jobs and the value added is estimated at about \$600 million. In 2003, TNCs attracted under the scheme included NEC, Seagate, Scandent Group and Tata Consultancy Services.

**Box table V.6.1. Industry breakdown of the Singapore EDB cluster HQs, January 2004**  
(Per cent)

Industry	Share
Electronics and precision engineering	22
Services <sup>a</sup>	20
Chemicals	19
Infocomms and media	19
Logistics and transport	15
Biomedical sciences	5
Total	100

*Source:* EDB.

<sup>a</sup> The services cluster encompasses HQs from emerging areas such as professional services, retail and hospitality, as well as established areas such as education and environmental engineering services.

that include high-skill services; the Government of Morocco exempts offshore banks from various duties and taxes; and the Australian film production industry received government support in several ways, including grants for post-production and low-budget production funding.

Subsidies are sometimes used to promote the universal provision of services or regional development. In Bulgaria, Canada, Chile, El Salvador, Namibia, the United States and Venezuela, they are granted to infrastructure

industries (e.g. transportation, energy, telecommunication). In Chile, the Fund for the Promotion and Development of Remote Areas aims at the development of various provinces in Chile's extreme north and south by providing assistance to SMEs investing there.<sup>19</sup>

Many countries use incentives to encourage production that generates export revenues (e.g. tourism, ship repair services, software development, call centres) (box V.8 presents the example of the Gambia). In

Mauritius, the Government, under its ICT scheme, offers a tax holiday until 2008 and a 15% corporate tax thereafter; companies investing in call centre and back-office services can opt for a uniform corporate tax rate of 5%. In addition, the Government provides for duty-free imports of specified equipment, accelerated depreciation for ICT equipment, electricity tariffs at competitive rates, a 50% reduction in personal income tax for foreign IT specialists and fast-track processing of work visas and residence permits for expatriates.<sup>20</sup> Similar schemes are found in many other locations. For instance, in Croatia an amount of approximately \$2,100 is granted for each new employee recruited;

Shanghai (China) and Singapore use tax incentives to attract regional headquarters; in Malaysia, the Multimedia Super Corridor's incentives seek to attract call centres and regional headquarters; and Ghana offers call centre companies a corporate tax holiday for ten years and a maximum rate of 8% corporate tax plus duty-free imports.

In order to increase the effectiveness of incentives offered to export-oriented FDI in services, the forms of financial assistance may have to be different from those used to attract investment in manufacturing. In the Czech Republic, for example, the IPA found that the

### Box V.7. The Republic of Korea: a regional business services hub for North-East Asia?

The economic success of the Republic of Korea has traditionally been linked to manufacturing. To face growing competition from countries offering lower costs, the Government is searching for new sources of growth. On the one hand, it pursues technological upgrading (implying higher value added and knowledge-intensity) of current manufacturing industries. On the other, more attention is being given to service industries. One area in which the Government seeks to attract FDI is business services, as the country aims to become a regional business services hub for North-East Asia.

In 2002, it was decided to develop the Republic of Korea as a regional logistics centre and business hub for high-value-added services (headquarters functions, trade, finance, IT, design, R&D, leisure and tourism). The plan is to develop three free economic zones around the Incheon international airport and the Busan and Gwangyang ports. These zones will be provided with state-of-the-art infrastructure (bridges, highways, railroads, ports, utilities, communications, IT) and an advanced business environment. Benefits include:

- *New tax incentives:* income and corporate tax exemptions for the first three years and 50% reduction for the two subsequent years; a flat 17% income tax rate for CEOs and other employees of foreign companies; import-tariff exemptions on capital goods for three years; and acquisition, registration, property and aggregate land-tax exemptions for the first three years and 50% reduction for the two subsequent years.

- *Financial support:* exemption or reduction of public land fees; and preferential assistance in the construction of infrastructure.
- *Deregulation:* minimal application of land-use regulations governing factory construction and enlargement applicable to the Greater Seoul Area; lifting of restrictions on businesses reserved for SMEs; and streamlining of 34 different types of permission related to construction activities.
- *More flexible labour market regulations:* unpaid weekly and monthly leaves; exemption from obligatory employment of veterans, the disabled and the elderly; and permission for outsourcing of highly skilled and professional work.
- *Administrative support:* one-stop services for 30 administrative areas; Foreign Investment Ombudsman Office established; port-to-port service managers assigned to foreign investors.

The Government also aims at improving the living environment for foreigners. In the free economic zones, there will be more green areas and recreation facilities, guaranteed allotment of housing, use of English in government services, permission to pay in foreign currency up to a limit of \$10,000 and establishment of world-class foreign schools, hospitals and pharmacies. The ratio of cable network foreign broadcasting retransmission channels will be expanded from the current 10% to 20%. The Government hopes that the business-friendly environment created in the zones will eventually spread to the rest of the country.

*Source:* UNCTAD, based on information from the Government of the Republic of Korea.



**Table V.3. Subsidies used in different service industries**  
(Number of WTO members)

Industry	Tax incentives	Direct grants	Preferential credit & guarantees	Equity injections	Duty-free inputs & free zones	Other & unspecified measures	Number of WTO members (counting the EU as one)
Tourism	41(2)	12(4)	15(2)	2(-)	30(-)	11(1)	63(6)
Banking	13(2)	4(1)	6(1)	9(1)	10(-)	6(-)	33(4)
Maritime transport	10(4)	6(1)	3(1)	-	9(-)	6(3)	25(4)
Transport, general or unspecified	9(1)	8(4)	2(-)	-	5(-)	7(-)	24(4)
Telecoms	3(-)	10(3)	1(-)	-	5(-)	4(-)	18(3)
Other financial services	9(3)	1(1)	3(1)	2(-)	9(-)	-	17(2)
Software, ICT and information processing	9(2)	3(2)	1(-)	-	8(-)	2(-)	15(2)
Construction	11(1)	3(2)	2(-)	-	4(-)	-	15(2)
Air transport	7(-)	2(2)	1(-)	1(-)	4(-)	5(4)	14(4)
Rail transport	4(1)	6(1)	-	-	-	6(1)	13(3)
Energy	7(1)	2(1)	-	-	1(-)	7(1)	14(2)
Recreation, culture & sports	7(1)	4(3)	1(-)	-	5(1)	-	12(4)
Audiovisual services	5(1)	6(4)	-	-	3(-)	-	11(4)
Wholesale & retail trade, distribution	6(1)	1(1)	1(-)	-	6(-)	-	11(1)
Real estate	3(3)	1(1)	1(-)	-	1(-)	-	5(3)
Other & unspecified sectors	11(1)	4(2)	5(1)	1(1)	12(-)	6(-)	28(3)
No. of subsidy programmes	165(24)	74(33)	44(6)	15(2)	112(1)	60(10)	..

Source: UNCTAD, based on WTO 2004b.

Note: The table includes subsidy programmes that are envisaged. Figures inside parenthesis indicate the number of developed countries.

existing incentive scheme in 2000 was ill adapted to the needs of services investors. It had been designed principally for investment in manufacturing and, given the relatively high dependence of fixed capital investment in manufacturing, it was inappropriate for business-support services. As a consequence, and as part of a broader programme to attract such services and technology centres, a new scheme was

initiated, which focused on human (rather than physical) capital. Investors who qualify can now receive a subsidy of up to 50% of eligible business expenses (i.e. wage or capital expenditures on tangible and intangible assets), along with a subsidy covering 35% of special training (i.e. skills that are not readily transferable from investors' projects) and 60% of general training (table V.4).

#### Box V.8. Investment subsidies in the Gambia

Under the Investment Promotion Act of Gambia, various tax incentives are available to encourage investment in priority industries and activities. These include tourism, transportation, energy, financial services, skills development, health services and IT services. Investment has to be undertaken by a company or partnership registered under Gambian law, and the investment must amount to at least \$100,000.

In awarding investment incentives, an investment's contribution to the following objectives are considered:

- generation of foreign-exchange through exports or import substitution;
- use of local materials, suppliers and services;
- creation of employment opportunities;

- introduction of advanced technology, or upgrading of indigenous technology;
- contribution to locally or regionally balanced socioeconomic development.

Free zone incentives are available to services such as packaging, labelling, warehousing, transportation, energy, telecommunications, financial services, information technology and health services. To benefit from free zone incentives, an investment must generate employment and include the training of nationals. Moreover, a substantial portion of output (currently 70%) must be exported. The incentives provided to free zone investors take the form of tax and duty concessions or exemptions.

Source: WTO 2004b.

**Table V.4. Specific conditions of the Czech incentives scheme for business-support services and technology centres, 2004**

Condition	Type of project	
	Technology centres, headquarters, software development centres, expert solution centres	Call centres, high-tech repair centres, shared service centres
Minimum investment	CZK15 million (€0.5 million)	CZK30 million (€1 million)
Minimum number of new jobs	15	50
Amount recipient must finance with own resources	CZK7.5 million (€0.25 million)	CZK15 million (€0.5 million)
Linkage with production (relevant for technology centres only)	The technology centre's work should link up with production	

*General conditions: minimum 50% of the earnings must be realized abroad; investment and jobs must be sustained for 5 years; project must be environmentally friendly.*

Source: UNCTAD, based on information from CzechInvest.

Few studies have been undertaken to analyse the impact of incentives on FDI in services. Studies of their use in manufacturing suggest that the effectiveness of incentive programmes depends on the market orientation of the foreign investor (*WIR03*). Whereas incentives tend to have little or no impact on the location decisions of firms oriented towards producing for the domestic market, they can influence those aiming at export-oriented investment. Technological developments have expanded the possibilities for attracting outward-oriented services FDI as illustrated by offshoring of services. Behavioural incentives, i.e. incentives that are linked to some kind of performance requirement, are more likely to affect both market-seeking and efficiency-seeking FDI. In general, the effectiveness of incentives depends on the ability of a host economy to provide matching human resources, technology and production inputs (*WIR03*; UNCTAD 2003h).

As in the case of manufacturing, there is risk of a “race to the top” in the use of incentives, especially for export-oriented FDI. The risk is accentuated by the footloose nature of many export-oriented services projects – if one country offers financial assistance, others may feel obliged to do the same. The experience of India shows that there can also be intense incentive-based competition within a country (Kumar 2001a). Excessive use of incentives is likely to be particularly difficult for developing countries to sustain, and resources that could have been used more productively may be diverted. The inherent “prisoner’s dilemma” in incentive-based competition is a classic case for international cooperation. However, whereas the WTO

Agreement on Subsidies and Countervailing Measures (SCM Agreement) prohibits the use of export subsidies in the goods area, there are no similar restrictions at the multilateral level in services (box VI.4).

### *c. EPZs in developing countries see potential in services*<sup>21</sup>

Export processing zones (EPZs) have traditionally been used to attract FDI in the export-oriented production of goods. Manufacturing activities carried out in EPZs were originally largely limited to garments and the assembly of electronic components. The services activities involved were mostly warehousing and trade facilitation. Information from EPZ authorities suggests that services are now gaining in importance. More than 90 of the 116 countries with EPZs covered by the ILO’s database promote a range of service activities (annex table V.1), with India (table V.5) and Kenya (box V.9) being good examples.

The types of services located in EPZs have expanded rapidly, from commercial services and simple data entry to call centres, medical diagnoses, architectural, business, engineering and financial services. A regional breakdown of services shows that most EPZs with service industries are located in developing countries (table V.6). There are some EPZs in developed countries, but these tend to be of a different nature, resembling industrial and/or technology parks and customs warehouses.

In India, many of the offshored services have been attracted to various dedicated

**Table V.5. Types of service activities attracted by an EPZ in India, 2004**

Advertising & marketing	Leasing services
Architecture & interior design	Legal & licensing
Brokers/commission agents	Logistic services
Buying & sourcing agents services	Marketing/distribution agents & services
Catering services	Media, entertainment & related
Clearing & forwarding	Medical & Healthcare
Communication	Miscellaneous
Computers, software & Internet	Photography
Consultancy	Plantation management
Content providers	Printing & packaging
Courier	Production & distribution
Education & training	Public relations
Energy/power	Real estate & construction
Environmental/pollution control	Recruitment & manpower
Events management services	Redundant & surplus stock marketing
Extraction & mining	Refining
Fabrication & designing	Repair & maintenance
Farming services	Research & development
Financial & banking	Safety & security
Fishery services	Shipping, air, cargo & railways
Hospitality	Tailoring
Immigration	Tours & travel
Import/export	Trade promotion
Industrial processes	Translation
Information directory	Transporters, packers, movers
Inspection & testing	Warehousing
Installation & de-installation	Waste management
Insurance	

Source: UNCTAD, based on [www.indiatradezone.com](http://www.indiatradezone.com).

technology parks for IT services that were set up by individual states. The first software technology parks were established in 1990 in Bangalore, Pune and Bhubaneswar, and another four were set up in 1991. In some cases, the private sector engaged directly in the development of technology parks.<sup>22</sup> As of 2003, there were 39 such parks with about 7,000 units registered. In 2002/03, these parks accounted for 80% of all software exports from India. In addition to providing modern computers and communication technologies, they offer such incentives as approvals under a “single window clearance” mechanism; permission for 100% foreign ownership; five-year tax holiday with no value addition norms; duty free imports; and permission to subcontract software development activity (India, Department of Information Technology 2004).

Another example is Mauritius, which is seeking to position the country as a location for FDI in offshoring. To this end, it has initiated the “Cyber City” project to attract call centres, back-office services and programming especially to serve francophone Africa, France and parts of Canada. It aims to make Cyber City a state-

of-the-art technology park with office buildings and a world-class telecom network. An important feature is its computing-on-demand facilities that can accommodate back-up centres for disaster recovery services, where the data can be stored and call centres can respond on demand.<sup>23</sup> The Government of Dubai adopted a similar strategy in the 1990s, creating an Internet City to become a hub for regional headquarters.<sup>24</sup> In Jamaica, the transformation of manufacturing free-zones into “teleports” has successfully attracted considerable offshored services (box V.10).

EPZs seeking to attract services generally advertise the availability of high-quality telecommunications, a stable power supply and well developed technology support infrastructure. In addition, they offer a range of incentives such as 100% exemption of import duties and general sales tax, full repatriation of earnings and preferential customs clearance. From the information published by zone authorities, the availability of a highly skilled workforce is considered an important determinant of investment in services. Many of them advertise an educated workforce and some offer joint training. Some even provide details on the actual level of education of workers, including details on the types of degrees obtained, number of graduates, and number of universities and training institutes in the vicinity and enrolment therein. Various zone authorities also emphasize the linguistic capabilities of their workforce. This emphasis on the availability of knowledge workers differs from what the more traditional assembly EPZs emphasize, such as the availability of low-wage, low- or semi-skilled workers.

**Table V.6. Regional distribution of EPZs targeting services, 2004**

(Number)

Region	No. of countries with EPZs for services
European Union	5
Other developed countries	1
Africa	20
Latin America and the Caribbean	26
Asia and the Pacific	26
Central and Eastern Europe	13
Total	91

Source: ILO, [www.ilo.org/epz](http://www.ilo.org/epz).

### d. Infrastructure and skills development

As noted in chapter IV, adequate infrastructure and appropriate skills are important determinants in firms' decisions on where to invest in export-oriented service production. Of course, the appropriate infrastructure for services such as telecoms, power generation and distribution, financial services and distribution/logistics services are essential, not only for creating an environment conducive to IT-enabled

services, but for the conduct of business activities in general. From the perspective of attracting FDI, the importance of the type of infrastructure varies,<sup>25</sup> but for most types of IT-enabled services, the role of telecommunications deserves special attention.

Competitive telecom services are the backbone of the new services economy, and they are also a requirement for attracting IT-enabled services production for exports. No country can hope to succeed in this area without a high

#### Box V.9. Services sought by Kenya's EPZs

Kenya's EPZs target various export-oriented service ventures, such as back-office operations, software development and other IT services, printing services, transport and logistical services and audio-visual services related to sound recording, TV transmission and motion pictures. A number of professional and educational services are also promoted. The Kenya EPZ Authority has been targeting these export services since 1993, three years after the enactment of the EPZ Act. Companies in a range of industries have invested in the EPZs (box table V.9.1).

In order to attract investment in such services, EPZ exporters are offered a high quality zone infrastructure in the form of office buildings, serviced land and common services. They also enjoy attractive fiscal and regulatory incentives established under EPZ Act:

##### *Fiscal incentives:*

- 10-year corporate tax holiday and 25% income tax thereafter

- 10-year withholding tax holiday on dividends
- Duty and value-added tax (VAT) exemption on raw materials, machinery and other inputs
- Stamp duty exemption
- 100% investment deduction on capital expenditure within 20 years.

##### *Procedural incentives:*

- Rapid project approval and essentially one licence
- No minimum investment level and unrestricted investment by foreigners
- Access to offshore borrowing
- No exchange controls
- Autonomous control of investment proceeds
- Exemption from the Industrial Registration Act, Factories Act, Statistics Act, Trade Licensing Act, Imports, Exports and Essential Supplies Act
- Work permits for senior expatriate staff
- On-site customs documentation and inspection
- One-stop-shop service by the EPZ Authority for facilitation and aftercare.

**Box table V.9.1. Selected companies engaged in EPZ export services, April 2004**

Company	Service activity	Country of origin
Logistic container centre Ltd	Repair of containers	Denmark
Al-borj (Kenya) Ltd	Brokerage, training and after-sales services for garments	Pakistan
Hong Kong Garments Ltd	Brokerage services for garments	India
Shipmark Ltd	Brokerage and ship management, repair and operation of marine vessels	Denmark/United Kingdom
Film Studios Ltd	Film production services	Kenya
Bluesky Films Ltd	Film production services	Croatia/Kenya
Pontact Productions Ltd	Film production services	Kenya/Netherlands
Kencall Ltd	Call centre services	Kenya/United Kingdom
Tibbet & Britten Ltd	Warehousing	United Kingdom/ Kenya
Kenya Marine Contractors Ltd		United Kingdom/ Kenya / Denmark

*Source:* UNCTAD, based on information provided by Export Processing Zones Authority, Kenya.

quality and efficient telecom system, but once it is in place, many opportunities are created (box V.11). The transmission of voice-based data is

particularly demanding in terms of bandwidth and instantaneous transfer. Ensuring competitive telecommunications and Internet access typically

#### Box V.10. Jamaica's teleports

Between 1998 and 2003, Jamaica successfully took advantage of the accelerating pace of offshoring from the United States. In so doing, it has become a leading Caribbean recipient of FDI in the fast-growing offshoring of services. An important factor in this process has been the conversion of the country's manufacturing EPZs into modern teleports: corporate parks wired with fibre-optics and satellite technology.

Currently, Government-owned and private EPZs house 15 communication-based companies providing 5,000 jobs. Office space built or reallocated to facilitate helpdesks, debt collection and travel reservations, along with software development and back-office processing primarily from the United States, grew by an average of 30% a year, from 89,000 sq.ft. in 1998 to 210,000 sq.ft. in 2003.

This rapid success is the result of a strategy that began in the late 1980s. In an attempt to develop Jamaica's service industries, the Government created the Jamaica Digiport in conjunction with telecom companies (Cable & Wireless and AT&T) to provide satellite-based telecommunications primarily for the fledgling data-processing industry. As the offshoring of services increased in sophistication, Jamaica's Investment Promotions Agency ([www.investjamaica.com](http://www.investjamaica.com)) developed a targeting programme based on:

- competitively priced EPZ space (originally created for the apparel industry);
- competitive telecommunications with fibre-optic capacity supported by satellite capability;
- an ample supply of highly literate English-speaking people;
- a human resource development programme to support the types of companies being targeted
- targeted tax and duty incentives; and
- proximity to the eastern part of the United States.

These locational advantages have attracted many companies, resulting in positive impacts for the Jamaican economy. Today, Jamaica has five main corporate zones: the Cazoumar, Garmex, Kingston and Montego Bay EPZs and the

Portmore Informatics Park. IT office space in all zones is almost at full capacity. This has prompted the Government to create a "single entity" EPZ legislation to provide the same benefits to stand-alone and independently owned facilities. The legislation, coupled with high-capacity telecoms becoming accessible island-wide, has set the stage for more broad-based development, and is opening up possibilities for a new wave of wired zones.

Efforts to attract and upgrade offshored services involve various initiatives to ensure the needed human resources for the full gambit of IT-enabled industries. A number of government and private institutions are involved:

- HEART NTA is a government organization that focuses on the training and certification of students in customer service skills. It also partners with Cisco and Microsoft to provide training courses.
- The Caribbean Institute of Technology created in 1998 focuses on providing certification and diplomas in web-based software languages, software design and development and web design and programming. The curriculum and certification is also offered at eight satellite colleges on the island.
- The University of the West Indies, which provides degree courses in IT, has produced 1,741 graduates in computer programming since 2001, and the University of Technology and Northern Caribbean Universities also provide degree courses in IT.

Jamaica has recognized the need to ensure that the IT industry develops local capacity with the potential to export services. An incubator facility to support the development of technology-related companies was established by the University of Technology in 1999. The Technology Innovation Centre currently houses 32 IT-focused clients. Various technology funds are available to qualified clients, including a 140-million Jamaican dollar fund administered by the National Export-Import Bank and a Young Entrepreneurial Scheme administered by the Innovation Centre. The University of the West Indies has also established a science park and has funded Mona Infomatics, an IT company that currently provides services to Boeing and several other aerospace companies.

Source: UNCTAD, based on information provided by Jamaica Promotions Corporation.

requires liberalization and a regulatory framework that spurs competition among service providers. In mobile telephony, the bargaining position of governments vis-à-vis potential investors is better than in fixed-line services: through licensing/bidding for licences, governments can negotiate more competitive arrangements with foreign operators who typically undertake greenfield investment.

There are many examples showing the importance of competitive telecoms. In India, while the domestic telecom infrastructure is still weak in many parts of the country, the supply of lines in key locations has greatly improved. Various policy reforms since 1994 – when the National Telecom Policy took the first major steps to open up the industry to competition – have contributed to a rapid expansion of the telecom network. Except for the cellular mobile phone segment, there are no restrictions on the number of telecom operators. In international, long-distance and local services, unrestricted competition is now allowed, and fibre-optic links connect the country to major external markets. Private sector investment has helped bridge the resource gap to a considerable extent (India, Department of Telecommunications 2003).<sup>26</sup> In the Philippines, expansion of the multimedia infrastructure and reregulation of

telecommunications have led to better services, more stable and reliable fibre-optic links as well as a 70% drop in the costs of bandwidth over the past four years. There are currently nine major players in the Filipino industry and there is full competition in all segments of the telecom services market.<sup>27</sup> Good and low-cost telecommunications suited to data and voice transmission have been an important factor in the location of shared service centres in Chile. The industry was privatized and liberalized in the 1980s, and the telephone network was digitalized in the 1990s.<sup>28</sup>

To attract offshored services, international connections are a vital element of the telecoms infrastructure. In the case of India, Mumbai and the southern states – which have been the most successful in attracting offshored services – had an early advantage of being in close proximity of the landings of two submarine fibre-optic cables.<sup>29</sup> Fibre-optics are generally cheaper and more efficient than satellite links. Whereas there is a range of cables between the main markets, many developing countries remain delinked from such international networks, which limits their ability to develop competitive bases for services exports. (Figure V.3 shows the global network of interregional submarine fibre-optic cables as of 2004). Whereas the United States, Europe and East and South-East Asia are well supplied in terms of cable capacity, only one major cable connects parts of Africa to the rest of the world – the SAT-3 cable. In sub-Saharan Africa, for example, Angola, Benin, Cameroon, Gabon, Ghana, Côte d'Ivoire, Mauritius, Nigeria, Senegal and South Africa are directly linked to this cable.

Skills development is another key policy area. The knowledge-intensity of services production places basic education and skills development at the centre of the policy challenge to attract FDI and to extend the benefits of IT-enabled services more broadly throughout the economy. The types of skills required differ by the kind of service. Most offshored services essentially process information of various kinds. Some of the skills needed are general in nature, whereas others are specific to the activity being undertaken. Host countries have to ensure that the skills base is adequate to the services being promoted.

India's software export performance is partly a reflection of its large pool of English-speaking and technically trained manpower, the

#### **Box V.11. Digital networks in Ireland: a locational advantage**

About two decades ago, the phone system was a weak link in Ireland's efforts to attract FDI. When the Industrial Development Agency sought to raise the issue directly with the Department of Posts and Telegraphs, the response was not encouraging. Shortly thereafter, however, a new State agency was established to run the service on a commercial basis, and an investment plan was announced to build a digital network. This allowed the Irish IPA to claim in its promotional efforts that, apart from France, Ireland had the most advanced digital-based telecom system in Europe. A new set of industries, for which first-class international telecommunications are a key factor, could now be targeted. These ranged from software development to call centres, customer support and data-related services. For Ireland, these new knowledge-based industries became a major source of job creation.

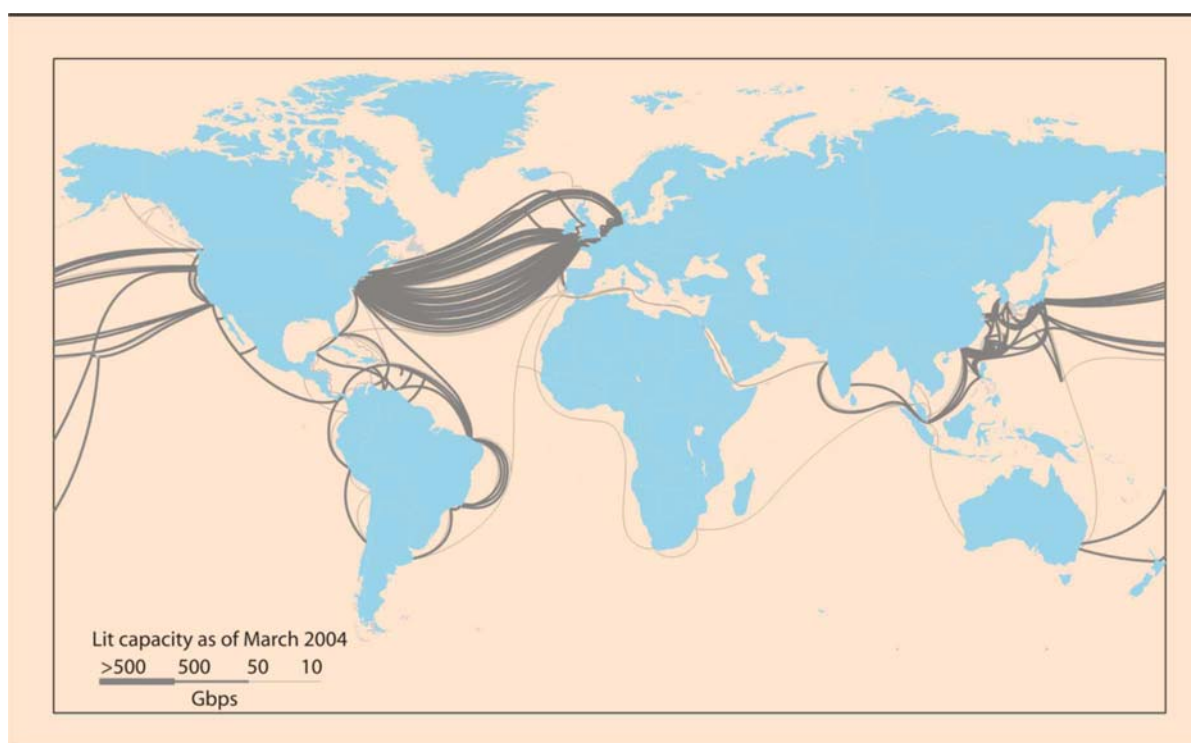
*Source:* MacSharry and White 2000.

result of decades of education and training (Kumar 2001a).<sup>30</sup> The concentration of export activity reflects the agglomeration of skilled manpower: most software companies are in Mumbai and Bangalore, where the software industry originally developed.<sup>31</sup> Delhi and its surroundings host a number of software firms, while Andhra Pradesh and Tamil Nadu are growing rapidly. These five states account for nearly half the diploma-granting technical institutions in India and two-thirds of all diplomas awarded by private training institutions (D'Costa 2003, p. 216). Some 850 private training institutions had been accredited by the Government as of January 2004 for IT diplomas at four different levels (India, Department of Information Technology 2004).<sup>32</sup> Currently, the annual turnover of engineering degree and diploma holders is estimated at 150,000 and 140,000 respectively. In addition, some 2.2 million arts and science graduates are added every year to the existing stock. Nonetheless, there are concerns that the quality and supply of middle-level manpower is insufficient.<sup>33</sup>

But less sophisticated services also need special skills. While call centres require customer support and telesales skills, a shared service

centre typically needs staff with financial, data entry and processing skills. Language skills are equally important. Even developed countries such as Canada (box V.5), the United States, the United Kingdom and Sweden have launched university level programmes to improve the supply of management skills.<sup>34</sup> Among developing countries, the Industrial Vocational Training Board of Mauritius provides training to call centre and other services agents; and Hungary is developing specialized vocational training programmes for both shared services and customer services. To maintain the ready availability of a large pool of college/university graduates who are customer-oriented, fluent in English and familiar with western business practices, various efforts have been made in the Philippines. The Government has reaffirmed, through a Presidential instruction, the use of English as the medium of instruction. Moreover, in partnership with industry and large universities, it has conceptualized and implemented training and bridging programmes tailor-fitted to the needs of the contact centre industry. The private sector has also contributed by establishing call centre academies that offer short courses to prospective call centre agents.<sup>35</sup>

**Figure V.3. Interregional submarine cable capacity, March 2004**



Source: TeleGeography research, PriMetrica, Inc., [www.primetrica.com](http://www.primetrica.com).

#### e. *Regulatory issues related to data protection and intellectual property*

Services offshoring raises a number of regulatory issues, particularly with regard to data security and intellectual property protection. Some developed countries prohibit the exchange of data with countries that do not have adequate data protection legislation.<sup>36</sup> For example, European firms are restricted under the Data Protection Directive of 1995 as to what data can be transferred or stored in countries without equivalent rules and enforcement procedures.<sup>37</sup> The largest recipient country of offshored services, India, currently does not have such national regulations,<sup>38</sup> although the IT Act 2000 (Chapter 11 Article 72) deals with the penalty for breach of confidentiality and privacy, which could go a long way towards addressing some of the data protection issues.<sup>39</sup> At present, individual contracts between a main company and its Indian contractor are used to address data protection issues.<sup>40</sup> A weak regulatory framework in some developing countries may be a factor limiting the extent to which certain services are offshored from Europe or North America (chapter IV).

In a few cases, companies have decided to terminate contracts with providers of offshored services due to customer complaints or to misconduct on the part of the local service provider.<sup>41</sup> Various observers suggest that stricter regulations in developing countries (notably India) are necessary to avoid a backlash. In the financial industry, the need for data security measures may be particularly high to ensure consumer confidence. Indeed, some countries view concerns of this kind as an opportunity to compete successfully with lower cost locations. Singapore, for example, which is no longer perceived to be a low-cost location for export-oriented services, seeks to attract additional FDI in services on the basis of its regulatory framework. Its FTA with the United States sets high standards of protection and enforcement of intellectual property; the country has also signed a memorandum of understanding with the EU in this area (A.T. Kearney 2004).<sup>42</sup> Such commitments are followed up by an active Intellectual Property Office to formulate and implement laws related to intellectual property protection. Developed countries such as Canada and Ireland also emphasize strong regulatory frameworks.

#### 4. Benefiting more from services FDI: upgrading and linkages

Policies to attract FDI in services need to be supported by various initiatives aimed at addressing possible concerns related to inward services FDI and at maximizing the benefits from the presence of foreign companies. Beyond the regulatory needs arising in the context of sequencing FDI liberalization and privatization (dealt with above), two additional issues deserve attention: how to promote closer interaction between local and foreign affiliates in the services sector; and how to facilitate the upgrading of existing investment into higher value-added activities.

The main rewards of FDI are realized in the longer term, when TNCs strike local roots, expand operations, improve local skills, establish linkages with local institutions and upgrade technology. Governments can induce market-seeking TNCs to deepen and extend their operations; they can also induce export-oriented ones to stay and upgrade when wages increase and cheaper competitors appear. This does not happen automatically. Policies are needed to improve local capabilities (skills, institutions, infrastructure), in line with changing technological and market realities.

The potential for linkages in the services sector differs by industry. Foreign affiliates in infrastructure services establish forward linkages with their clients and channel know-how and management expertise. Foreign affiliates that provide intermediate service inputs can transfer technology to their local customers in the same way as foreign affiliate producers of intermediate goods have done (Vangstrup 1999). While some service industries offer limited scope for fragmenting production into discrete stages and subcontracting out parts to domestic suppliers, some service industries (such as construction and retailing) present important potential for linkages with suppliers of physical inputs (*WIR01*, p. 139). The tourism industry also offers a considerable (but often not realized) potential for backward linkages, especially in the hotel industry, in which foreign affiliates can make sizeable purchases of foodstuffs, furniture and fittings (Dunning 1993).

In the production of services exports (e.g. call centres, back-office functions), foreign affiliates outsource some work to local



companies. However, evidence from India suggests that most export-oriented software companies operate as “export enclaves” with few linkages with the domestic economy (Kumar 2001a). Foreign affiliates in software development derive most of their income from exports to their parent companies. The enclave nature of their operation generates few knowledge spillovers for the domestic economy. Otherwise, in the area of R&D, foreign affiliates may engage in cooperative projects with local companies, universities or technology institutions. Such collaboration can be encouraged, for example, by the establishment of technology and science parks.

The promotion of backward linkages with foreign affiliates in the services sector is in principle no different from manufacturing. Government intervention can seek to bridge information market failures by disseminating information on the availability of local suppliers as well as on the specific procurement needs of foreign affiliates. But matchmaking initiatives are typically not effective without complementary efforts to raise the capabilities of domestic suppliers to the standards required by foreign affiliates. The provision of training, assistance in technology upgrading and financial support can help overcome this constraint. An extensive discussion on such policy initiatives can be found in *WIRO1*.

For most services activities, upgrading is closely linked to ensuring an adequate supply of skills. Where requirements from industry are evolving fast, such as in offshored services, a case can be made for close interaction between the public and private sectors. In the Philippines, for example, the Government collaborates with industry associations and other stakeholders in developing training and certification programmes. Various projects are also being implemented to encourage and assist firms in acquiring internationally recognized third-party certification.<sup>43</sup> In Europe, a consortium of nine major ICT companies (including non-European firms such as Cisco Systems, IBM, Intel, Microsoft) and the European Information, Communications and Consumer Electronics Industry Technology Association is exploring ways of addressing skill shortages with the support of the European Commission. It has developed generic skill profiles for key ICT jobs and created a dedicated website ([\[space.com\]\(http://space.com\)\).<sup>44</sup> Ireland has a similar initiative: the Government has established the Expert Group on Future Skills Needs to develop strategies on skills, manpower planning and training for business and education \(\[www.skillsireland.ie\]\(http://www.skillsireland.ie\)\). The Group includes representatives of industry, trade unions, training institutions, government departments and State agencies.](http://www.career-</a></p>
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Some countries encourage private sector training with the provision of grants and tax incentives. In Jamaica, for example, employers are eligible for a reimbursable training grant, which is administered by the State agency responsible for vocational training. Companies may access training grants up to a maximum of 20,000 Jamaican dollars per employee.<sup>45</sup> The Government of Croatia offers incentives for vocational training or retraining of employees (of up to 50% of related costs). Skill levies are in wide use in many countries (e.g. Malaysia, Singapore, South Africa), while tax incentives to encourage training are offered in Chile, Hungary and Thailand (*WIRO1*; UNCTAD 2003h).

## B. Home countries: the challenge of adapting

Home countries use various policies that influence the ability of host countries to attract and benefit from FDI. Some home-country measures seek to facilitate – partly in the interest of the home countries themselves – FDI flows into developing countries. Many industrialized countries already have in place a wide range of policies and measures in this area, for example, to provide information, encourage technology transfer, offering incentives and mitigating risk. Meanwhile, other measures – such as certain trade policies – may limit the ability of other countries to attract FDI.<sup>46</sup>

In light of the development opportunities created by the increased tradability of services (chapter IV), this section focuses on responses of governments in developed countries to the growth of offshoring of services. During the past year, concerns regarding the potential loss of jobs in some countries through offshoring have triggered a range of reactions by policy-makers as well as trade unions. The chapter reviews reactions to date mainly in the United States and the United Kingdom, the two countries that have

so far been the most affected. It concludes by discussing the need for government intervention to ensure a win-win outcome as a result of services offshoring.

## 1. The reaction to offshoring in the United States

The offshoring of services has prompted intense debate in the United States on the issue of white-collar jobs lost through offshoring.<sup>47</sup> The “jobless recovery”, which some observers link to offshoring, has further intensified the debate. That certain services are seen as the top end of the value-added ladder has added to uncertainties for developed-country workers once their jobs are offshored. The offshoring of government jobs has evoked particularly strong interest.<sup>48</sup> But concerns about offshoring go beyond job losses. One relates to the loss (or reduction) of control of States over sensitive issues. It has been argued that foreign service providers are outside the legal system of the United States and cannot be held accountable under the laws of that country. This is particularly sensitive if the work is associated with security and privacy issues. Another objection is that the actual savings for public institutions are not clear. Government agencies often outsource to a local service provider, who in turn offshores the activity.<sup>49</sup> Various steps have been taken at both federal and state levels that seek to limit the extent to which companies shift service production abroad.

At the federal level, the President signed a bill in January 2004 prohibiting private companies that win government contracts in the federal transport and treasury departments from moving the work offshore (*Financial Times*, 28 January 2004). This so-called Thomas–Voinovich Amendment is to date the only federal legislation to be adopted in this area. It provides that an “activity or function of an Executive agency ... may not be performed by a contractor outside of the United States” unless the activity or function was previously performed by federal employees outside of the United States (Klinger and Sykes 2004).<sup>50</sup> Various other bills have been proposed with a view to limiting the transfer of data overseas, providing preferential treatment for business in the United States, obliging federal Government contractors to use domestic workers or to observe minimum domestic requirements

and/or prohibiting federal contract work from being performed overseas (*ibid.*, pp. 16-17). Initiatives have also been taken that make it more difficult for IT firms to get visas for foreign professionals to work in the United States.<sup>51</sup> This may in effect lead to even more offshoring.

At the state level, more than 100 bills have been introduced in at least 36 states to restrict offshoring of services (table V.7).<sup>52</sup> Most of the proposals aim at two aspects: prohibiting companies on state contracts from using foreign workers in the United States and prohibiting companies from moving jobs overseas.<sup>53</sup> Another type of legislation proposed by some states does not prohibit the movement of jobs overseas but seeks to introduce more transparency by requiring foreign call-centre employees to say where they are located. Yet other bills propose to regulate the extent to which financial, medical or other personal data are sent overseas by private sector call centres. As of May 2004, at least two related bills had become public law.<sup>54</sup> In Alabama, Senate Joint Resolution 63 was introduced in April 2004 to encourage state and local entities to use Alabama-based professional services. In Indiana, House Bill 1080, which was signed into law in March 2004, provides for price preferences between 1% and 5% for Indiana companies in the awarding of state contracts.

The eventual impact of this kind of legislation – if and when it is enacted – is unknown.<sup>55</sup> The economic impact may not be too important as the volume involved is small: it is estimated that government offshoring at both the state and federal levels accounts for less than 3% of software exports from India (Chandran 2002),<sup>56</sup> and forecasts suggest that the share of offshored technology spending by states could increase from 5% in 2003 to about 10% by 2006.<sup>57</sup> Rather, the significance of such legislation lies in its possible symbolic impact on liberalization and globalization by setting a precedence.

Trade unions in the United States have also expressed concern about services offshoring. The Communication Workers of America, for example, are lobbying Congress on this issue (Agrawal and Farrell 2003). The number of white-collar staff joining trade unions is increasing: WashTech, a Seattle-based union formed in 1998 to organize high-tech employees, saw its membership grow from 2,000 to 16,000 during the first 10 months of 2003.<sup>58</sup>

**Table V.7. Summary list of United States states with proposed legislation restricting offshoring, 2004**

State	Proposed legislation
Alabama	State contract restrictions on overseas work; call centre restrictions
Arizona	Ban on state contracts with foreign call centres, call centre and data transfer restrictions, ban on state contracts for foreign call centres
California	State contract ban, call centre, personal data and health-care information restrictions, outsourcing notification requirement
Colorado	State contract ban, data transfer restrictions, ineligibility for state contracts and development assistance if outsourcing causes job losses
Connecticut	State contract ban, call centre, personal data and health care information restrictions, development assistance restriction for outsourcing companies, ban on state contracts for call centres, in-state preference
Florida	In-state resident requirement for state contractors
Georgia	State contract ban and call centre restriction, including state contract ban on foreign call centres
Hawaii	Ban on state contracts with foreign call centres, call centre and data restrictions
Idaho	Employment preference for state residents
Illinois	State contract ban, in-state preferences
Indiana	State contract ban, in-state contract preference
Iowa	State contract ban
Kansas	State contract ban, call centre and data transfer restrictions
Kentucky	State contract ban
Louisiana	State contract ban, in-state contract preference
Maryland	State contract ban
Michigan	State contract ban
Minnesota	State contract ban, call centre restrictions, including state contract ban on foreign call centres
Mississippi	State contract ban, call centre restrictions
Missouri	State contract ban, data transfer and call centre restrictions, including state contract ban on foreign call centres, in-state preference
Nebraska	State contract ban
New Jersey	State contract ban, data transfer and call centre restrictions
New Mexico	State contract ban
New York	State contract ban, call centre restrictions, development assistance restricted for companies that outsource overseas
North Carolina	Call center restrictions, including state contract ban on foreign call centres
Pennsylvania	Legislative investigation of offshore outsourcing from state
South Carolina	Call centre restrictions, including state contract ban on foreign call centres
South Dakota	State contract ban
Tennessee	State contract ban, call centre restrictions
Vermont	State contract ban and ban on state contracts for foreign call centres
Virginia	State contract ban, in-state preference
Washington	State contract ban, call centre and data restrictions
West Virginia	Call centre restrictions, seven-year ban on state contracts and assistance to companies that outsource overseas and have 100-person job loss
Wisconsin	State contract ban, call centre restrictions

Source: Klinger and Sykes 2004.

## 2. The European response

### a. The United Kingdom

In comparison with the United States, policy-makers in the EU generally have not reacted much to the offshoring of services, though some have initiated research. This may partly be because offshoring in Europe is still only about to take off. Trade unions have been more active, calling for protection and strikes, and sometimes they have entered into partnerships with outsourcing companies.

In general, the most intense debate in Europe occurred in the United Kingdom, which

among the EU countries (as noted in chapter IV), has the highest number of cases of offshoring to date. However, the Government has not moved towards protectionism and, judging from statements by various ministers, there are no plans to do so. For example, Prime Minister Blair said in relation to offshoring that it is “the way the world is today”;<sup>59</sup> the Trade and Industry Secretary said that “however strong the short-term case for protectionism appears to be, the long-term costs are far greater for consumers and jobs. We cannot preach liberalisation to the rest of the world and practise protectionism at home.”<sup>60</sup> One of the most explicit remarks was made by the Minister for Energy, E-Commerce and Postal Services, Stephen Timms:

“recourse to protectionism is not the right way forward. ... Closing our markets would also be inconsistent with our aim of helping developing countries out of poverty through trade. Indeed, it would be perverse to do so when countries such as India are growing through the sort of international trade that we in the United Kingdom have encouraged.”<sup>61</sup>

While the Government has said that it does not intend to limit offshoring to protect jobs, there may be some consideration that have this effect. For example, the Office of Government Commerce has stressed that some government jobs would not be offshored for security reasons,<sup>62</sup> and incentives are being offered to attract call centres to certain parts of the country. In addition, there are calls for voluntary action such as that by the Employment Relations Minister, who said: “We cannot do anything to stop these companies, but they have to look at how these decisions affect their customer base”.<sup>63</sup> The Government has also underlined the need for policies to help those affected by the offshoring of services.<sup>64</sup>

In general, trade unions in the United Kingdom do not appear to take a protectionist approach. The largest private sector union, AMICUS, has expressed concern about the impact of offshoring, but it does not propose protectionist measures due to the risk of beggarthy-neighbour reactions and xenophobia.<sup>65</sup> UNIFI, Europe’s largest specialist finance-industry trade union, with 158,000 members, regards offshoring as a growing issue and favours a three-pronged approach: early consultation to influence decisions; questioning of the case for offshoring; and avoidance of compulsory redundancies if a decision is taken to offshore. Where possible, UNIFI also engages in partnership framework agreements with employers (box V.12). It argues that the Government could contribute in three ways: funding local initiatives, emphasizing data protection issues and highlighting corporate social responsibility.

### **b. Other European responses**

There does not seem to be strong sentiment against offshoring in other EU countries either. The main response from the Government of *Ireland*, for example, has been to promote the upgrading of existing services.

The Government of the *Netherlands* is looking into the issue of offshoring, although its main focus is on relocation of manufacturing to CEE countries. In *Germany*, the Government has not announced any measures related to services offshoring, although, in an interview, the Chancellor called the transfer of jobs to lower cost locations “unpatriotic”.<sup>66</sup> The IG Metall union at Siemens advocates the use of industrial and trade policy to control the information infrastructure, and a green card system for skilled workers.

At the EU level, The European Commission has taken note of services offshoring notably from the angle of data protection. The European Data Protection Directive (data on individuals) prohibits data on individual Europeans from leaving the EU unless it goes to countries with full data-protection laws. Some international agreements (e.g. between the EU and Chile, Mexico and Singapore, respectively) also deal with data-protection issues. The European Parliament has begun to examine the possible consequences and the need for a policy response. The Union Network International (UNI) coordinates the trade union response to offshoring at the European level.<sup>67</sup> A UNI-Europe offshore outsourcing charter is under development, but

#### **Box V.12. Social dialogues in the finance industry**

One of the ways in which banks and trade unions are addressing job redundancies resulting from offshoring is through social dialogue. Examples include the recent agreements concluded between one of the United Kingdom’s main financial services trade union, UNIFI, and two transnational banks, Barclays and HSBC. The Barclays Group Globalization Human Resource Framework agreement seeks to avoid or contain compulsory redundancies as a result of offshoring. It provides for measures such as voluntary redundancy registers, job search and redeployment and funding for external training support. The Agreement with HSBC Bank plc on the Management of Change Arising from Global Resourcing covers such issues as the provision of information, a consultative framework, redeployment processes, terms for voluntary early retirement and voluntary redundancy, lifelong learning and outplacement.

Source: [www.union-network.org/UNIFinance.nsf](http://www.union-network.org/UNIFinance.nsf).

UNI Europe's position is that offshoring should be tolerated if certain conditions apply, notably those highlighted by AMICUS in the United Kingdom.

### 3. Reactions in other developed countries

In *Australia*, the offshoring of services to India has provoked responses by both trade unions and politicians. A decision by the telecom firm, Telstra, to outsource certain IT services to IBM Global Services, which subsequently placed some 450 jobs in India, sparked particular criticism. The Community and Public Sector Union, the Association of Professional Engineers, Scientists and Managers and the Australian Computer Society have been among the most vocal opponents of offshoring. Meanwhile, the Australian Labor Party's national conference has passed a resolution forbidding government departments and related entities from having any work done overseas if it could be done efficiently in Australia.<sup>68</sup> There has also been some concern in *Japan* over the increased direct competition from overseas IT workers through offshoring of services, but no measures have been taken in a protectionist direction (Sasaki 2004).

### 4. Meeting the challenge of adapting

As pointed out in chapter IV, there are reasons for developed countries to welcome offshoring, and it is in the interest of all parties concerned to consider how best developed countries can meet the challenge of adapting. As in manufacturing, a case can be made that international trade based on comparative advantage results in gains for all parties concerned. This does not mean this process will necessarily be smooth; there are bound to be short-term challenges for policy-makers, especially in terms of adjusting to the restructuring taking place in response to shifting comparative advantage. Given that the pace of change may be higher for services offshoring as compared to the relocation of manufacturing jobs, appropriate policy responses are particularly important.

White-collar workers in developed countries threatened with job losses could receive assistance (for example, for retraining and

seeking new jobs), similar to the trade adjustment assistance provided to vulnerable manufacturing firms. Workers moving to new careers could be offered "wage insurance", covering part of the difference between their former and new wages. Such programmes would encourage workers to get back to work as soon as possible, without having to reject new careers that require learning or on-the-job training.<sup>69</sup> Public-private partnerships could play a role in skills development, for instance, through the use of fiscal incentives for employee training. Such a scheme would be similar to tax credits offered for investment in physical capital.

Adjustment to any change in employment patterns needs greater labour mobility and changes in skill profiles. Preventing adjustment because of its costs may be a short-sighted response, as it could handicap income and employment growth in the longer term. In principle, the challenge for developed countries is the same as that facing developing countries: given the footloose nature of some services, even countries that attract offshored services face the risk of activities relocating to even more competitive sites. However, industrialized countries generally have more resources and better institutions to make the adjustment and move up the technology and skills ladder.

The international community can also aid this process by enhancing the understanding of the implications of the current international restructuring in services. The ILO, for example, has launched a programme to this end (box V.13).

## C. Conclusions

Services are globalizing rapidly. The impact of this process on development depends on policies in both host and home countries. This is as true for market-seeking (like infrastructure services) as it is for efficiency-seeking investment (like the offshoring of call centres, shared services, software development), although the challenges differ.

To benefit fully from the globalization of services, governments must start with a clear idea of what they expect from FDI in services. They must then regulate the industry or activity accordingly. There are no clear-cut or uniform policy recipes that apply to all industries, all countries and at all times: policies must reflect the nature of the service industry and conditions

### Box V.13. ILO Action Programme on Financial Services Restructuring: promoting best practices

The ILO is developing an Action Programme to address worldwide financial services restructuring resulting from work relocation and offshoring. The Action Programme will initially cover four pairs of source destination countries: France-Mauritius, Spain-Argentina, Sweden-Estonia and United Kingdom-India. Its focus is to identify and promote appropriate strategies, to address the social consequences of restructuring and promote decent work throughout the global supply chain for financial services. The role that social dialogue plays in this regard will also be examined. The programme will assist ILO member States and the social partners in target countries, through processes of social dialogue, to:

- develop and implement decent-work based strategies to maximize the employment opportunities of offshore outsourcing and work relocation in destination countries; and
- devise and apply negotiated socially-sensitive solutions to mitigate the negative impact of offshoring and work relocation in source countries.

The programme includes a research component, the first results of which will be presented towards the end of 2005 in subregional and/or national seminars, and a capacity-building component to support processes of social dialogue during financial-sector enterprise restructuring.

*Source:* Information provided by the ILO, March 2004.

and priorities of each country. This is why there are large differences in the extent to which countries allow FDI in services and in the way they regulate them.

The regulation of (some) services is a complex and demanding task, and there are many best practice models in use in developed countries. It is important to diffuse knowledge about these models to developing countries. Donors and the international community should help governments design and implement the measures that best suit their needs. In addition, policy needs to take into account the emerging international rules of the game, which increasingly are becoming the parameters of national policy-making (an issue examined in chapter VI).

International competition for export-oriented FDI in services is particularly intense and growing, especially for FDI involving offshoring. However, the process, despite the amount of attention it has attracted, is still in its infancy. While there is much to be learnt in this area, it is clear that attracting offshoring FDI has two basic preconditions: infrastructure and skills. The infrastructure needs – apart, obviously, from modern ICTs – include power and data protection rules. The skill needs vary by the complexity of the offshored activity. Simple services need basic education and familiarity with the relevant language. Advanced services require different

kinds of specialized skills; some call for a minimum critical mass of skills across different areas to provide an attractive cluster of service activities.

Governments also need to build an efficient regulatory structure in services for which market forces cannot ensure optimal social outcomes. “Lumpy” infrastructure services like power, telecoms and water are good examples. Finally, there is a need to promote and target foreign investors in desirable activities. As previous *WIRs* have argued, effective promotion is now an indispensable tool in the armoury of FDI policies, but it should not be undertaken at a scale that drains the government budget.

As far as offshoring is concerned, the evidence suggests that it will continue to grow. In fact, it is likely to accelerate as its benefits become more evident, technologies improve and more companies and countries join the early movers. The process involves countries at all levels of development. The bulk of offshoring to date has in fact taken place among developed countries. The economic benefits – the outcome of specialization based on comparative advantage – accrue to all who participate: exporting countries gain employment, foreign exchange and skills while importing countries become more competitive, have better and cheaper services and can move up the skill and technology ladder. This is an irreversible shift in the global division of labour, in a segment of productive activity that

has only recently been given the technological means to globalize in a similar way as manufacturing production. The full effects are difficult to forecast, but they are likely to be considerable.

This is not to deny that there are lags, frictions and costs involved in offshoring. On the side of developing countries, offshoring is concentrating in a few sites and is likely to carry on doing so until new aspirants improve their investment climate and create competitive capabilities. Successful exporters cannot stand still: they have to invest in new skills to move up the value chain as wages rise and cheaper competitors emerge. There is also a regional dimension: given the need for high quality infrastructure and skills, there is a risk that offshoring will stay in a few urban agglomerations with first-mover advantages. Finally, developing countries themselves will also offshore services to other locations, to take advantage of skills and markets.

In rich countries, adjustments will be needed to labour markets and education systems to create new, higher value jobs as the simpler ones move abroad. There will be transition costs that governments and enterprises will have to bear. The process is not new, of course – it has been happening in manufacturing for some time (box V.14). As in manufacturing, the competitive gains offered by offshoring should more than offset the loss of particular jobs and the adjustment costs. But targeted policies are needed to allow the process to continue smoothly and to ease the hardship for affected employees.

Should developing countries try and build competitiveness in trade in IT-enabled services? The answer is clearly yes. But the export of services as such is not the final goal. Such exports help the development process more broadly, creating not just jobs and foreign exchange but also supporting competitiveness in

other activities. They help to upgrade the physical infrastructure. They create new skills, technical as well as managerial. They improve the international image of the exporting country and so can make it easier to sell other products abroad. They can help improve the financial system and the investment climate. And they can raise the efficiency of domestic services, spreading new ICT technologies and skills. If a country can provide these services broadly to its citizens and local producers, the gains in GDP growth and human development will far exceed the export revenues. These broad-based gains come as a result of cheaper services inputs to all forms of productive activity, as well as to the transformation of business activities that results when resources are freed up to be used in new business endeavours throughout the economy.

Realizing all these benefits and spreading them through out the economy is not automatic. Governments have to support competitiveness in services, by providing a conducive climate for private sector – local and foreign – activity and the necessary infrastructure, skills and institutions.

It is vital that developing countries be allowed to benefit from the globalization of IT-based services. The importing economies need to defuse growing fears of permanent job losses and make their populations aware of the competitive benefits of offshoring. They need to ease the transition costs and meet the retraining needs of displaced workers. It may be tempting to hold back offshoring to avoid adjustment costs. This would be short-sighted politically and economically. It would strengthen the critics of globalization who would argue that the rich countries only support globalization when they gain immediately. It would hold back the growth of poor countries and cost more in terms of other forms of aid. The challenge is to create a competitive environment that allows a win-win situation for all parties from FDI in services.

### Box V.14. The debate on offshoring – a case of déjà vu?

It is not the first time that concerns have been voiced about foreign competition destroying the jobs and standard of living of workers in home countries. In fact, the current debate on the offshoring of services resembles earlier debates in developed countries. In the late 1960s and 1970s, for example, worries in the United States about job growth were combined with those about the widening trade deficit and the apparent decline in its competitiveness. This decline was exemplified by rising imports of cars and machinery – first from Europe and then from Japan – and the falling share of the United States in world exports of manufactured products. In the 1980s, the focus was the threat from Japanese companies to the semiconductor industry of the United States.

This led to protectionist calls. For example, a labour union official complained in 1978 that “...imports are flooding the country...American workers are losing their jobs...something has to be done...”. Industries affected included textiles and clothing, the shoe industry, which “...has been all but destroyed” and “...Black and white TVs-the industry has been wiped out by imports...”. Productivity growth was declining because “...technology is more readily applied to manufacturing...than it is to the production of services” (Finley 1978, pp. 129-130). Proposed solutions included the discouragement of outward FDI from the United States (as in the proposed Burke-Hartke bill), subsidies for domestic employment and “orderly marketing agreements”. The last of these would “...set a base level for imports and ... thereafter allows imports to vary according to the level of demand or sales. It allows imports to participate proportionately in the benefits of expanding markets but does not allow them to be disruptive in static or contracting markets” (Ruttenberg 1978, p. iv-17).

As it turned out, manufacturing prospered in the United States and employment levels remained high. The absolute number of manufacturing jobs fell only marginally, and much less than in countries like Germany and Japan. In the export arena, the share of the United States at the end of the 1990s was similar to that of the early 1970s, in spite of the growth of other countries’ manufacturing capabilities. Real per capita output in the United States, despite the supposed loss of high-wage jobs, has remained steadily at 35% to 45% above the level of the EU.

The United States managed to absorb competitive threats without losing ground to its main competitors in terms of per capita output. The wage system continues to reward high skills with a larger premium than in most other developed countries.

Adjustment to foreign competition took various forms. Some foreign firms expanded in the United States (e.g. in automobiles and semiconductors). In manufacturing, while employment in parent companies of United States TNCs fell by two million from 1977 to 1990, 75% of the decline was offset by the growth of foreign-owned manufacturing operations in the country. A further decline of 600,000 jobs in parent firms in the 1990s was almost entirely offset by the growth of foreign firms’ operations in the United States. Exchange rate changes also helped the adjustment process by reversing some losses of competitiveness for the economy as a whole. The composition of production changed, usually from older, less complex or less sophisticated products to newer, more sophisticated ones. In semiconductors, the complaints of downstream industries that their competitiveness was being undermined by measures protecting semiconductor producers shortened the lives of restrictive measures or softened their application.

The recent growth in the offshoring of services has revived similar fears, even though imports are negligible relative to the total volume of business services. One possible reason for the strong reaction is that it coincides with the collapse of the information technology boom. Another is that most of the imports are coming from India, a developing country with low wage levels and a large educated population. A third is that these are by definition labour-intensive industries, in which the “relocation of jobs” is more obvious than in manufactures. Finally, offshoring affects white collar jobs rather than blue collar ones, and creates a more vocal opposition. It also raises the fear that it is affecting the higher level jobs that high wage countries are supposed to be moving into.

However, in economic terms the offshoring of services is no different from that of manufacturing. The main driver in both is technological change, making it possible to relocate processes or functions economically. The main permissive factor is the liberalization of trade

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### Box V.14. The debate on offshoring – a case of déjà vu? (concluded)

and FDI, and the main determinant of location is the availability of competitive sites (in turn dependent on infrastructure, skills and a good investment climate).

In services, rapid falls in communication costs make it possible for poor countries to exploit latent competitive advantages. As these countries build new skills and capabilities, their comparative advantages also grow, and they encroach more on the former comparative advantages of developed countries, forcing them to adapt by innovating or by shifting the composition of their production.

Source: UNCTAD.

But this has been the case through the entire history of trade and production – and in economic development.

If the past experience of manufacturing is any guide, domestic producers of related service activities will adapt by shifting their specializations to higher skill segments of their industries. Just as the fears raised in previous periods of international restructuring proved exaggerated, the present ones are likely to be unfounded. The final outcome should again be a win-win situation for the parties involved.

## Notes

- <sup>1</sup> Under the negative list approach, the principle is that all industries are open unless a specific reservation is taken. Hence, reservations in this case indicate areas in which countries prefer to restrict or condition FDI access in some way. Under a positive list approach, the non-listing of specific industries suggests that there may be sensitivities. An important limitation of looking at selected IIAs is that it only produces information on restrictions maintained by countries that are parties to the relevant agreements. Another is that “mere counting” does not control for the nature of the non-conforming measures.
- <sup>2</sup> The basis for figures V.1-V.2 are reservations of non-conforming measures lodged in negative lists of seven IIAs or drafts thereof: the Andean Pact (1991); the Canada – Chile Free Trade Agreement (1996); the G3 Free Trade Agreement between Colombia, Mexico and Venezuela (1990); NAFTA (1992); the draft Multilateral Agreement on Investment negotiated at the OECD (negotiations were abandoned in 1998); the OECD’s National Treatment Instrument (2000); and the United States – Chile Free Trade Agreement (2003).
- <sup>3</sup> The figures on transportation relate to modes other than aviation (i.e. concern maritime and land transportation – buses, trucks, rail services), the bulk of which (i.e. hard rights and services involved in the exercise of such rights) are specifically carved out from all of the agreements under review (as they are from the coverage of the GATS).
- <sup>4</sup> The indicator of restrictiveness applied in the study by Golub used data on GATS commitments, reservations under the OECD Code of Liberalisation, information from the United States Special Trade Representative (USTR) and several other sources.
- <sup>5</sup> For services that are crucial inputs to other industries, infant industry/national champion considerations may affect the competitiveness of other segments of the economy. If it implies keeping FDI out, the nurturing of the local providers is paid by the users of the services. Similarly, if the role of a national champion is given to a foreign investor without checks and balances, it is again the local economy that will pay the price of a virtual monopoly.
- <sup>6</sup> For example, the privatization of telecom companies to foreign strategic investors has generally been done by means of “controlled auctions”, designed to achieve the highest possible price for the shares sold from among a limited number of pre-selected candidates that meet pre-established criteria.
- <sup>7</sup> In one country in Latin America, inadequate tariff and pricing policies applied in its privatization of electricity apparently contributed to a slowdown of the expansion of existing generation capacity and allowed monopolistic rents to be captured by distribution companies (Gabriele 2004).
- <sup>8</sup> A World Bank survey found that payment discipline among customers in Brazil and China was the most important factor in the success of investments in those countries. Conversely, non-payment by customers and weak enforcement of collection in the Dominican Republic, India and Pakistan had contributed to the dissatisfaction of investors (Lamech and Saeed 2003, pp. 10-11).
- <sup>9</sup> In the Russian Federation, for example, the Civil Code, until recently, did not allow utilities providers to disconnect supplies to physical persons for payment default. In respect of legal persons (e.g. industries, companies), disconnection for payment default was not possible without their consent (Krishnaswamy and Stuggins 2003, p. 8).
- <sup>10</sup> Hungary, Poland and Turkey have focused on improving their laws on electricity supply and theft with some measure of success (Krishnaswamy and Stuggins 2003, p. 9).
- <sup>11</sup> The GATS recognizes the importance of having an independent regulator. The Telecommunications Services Reference paper (which WTO members can adopt via additional commitments in their schedules) sets out definitions and principles of regulatory frameworks for basic telecommunication services,

including for independent regulators. It recommends that “[t]he regulatory body is separate from, and not accountable to, any supplier of basic telecommunications services. The decisions of and the procedures used by regulators shall be impartial with respect to all market participants” (Section 5).

- 12 Such commitments are widespread, although, in many countries (such as the former German Democratic Republic, Hungary, Poland), the enforcement of contractual commitments and penalties often proved to be ineffective.
- 13 See *WIR02*, chapter VIII, for a discussion on targeted investment promotion.
- 14 Singapore and Ireland show that, where an IPA is able to coordinate the strengthening of domestic capabilities in parallel with attracting FDI, it can transform the development prospects of the host country. Both these economies have targeted high-value services (as well as manufacturing) and ensured that new skills, state-of-the-art infrastructure, support institutions and policies have evolved in line with the needs of these activities.
- 15 See *WIR02*; Loewendahl 2001.
- 16 In business-process outsourcing, for instance, the physical infrastructure for transportation, the quality of local input suppliers or the availability of long-term investment capital does not matter as much as the availability of specialized skills and technology institutions, and IT infrastructure and reliable power supplies.
- 17 Investment incentives are intended to induce investors to establish a presence, to expand an existing business or not to relocate elsewhere. They may also be provided to increase the benefits from FDI by stimulating foreign affiliates to operate in desired ways (*WIR03*). Governments may offer enterprises measurable economic advantages in order to attract investment into certain industries or regions or to influence the character of an investment. Incentives may be granted unconditionally or conditionally (by linking them to performance requirements), and addressed to foreign companies, local companies or both.
- 18 The WTO review covers subsidies given to domestic and/or foreign firms. As subsidies directed only to domestic firms are likely to represent a minor share, it gives an indication of the use of FDI incentives in service industries. The definition of “subsidy” in Article 1 of the WTO Agreement on Subsidies and Countervailing Measures contains three basic elements: (i) a financial contribution (ii) by a Government or any public body within the territory of a WTO member (iii) which confers a benefit. All three of these elements must be satisfied in order for a subsidy to exist.
- 19 Other subsidies have been used to cope with various crises. Many countries extended financial support to their air carriers in the aftermath of the attacks on 11 September 2001; and a number of Asian economies supported their banking industries after the Asian financial crisis towards the end of the 1990s. But most of these subsidies have been provided only to domestic firms.
- 20 Information from the Board of Investment of Mauritius.
- 21 This section draws on information provided by the International Labour Organization (ILO) database on EPZs ([www.ilo.org/epz](http://www.ilo.org/epz)), which links the websites of EPZ authorities in 116 countries. However, since there has been no attempt to verify the accuracy of the public information provided by these authorities, it should be viewed only as indicative.
- 22 For example, a Singapore consortium and the Tata Corporation established an IT park in Bangalore; Infosys, ICICI Financial Services & Hughes Software set up software parks in Karnataka; and Quark Infrastructure set up a technology park in the Punjab in collaboration with Punjab State Electronics Development and Production Corporation (Kumar 2000).
- 23 For example, in 2002, the Indian company, Infosys, established a disaster recovery centre in Mauritius. Complete with infrastructure, network connections, telecommunication facilities as well as back-up client data, this centre will be on standby to take over client projects from across the globe in case of an emergency. Serving as an alternative location in case of a disaster in other Infosys centre, it will have a capacity to accommodate 1,500 people ([http://www.infy.com/media/disaster\\_recovery\\_Mauritius\\_28oct\\_02.pdf](http://www.infy.com/media/disaster_recovery_Mauritius_28oct_02.pdf)).
- 24 The Internet City is located in the Dubai Technology and Media Free Zone and provides a high bandwidth technology platform. Its services include web hosting e-mails, various internet services, a data centre and a content and security network. The Internet City offers tax privileges, full repatriation of capital and profits without currency restrictions, easy registration and licensing, stringent cyber regulation, 50-year land leases and protection of intellectual property in addition to facilities for financing, training, education and research.
- 25 For example, in the case of FDI in regional headquarters, excellent air connections and competitive real estate conditions are key requirements.
- 26 Recent initiatives include allowing private operators to offer Internet telephony, and opening up of the National Long Distance Service to private operators by abolishing the monopoly of the national telecom operator, VSNL. Moreover, the Indian policy on Internet services envisages no restriction on the number of service providers, operations can be on a national, regional or district basis, the services provider can decide whether to build or lease capacity from infrastructure owners (railways, energy utilities), foreign equity participation is capped at 49%, licences are issued for a period of 15 years (extendable by 5 years), no licence fee is charged for the first 5 years and telephony on Internet is permitted. At the end of 2002, 24 Internet service providers had been given clearance for the commissioning of 55 international gateways for Internet using satellite systems, while 4 providers had applied for the setting up of submarine cable landing stations for international gateways for the Internet (India, Department of Telecommunications 2003).
- 27 Communication from the Board of Investment of the Philippines, May 2004.
- 28 Recently, the Government permitted network unbundling, obliging telecom companies to allow competitors access to their infrastructure; this was a key step in the development of a competitive broadband market. In 2001, it awarded licences for wireless local loop services (that allow deployment in remote areas,

- increased access to broadband services and high-speed data transmission).
- 29 The SEA-ME-WE3 docks with India in two places: Mumbai and Cochin; the SAFE cable has a landing in Cochin.
- 30 Ever since the early 1970s, the Government of India has taken steps to promote the development of skilled manpower needed in the software and service industry. Key elements have included careful and regular analysis of expected needs for engineers at the bachelor, masters and PhD levels, the establishment of new courses in computer science, computer applications, new polytechnic diplomas and mathematics and provision of training in software development (RIS 2004).
- 31 The strong position of Mumbai has also been associated with its role as a financial and commercial centre, the presence of a few large software firms, as well as considerable software development to cater for the in-house needs of major financial firms such as Citibank. Mumbai has also been able to tap other parts of India for talent (D'Costa 2003).
- 32 The levels are O – foundation course, A – advanced diploma, B – MCA level, and C – M.Tech level.
- 33 See [www.mit.gov.in/studyteam.ppt](http://www.mit.gov.in/studyteam.ppt).
- 34 Invest in Sweden Agency 2000.
- 35 Information provided by the Board of Investment of the Philippines, May 2004.
- 36 These issues emerged first in the 1980s in the context of trans-border data flows (see UNCTC 1983a,b; UNCTC 1984a,b; Robinson et al. 1989; Sauvart 1986a, 1986b).
- 37 Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data (*Official Journal L 281*, 23 November 1995, pp. 0031 - 0050).
- 38 See “Indian BPO firms constrained by lack of data protection”, *Express Computer*, 26 April 2004 (<http://www.expresscomputeronline.com/20040426/coverstory01.html>)
- 39 The Act stipulates that any person who has secured access to any electronic record, book, register, correspondence, information, document or other material without the consent of the person concerned, and discloses such material to any other person, shall be punished with imprisonment for a term that may extend to two years, or with a fine that may extend to one lakh rupees, or with both. Yet to address the specific issues of concern with respect to business process outsourcing business, the IT Act is being reviewed at the national level (see <http://www.ap-it.com/itact.pdf>).
- 40 Most of the state governments of India have sought to address IT security and data protection issues. For example, the state of Andhra Pradesh is developing a data protection and consumer privacy act to assure the companies in IT-enabled services and their customers of the safety of their data, and to specify the nature of information protected under the law. It also plans to set up a regulatory authority for enforcing this act, and to specify the consequences of violation (for details see <http://itfriend.mit.gov.in/stateit/andhrait.asp>).
- 41 Well-known examples include Littlewoods (United Kingdom) as well as Dell and Lehman Brothers (United States), both of which repatriated service production from India. Moreover, in March 2004, the credit card company Capital One (United States) decided to cease its cooperation with the Indian call centre company, Wipro Spectramind (“Credit card chaos in India”, *BBC News*, 25 March 2004).
- 42 Many recent FTAs, including the Chile–United States Agreement or various European agreements, contain strong provisions on the protection of intellectual property rights.
- 43 Information provided by the Board of Investment of the Philippines, May 2004.
- 44 The generic skills profiles cover the main job areas in which the ICT industry is experiencing skills shortages, and describe the jobs associated with them. The specific technology areas and tasks associated with each job are also outlined, as well as the skills required.
- 45 A call centre curriculum has been introduced in its training programmes, with modules entitled as follows: Orientation to the Occupation, Customer Service, Developing Telephone Skills, Selling Products & Services, Basic Computer Technology and Introduction to Database Management (of approximately 280 hours duration). Additional support modules include Language and Communication, Calculations and Computations and General Studies (Employability Skills) (approximately 100 hours) (Jamaica Promotions Corporation, [www.investjamaica.com](http://www.investjamaica.com)).
- 46 For a detailed review of such measures, see *WIR03*, part III, UNCTAD 2001b.
- 47 See, for example, Herbert Bob, “Outsourcing jobs is a threat to the United States economy”, *International Herald Tribune*, 27 January 2004; “White House economist gets lesson in politics”, *International Herald Tribune*, 26 February 2004; Paul Krugman, “Free trade and jobs”, *International Herald Tribune*, 28-29 February 2004; Douglas A. Irwin, “Outsourcing is good for America”, *Wall Street Journal*, 28 June 2004; Charles Schumer and Paul Craig Roberts, “Second thoughts on free trade”, *New York Times*, 6 January 2004; “The great hollowing-out myth”, *The Economist*, 19 February 2004.
- 48 Government work that has been offshored so far includes food stamps programmes, human resource functions, insurance programmes and some IT work, particularly software development, upgrading of existing systems and integrating systems with other state and federal electronic systems.
- 49 For example, the state of Georgia’s department of human resources pays Citigroup \$8 million a year to manage phone inquiries from its 438,000 stamp recipients. Citigroup in turn outsources the work to an Indian call centre run by an independent Indian company (“Job loss creates political stir”, *The Atlanta Journal*, 15 October 2003).
- 50 See Consolidation Appropriations Act of 2004, P.L. 108-199, II8 Stat. 3 6 647 (e) (2004).
- 51 For instance, the number of H1-B visas (that give work permits for professionals for up to six years) was reduced from 195,000 in 2000 to 65,000 in 2003 (*Business Week*, 2003). Bills pending in Congress propose to reduce the number of L-1 visas by 50%; these visas allow companies to transfer their own

- employees from overseas to the United States for up to seven years.
- <sup>52</sup> The New Jersey state authorities were the first to do so in September 2002, by proposing to prohibit the shift of state services work to cheap foreign locations. The bill was a reaction to a discovery that a local contractor hired by the state to manage the welfare and food stamp programme had moved its customer service operations to Mumbai.
- <sup>53</sup> See also “Unions and states aspire to block job outsourcing”, *Wall Street Journal*, 3 June 2003.
- <sup>54</sup> See [www.nfap.net](http://www.nfap.net), visited 11 June 2004.
- <sup>55</sup> In at least one case (in Indiana), a law proposal triggered the cancellation of an offshoring contract. The official explanation for this move was irregularities in the way in which the contract had been awarded (*Business Week*, 2003). In Utah, the company eFunds was planning to recall jobs at an Indian call centre taking calls for the Utah Department of Workforce Services, resulting in higher costs. The eFunds’ Indian centre handles calls about the department’s electronic Horizons welfare benefits cards (see [www.callcentres.net/callcentres/Live/me.get?SITE.HOME](http://www.callcentres.net/callcentres/Live/me.get?SITE.HOME)).
- <sup>56</sup> See also “Protectionism hits the outsourcing industry”, *IDG News Service*. [www.idg.net](http://www.idg.net), 15 April 2003.
- <sup>57</sup> “Calling New Jersey via New Delhi”, *Business Week*, 29 September 2003.
- <sup>58</sup> “Job loss creates political stir”, *The Atlanta Journal*, 15 October 2003.
- <sup>59</sup> *The Guardian*, 6 December 2003 ([http://www.guardian.co.uk/guardian\\_jobs\\_and\\_money/story/0,3605,1100689,00.html](http://www.guardian.co.uk/guardian_jobs_and_money/story/0,3605,1100689,00.html)).
- <sup>60</sup> See *The Guardian* (<http://www.guardian.co.uk/business/story/0,3604,1087381,00.html>).
- <sup>61</sup> Statement made in a Westminster Hall debate on call centres, 3 March 2004.
- <sup>62</sup> See *Financial Times*, 16 December 2003.
- <sup>63</sup> See *The Guardian* (<http://www.guardian.co.uk/business/story/0,3604,1098529,00.html>).
- <sup>64</sup> The Minister of State for Industry and the Regions has argued that “where jobs are lost, we must do everything that we can to help people to find new jobs, and new skills, if necessary, as quickly as possible. We shall call on the services of the reformed Jobcentre Plus, particularly its rapid response service, which focuses on redundancies where particularly intensive work is needed” (Debate in the House of Commons, ([http://www.parliament.the-stationery-office.co.uk/pa/cm200304/cmhansrd/cm031210/halltext/31210h01.htm#31210h01\\_head0](http://www.parliament.the-stationery-office.co.uk/pa/cm200304/cmhansrd/cm031210/halltext/31210h01.htm#31210h01_head0))).
- <sup>65</sup> AMICUS argues that employers should adhere to five points: consultation, no redundancies, reinvestment of profits in worker skills, protecting careers and compliance with labour standards. It believes the Government should act by investing in skills or providing incentives for R&D (interview with AMICUS).
- <sup>66</sup> “Schröder condemns job offshoring as unpatriotic”, *Financial Times*, 23 March 2004.
- <sup>67</sup> Gerhard Rohde “Jobs with no frontiers global mobility: a challenge to unions and researchers”, *WSI Mitteilungen*, 10/2003.
- <sup>68</sup> “Australia: campaign to halt job flight gathers steam”, *IPS/Kalinga Seneviratne*, 24 February 2004, [www.ipsnews.net](http://www.ipsnews.net).
- <sup>69</sup> For a discussion of how this policy is implemented in the United States, see Kletzer and Litan 2001.