



## SERVICES: NEW FRONTIER FOR SUSTAINABLE DEVELOPMENT



### Building Supply and Export Capacity: The Case of Offshored Services

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## INTRODUCTION

This document provided an UNCTAD perspective for a discussion on building supply and export capacity in offshored services that took place in May 2013 during the Global Services Forum, Beijing Summit. The document summarizes the findings of past research work by UNCTAD.

The document begins by defining the conceptual framework of outsourcing and offshoring in order to underscore the development importance of this topic. The origin and evolution of outsourcing and offshoring are reviewed, as well as determinants and recent trends. Finally, the document identifies key policy challenges for developing countries seeking to maximize development gains from trade and the policy action spheres for building supply-side capacity and promoting the export of offshored services.

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# Conceptual framework of outsourcing and offshoring

I

### A. Definitions of outsourcing and offshoring

Outsourcing refers to when companies contract out non-core activities to other companies. Offshoring refers to when the source of supply is located in a country that is different from the home country of the outsourcing company. Offshoring may be achieved internally by moving production from the parent company to its foreign affiliates, often referred to as “captive offshoring”, or externally by outsourcing services to a third party service provider abroad. Table 1 provides a summary reference of these definitions.

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

### B. Categories of services affected by offshoring

In analysing the scope of services activities affected by offshoring, it is common to make a distinction between information technology (IT) services and information and communication technology (ICT)-enabled services. Table 2 provides examples of each.

**Table 1. Offshoring and outsourcing**

Location	Internalized production	Externalized production (outsourcing)
Domestic	Production kept in-house at home	Production outsourced to third party service provider at home
Foreign (offshoring)	Production by own foreign affiliate “captive offshoring”	Offshore outsourcing to third party provider abroad

Source: UNCTAD, 2009, *Information Economy Report 2009: Trends and Outlook in Turbulent Times* (New York and Geneva, United Nations publication).

**Table 2. Categories of services affected by offshoring**

Service category	Examples of service activities
IT services	Programming, application testing, data processing and database services, data warehousing, IT consulting, IT support services, IT infrastructure management and maintenance, systems integration, software development and implementation and content management and development
ICT-enabled services: <ul style="list-style-type: none"> <li>• Front office services (business process outsourcing (BPO))</li> <li>• Back office services (BPO)</li> <li>• Knowledge process outsourcing*</li> </ul>	<ul style="list-style-type: none"> <li>• Call centres and customer contact centres (inbound and outbound)</li> <li>• Data entry, human resources, finance and accounting, payroll, procurement and transcription</li> <li>• Financial analysis data mining, engineering, insurance claims processing, remote education and publishing, research and development, architectural design, medical diagnostics, journalism</li> </ul>

Source: UNCTAD, 2009, *Information Economy Report 2009: Trends and Outlook in Turbulent Times* (New York and Geneva, United Nations publication).

\* Knowledge process outsourcing activities, such as business consulting, business analysis, market intelligence and legal services, are particularly human-capital intensive as they are performed by highly educated professionals holding master's degrees or PhDs, and thus belong to the highest segment of the ICT-enabled value chain.

### C. Origins and evolution of outsourcing and offshoring

The trend towards the globalization of services first emerged in the early 1990s and rapidly gained momentum. Two decisive factors in promoting the offshoring of services and increased trade in IT and ICT-enabled services were advancements in ICT and the transnationalization of corporate service functions by transnational corporations (TNCs).

Increased broadband connectivity and acceptance of standardized software platforms introduced a degree of tradability in services that had not previously existed. It was no longer necessary for providers and users to be in physical proximity, and services could be fragmented into smaller components that could be internationalized in order to take advantage of differences in costs and quality between countries and to profit from economies of scale. ICT advancements facilitated the shifting of some services and parts of the production process to other countries.

This trend of tradability in services coincided with greater competitiveness and pressures to cut costs in key sectors of the economy that led to the practice of subcontracting work to third parties, with a view to reducing costs and enhancing efficiency by allowing companies to concentrate on their core activities.

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

Large companies in the United States of America were pioneers in outsourcing and began by domestically outsourcing their non-core IT services to other companies, preferring to obtain these services securely and reliably from the outside. The initial strategy was to relocate their non-core IT services from large metropolitan cities to smaller towns in order to take advantage of lower wages and property costs in areas where accents were neutral and education was adequate.

Increasingly, small and medium-sized enterprises in developed countries also chose outsourcing as a business policy that would enable them to obtain quality services flexibly and at a low cost, rather than setting up internal departments to perform the same

services. Companies in the United States offshored functions to Canada and Ireland, for instance, because of cultural affinity and the availability of a highly qualified workforce.

Later, savings related to lower-wage labour were a major incentive for companies to consider outsourcing to developing countries. Large providers of IT and ICT-enabled services and intermediaries in developed countries, such as Accenture, Cap Gemini, Deloitte, Ernst and Young, International Business Machines Global Services and PricewaterhouseCoopers, played a key role in linking the developed and developing world. Global and regional clients in the United States and the European Union progressively built, acquired and collaborated with delivery companies in developing countries.

India and the Philippines were among the first developing countries to explore offshoring and other countries have followed, including Barbados, China, the Czech Republic, Ghana, Hungary, Jamaica, Kenya, Malaysia, Mexico, Senegal, South Africa and Viet Nam.

### D. Drivers and determinants of outsourcing and offshoring

The choice of location is primarily determined by the cost and availability of appropriate skills. However, outsourcing decisions also depend on a variety of other factors related to the outsourcing company, the nature of the outsourced functions, the characteristics of the market of the service provider and the characteristics of the service provider itself.

The key driver for companies is the search for improved competitiveness through cost reduction and/or improved quality. To provide an order of magnitude of the possible cost savings, it may be noted that the banking industry in the United States saved up to US\$8 billion from 1999 to 2002 by offshoring services to India. During that period, the offshoring of call centres to India was estimated to be 30 per cent to 40 per cent less expensive than establishing them in the United States (UNCTAD, 2004).

Other studies also show that cost savings derived from offshoring can be substantial, often between 20 per cent and 40 per cent (Fredriksson, 2007). Savings may be achieved by seeking out lower cost locations and also by consolidating operations and reducing the costs of infrastructure, management and training.

The quality gains many companies have observed due to offshoring are also notable. The back office services of one firm become the front office services of

a specialized service provider and the latter often pays more attention to quality, while the principal may focus scarce resources on its core activities. Relocating some functions offshore may also be a way to cope with excess demand.

The decision to offshore service functions is also dependant on the risk management strategy of the outsourcing company, i.e. the weight of potential benefits and costs of externalizing business functions. Costs may relate, for example, to managing relationships with partners on a continuous basis, including flows of knowledge, goods and services, flows of communication and information and the monitoring of control and compliance with contractual obligations. The decision to offshore service functions may also entail losing control over parts of the value chain and relinquishing part of the profits generated along the chain, as well as increased exposure to business uncertainties derived from managing cross-border operations in economically, politically, culturally and socially diverse environments (UNCTAD, 2011a).

The skills required depend on the level of complexity of the outsourced business functions. Many BPO services involve back office functions requiring basic clerical skills that consist primarily of data entry, transfer or conversion tasks, billing services and tasks such as moving data from a document or database to a general ledger.

For the provision of ICT-enabled services that involve high levels of interaction with customers, for example at contact centres and in customer services, having a company presence in different time zones and different language areas is important. Business process outsourcing services providers working with clients worldwide must have not only excellent communication skills but also knowledge of the clients' mindset and native industry. For service providers offering consulting or advisory services, complex specialized business skills and relationship-building skills are required.

The nature of the outsourced functions also influences where a service may be offshored, and requirements in this respect may differ across companies. Infrastructure requirements are particularly strict for certain types of IT services. For example, for remote IT infrastructure management, only locations with very reliable infrastructures may be considered. The extent of available bandwidth is important for companies that process large quantities of data, and there might also be an interest, in certain situations, in relying on satellite connections. As another example, a reliable Internet

connection and low connectivity costs are required for voice-based services, and fibre-optic links might therefore be more relevant than satellite technology.

Offshoring decisions are also influenced by the characteristics of the market of the service provider. Although quality and affordability in ICT infrastructure is necessary, nowadays it is not a sufficient condition to attract export-oriented services projects in IT and ICT-enabled services. Other important variables include the sector-specific environment, overall business environment, geographic location and cultural affinity.

Finally, the characteristics of the service provider also play an important role. Services promotion and marketing is about selling a promise of trust and confidence. Two factors are thus critical: the level of knowledge, skills and expertise and a proven capacity to understand clients' instructions. Adaptability, flexibility and a competitive cost structure are also important factors. Box 1 provides an example of drivers and determinants of offshoring services.

## E. Trends

The global offshoring business is poised to grow, as more and more companies in a growing number of countries and industries are embracing the opportunities created by ICT for the specialization and internationalization of services. In addition, the scope of services affected by offshoring is continuously evolving, and countries should therefore carefully assess the areas in which they represent a competitive export location. Recent trends in the evolution of service sectors and regarding specific countries and regions are detailed in this chapter.

### 1. Trends in the evolution of different services sectors

Nowadays, enterprises choose to offshore services in multiple sectors as well as in processes with higher levels of complexity. Table 3 depicts the level of maturity of some service sectors, which are associated with different market features.

Traditional IT services are approaching a high level of maturity. Companies considering offshoring such services may therefore choose from among many suppliers and locations, and the growth in adoption rates has begun to lessen. By contrast, business process services are experiencing rapid growth.

Offshored ICT-enabled services are at an earlier stage of maturity and present better prospects for growth and revenues. The scope of industries

**Box 1. Central and Eastern Europe: Drivers and determinants for offshoring services to countries**

The offshore services industry began to develop in Central and Eastern European countries in the mid-2000s. The Czech Republic, Hungary, Poland, Romania, the Russian Federation, Slovakia, Slovenia and the Baltic countries have gained a foothold in services-related global value chains. Low wages and low operating costs play an important role in the level of attractiveness of these offshoring destinations, but other factors are also relevant.

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

Language capabilities and geographical and cultural proximity to Western Europe play an important role in the attractiveness of Hungary and Poland as services offshoring destinations. For example, capabilities in Poland in several European languages, including English, French, German and others, and capability in German in Hungary, as well as its linguistic proximity to minorities in neighbouring countries, were key factors in developing BPO and shared service sector activities in these two countries.

Enabling economic policies and a pro-business economic culture are also important determinants. In this regard, the Czech Republic is recognized for its well-established legal framework and investment incentives. In 2009, the country was ranked as the third most attractive offshore jurisdiction by the Economist Intelligence Unit, and the seventh in terms of investment attractiveness by Ernst and Young. From 2007 to 2011, the Czech Republic attracted the highest level of cumulative foreign direct investment in the region. As another example, the level of intellectual property protection in Poland was an important factor in successfully developing offshoring in research and development services

Source: Literature review including, among others, Czechinvest 2009; Ernst and Young, 2009; Gereffi, Castillo and Fernandez-Stark, 2009; Marriott and Tramacere, 2011; Marriott and Tramacere, 2012; and Sass 2008.

**Table 3. Offshoring maturity levels of different service activities, selected examples**

Level of maturity	Examples of services	Features
Already reaching maturity	IT services, such as programming and application development and maintenance	Decelerating adoption rates but continued growth in scope Clearly established players and locations Accepted business models and standards
Emerging rapid growth	Customer contacts Infrastructure management Finance and accounting Human resources Remote infrastructure monitoring Knowledge services	Accelerating adoption rates and increased scope and scale penetration Suppliers becoming established Market consolidation Location options with varying characteristics increasing Fewer, better established models leading to lower risk in choosing the appropriate design
Pioneer stage	Procurement Legal process offshoring	Untapped value proposition, early but few adopters Limited number of suppliers in few locations Multiple business models and unclear standards

Source: UNCTAD, 2009, *Information Economy Report 2009: Trends and Outlook in Turbulent Times* (New York and Geneva, United Nations publication).

and business functions that will become subject to offshoring is expected to expand in the long term. One assessment of the long-term prospects of the offshoring industry suggests that as much as 80 per cent of its incremental revenue until 2020 is expected to come from countries, customers, especially small and medium-sized enterprises, and new industries such as the public sector, health care, media and utilities (UNCTAD, 2009).

Developing countries therefore have an opportunity to develop a sizeable export-oriented services industry, if they are able to meet companies' time zone needs and needs for complementary assets in terms of skills, and an opportunity to exploit higher value niches, if they are able to develop competitive positions.

## 2. Trends regarding specific countries and regions

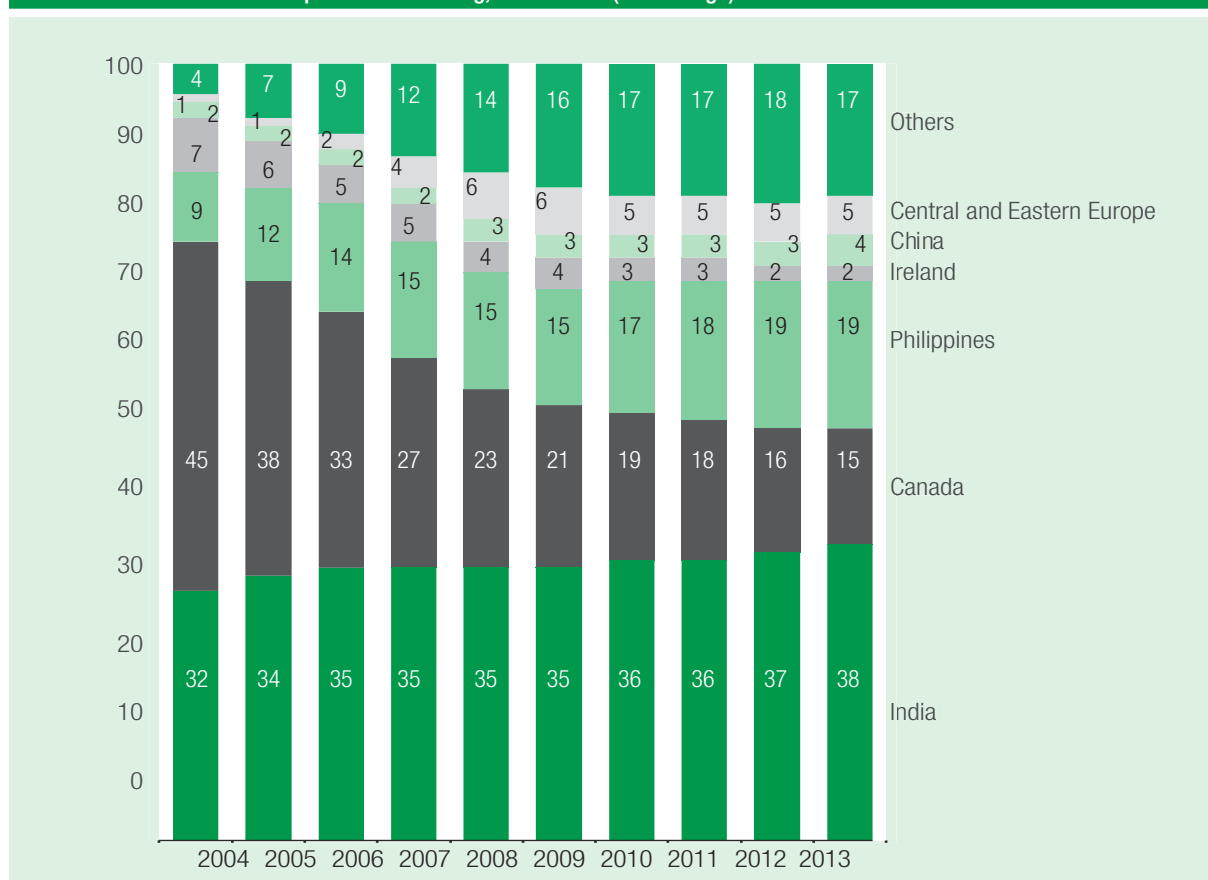
When growth in the export of IT and ICT-enabled services first began, four countries quickly emerged as key players: Canada and Ireland among developed

countries and India and the Philippines among developing countries. These initial key players remain present in the offshoring landscape today. The evolution of the shares of these countries and others during the last decade with respect to ICT-enabled services is depicted in the figure.

As shown in the figure below, India has long been and remains the preferred offshoring location for IT and ICT-enabled services. It is also apparent that although the early players remain leading global destinations for offshoring, other destinations are gaining ground for ICT-enabled services offshoring.

In fact, a trend towards geographical diversification in offshoring is evident. In the past few years, in the new geography of offshoring, dynamic new exporters have included countries from the developed and developing world. The most dynamic exporters of IT and ICT-enabled services appear to be concentrated in the Russian Federation and selected countries in the European Union and Asia and among transition economies.

Share of market for business process offshoring, 2004–2013 (Percentage)



Source: Everest Research Institute, 2013, Share of market for business process offshoring by location, April.

Table 4. Offshoring performers by category

Category	Source / period / data	Country performers
IT and ICT-enabled services	Balance of payments data / 2000–2007 / Exports of certain categories of services	<p><b>Top performers:</b> India and Ireland</p> <p><b>Gaining ground:</b> China, Singapore, the Russian Federation, Kuwait and Argentina</p> <p><b>Losing ground:</b> <i>Developed countries:</i> United States, followed by Japan, France and Canada <i>Developing countries:</i> Turkey, followed by Malaysia, Mexico, Saudi Arabia and Egypt <i>Territories:</i> Taiwan Province of China and Hong Kong (China)</p>
IT services	Market analysis data / 2003–2008 / Market analysis data	<p><b>Top performers:</b> Canada and India</p> <p><b>Dynamic newcomers:</b> New European Union members</p>
ICT-enabled services	Data of foreign direct investment projects related to selected ICT-enabled services / 2003–2008 / Business processes and customer contact services: proxy for front office services / Shared services centres: proxy for back office services	<p><b>Top performers:</b> United Kingdom of Great Britain and Ireland and United States</p> <p><b>Other excellent performers:</b> <i>Dominated by developed countries:</i> <b>Customer contact centres:</b> Canada, France, Germany and Ireland <b>Shared services centres:</b> Czech Republic, Hungary, Ireland and Poland <i>Dynamic developing countries:</i> <b>Asia (two-thirds of all customer contact centre projects in developing countries):</b> India and the Philippines <b>Africa:</b> Morocco, followed by Egypt and South Africa <b>Latin America:</b> Argentina, Brazil and Costa Rica</p>
	Market analysis data / 2003–2008* / Market analysis data	<p><b>Top Performers:</b> Canada, India, China, Ireland and the Philippines</p> <p><b>Dynamic emerging countries:</b> <b>Asia:</b> Malaysia, and Singapore <b>European Union:</b> Czech Republic, Hungary, Poland and Romania <b>Latin America:</b> Argentina, Brazil and Mexico</p>

Sources: Everest Research Institute, 2013, Share of market for business process offshoring by location, April and UNCTAD, 2009, *Information Economy Report 2009: Trends and Outlook in Turbulent Times* (New York and Geneva, United Nations publication).

\* In 2004, Canada, China, India, Ireland and the Philippines accounted for 95 per cent of the market. By 2013, their combined share accounted for 78 per cent.



In the developing world, a number of countries in Africa, Asia and Latin America and the Caribbean report significant gains in export shares, revealing their increased attractiveness in the provision of various business services. This evolution may relate to the fact that global service providers today seek to offer flexible solutions to their clients by employing different knowledge centres, with different language skills, in different time zones.

This trend is particularly evident in the case of voice-based services, for which companies seeking to offshore functions are searching for new locations in order to ensure round-the-clock delivery of flexible services. Latin America, due to its human capital, language capabilities, proximity to the United States and technology hubs is showing particular dynamism in this context. Table 4 identifies the top performers and dynamic newcomers in global offshoring.

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Benefits and challenges of  
participation by developing countries  
in the global offshoring market

II

## A. Potential benefits

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

Offshoring can contribute to economic efficiency for the importers of offshored services, for instance by generating efficiency gains from international specialization and trade. Importing companies and countries can access services at a lower cost and focus on areas where they enjoy a comparative advantage. It is important to recognize, however, that in recent years in many importing countries, the impact of offshoring on the labour market has become one of the major issues of concern for policymakers and in public opinion due to concerns over employment amidst the global financial crisis.

From the perspective of exporters, offshoring can lead to increased exports and employment, alleviate poverty and contribute to structural transformation and improved competitiveness. For exporting countries, successful participation in the offshoring services market may improve their chances of being better connected to the global economy, facilitating integration into the global trading system through participation in global value chains. Offshoring can also lead to the creation of attractive employment opportunities and to new sources of export revenues, positively influencing poverty alleviation and consumption.

Exporters may also benefit from spillover effects in respect of structural changes and enhanced competitiveness. For example, providing offshored services to TNCs related to knowledge-intensive activities may contribute to building productive capacity and economic upgrading through the dissemination of technology and managerial knowledge, enhancement of skills and provision of an impetus to restructure inefficient enterprises.

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

From the business exporters' perspective, offshoring has potential with respect to enterprise development. For example, offshoring may lead to the development of new business activities, increase the integration of small and medium-sized enterprises in global and regional value chains, increase efficiency by externalizing non-

core business functions and generate economies of scale through internationalization.

Box 2 provides an example of the benefits of offshoring.

## B. Challenges

Governments and businesses face challenges in maximizing development gains from the outsourcing and offshoring of services with regard to attracting clients and maximizing potential positive effects while minimizing potential negative effects, as detailed in this chapter.

### 1. Attracting clients

The first challenge faced by Governments and businesses lies in entering the global offshoring market by entering global value chains and linking with TNCs. Transnational corporations play an important role in ensuring that countries are able to enter the global services offshoring market, as demonstrated in foreign affiliate figures related to exports, employment and foreign direct investment. For instance, in 2008, even in a mature location such as the Philippines, foreign companies accounted for around 90 per cent of ICT-enabled services exports. Foreign companies also dominated with respect to employment. In the same year, in South Africa, foreign companies generated more than 50 per cent of the employment related to exports of business process services for the financial sector. Also in 2008, foreign companies' share of employment related to the offshoring of business services was 59 per cent in Honduras, 63 per cent in Saint Lucia, 82 per cent in Saint Vincent and the Grenadines and 90 per cent in El Salvador (UNCTAD, 2009). More than 60 per cent of global foreign direct investment stock is allocated to services activities, a significant portion of which is linked to global value chains (UNCTAD, 2013b).

Although foreign direct investment may be an important avenue for developing countries to gain access to and participate in global value chains, services outsourcing appears to be better fitted to the prevalent trend of non-equity modes of international production. Non-equity modes are contractual arrangements that coordinate the activities in host-country firms without ownership of a stake in those firms.

The main challenge in establishing offshoring relationships with potential partners is in promoting trust in service providers, by raising awareness of their know-how and domain knowledge. Policy and regulatory frameworks play a key role in promoting such trust and awareness and are further discussed in part two, section C.

### Box 2. India: Success with offshoring IT and ICT-enabled services

From a development perspective, outsourcing has visibly demonstrated its success in India. The country's growth as an offshore destination began in the mid-1990s. The country benefitted from the pioneer advantage and a time zone that was convenient for developed countries. Other factors in the attractiveness of India as a market for offshoring during this period included low labour costs, a sizeable English-speaking skilled workforce with demonstrated capacities in the field of software development, an appropriate ICT environment and agglomeration advantages.

Offshoring led to an exponential increase in exports, revenues and employment in India. Between 1994 and 2004, exports of software and ICT-enabled services grew from less than US\$0.5 million to US\$12 billion in 2003–2004. Between 2004 and 2009, the Indian offshore services industry showed continuous growth rates, with revenues growing fourfold and indirect job creation more than doubling.

In terms of structural change and increased competitiveness, India developed an efficient infrastructure and infrastructure-related services, for example in financial and telecommunications services, to support supply and export capacity in IT and ICT-enabled services. These changes benefitted the overall economy. India also developed its competitiveness at the firm level by upgrading its supplier capabilities and continuously expanding the range of exported services, as shown in the fact that India maintained its share in the rapidly evolving and highly competitive global offshoring market of ICT-enabled services in the last decade, as depicted in the figure in page 8.

In India, TNCs played a crucial role in business development in ICT-enabled services at the beginning of the 2000s. Initially, TNCs provided capital, knowledge expertise, new infrastructure and access to markets, and fostered the formation of new companies. Later, India was able to build on this by developing local suppliers' capabilities for offshored activities that were no longer linked to the operations of TNCs, evolving from a model of intrafirm captive offshoring to a model of outsourcing to third party external providers abroad. India was also able to move up the value chain of ICT-enabled services to providing services related to more complex corporate functions. The development and increased capabilities of the country's businesses also translated to investments and led to Indian companies venturing abroad. For example, in the mid-2000s, India invested heavily in software and related services in the United States and other developed countries (in Western Europe) and Indian business process outsourcing and call centres established foreign affiliates in Mexico and the Philippines.

*Sources:* Gereffi G and Fernandez-Stark K, 2010, The offshore services value chain: Developing countries and the crisis, Policy Research Working Paper No. 5262, World Bank, available at <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-5262> (accessed 21 July 2014); Suri N, 2005, Outsourcing and development, paper presented at the Expert Meeting on Strengthening Participation of Developing Countries in Dynamic and New Sectors of World Trade: Trends, Issues and Policies, Geneva, 7–9 February; UNCTAD, 2004, World Investment Report 2004: the Shift towards Services (New York and Geneva, United Nations publication); and UNCTAD, 2009, Information Economy Report 2009: Trends and Outlook in Turbulent Times (New York and Geneva, United Nations publication).

### 2. Maximizing potential positive effects and minimizing potential negative effects

Ensuring development gains involves maximizing potential positive effects and minimizing potential negative effects. Services offshoring can yield significant development benefits in terms of employment, export earnings, knowledge transfers, technology dissemination and the upgrading of productive capacities. However, not all of these benefits are automatic. The extent to which they materialize will depend on the capabilities of local firms and on the balance of power between firms and partner TNCs, as well as the general policy framework in host countries.

Minimizing potential negative effects has its own challenges. One challenge is that local companies may have little bargaining power to negotiate the terms and conditions of their contractual arrangements with TNCs. Table 5 identifies aspects of non-equity modes

that represent contractual levers of TNC control over host country firms and sources of bargaining power for TNCs in respect of services outsourcing.

Maintaining the presence of offshored service providers is another challenge in minimizing potential negative effects. The location of offshored tasks and activities can easily shift among the international production networks of multinational firms, as it is determined by dynamic factors such as relative labour productivity and costs. In addition, the global offshoring market is becoming increasingly competitive, with a rise in labour costs in the most popular locations, competitive pressures, pressures to improve host country environments and a broadening of the geographic scope of locations for services offshoring. Developing countries are thereby made vulnerable if TNCs decide to shift their services activities, and their dependency is not only in relation to access to markets but also, in certain cases, access to technology.

**Table 5. Contractual levers and sources of bargaining power for transnational corporations in respect of services outsourcing**

Contractual levers	Sources of bargaining power
Specifications for design, process, service and quality	Access to the TNC internal market, guaranteed sales
Commercial terms and capital expenditure obligations/ assurances	Access to TNC know-how, supplies of inputs, logistics network
Obligations regarding the corporate social responsibility practices of TNCs	Existence of many potential contract suppliers

Source: UNCTAD, 2011, *World Investment Report 2011: Non-equity Modes of International Production and Development*, (New York and Geneva, United Nations publication).

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

Services offshoring may also generate potential negative social effects. Offshoring is focused on the reduction of production costs and may therefore lead to weak employment conditions and the violation of national and international labour rights. For example, complaints regarding BPO-related work in India encompassed health concerns with regard to night shifts and sleep deprivation, concerns related to social life due to night-time and sleep routines and concerns regarding the dilution of cultural values. The *Information Economy Report 2010* explored the link between the export of offshored services and poverty reduction in India, and concluded that most direct and indirect job creation had occurred in a few major urban agglomerations, partly due to stringent requirements related to infrastructure quality and costs, and had therefore not significantly benefitted the rural poor, which constituted the population segment with the highest poverty rate (UNCTAD, 2010).

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

### C. Policy action spheres for developing supply-side capacity and promoting exports

Research conducted by UNCTAD shows that Governments have a fundamental role to play in ensuring that companies in developing countries benefit from the existing opportunities in outsourcing and offshoring markets. Policy spheres significant for the development of supply-side capacity and the promotion of exports in IT and ICT-enabled services are detailed in this chapter.

#### 1. Building supply-side capacity

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

##### *Developing infrastructure*

A sound telecommunications infrastructure, along with a skilled work force, is an imperative for establishing a successful ICT-enabled services sector. Countries

that have been able to set up international platforms that provide competitively priced high-speed Internet connectivity have a much higher probability of succeeding. A key issue to address in this regard is the quality and cost of broadband connectivity, as detailed in box 3.

### *Developing human and business skills*

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

Countries that seek to take advantage of the opportunities available in these sectors must develop a set of policies to ensure that they can produce a sufficient number of professionals with the skills needed, establish a standard to certify the quality of skills provided and attract candidates for certification and deployment in these sectors. The possible spheres of action to develop the requisite skills are summarized in table 6.

In addition to skills specific to the functions of ICT-enabled services, certain horizontal skills are also important to successfully integrate local businesses in global value chains through non-equity modes for services outsourcing. These skills include general managerial competencies, such as financial, marketing and management knowledge, and are critical in allowing entrepreneurs to manage their businesses efficiently and in ensuring that local firms develop absorptive capacities in order to benefit from skills and technology derived from their participation in global value chains.

A good way to develop entrepreneurship skills is to embed training on financial literacy and business strategy for start-ups in the formal education system at all levels, including schools, universities and private sector bodies. Vocational training may also contribute to developing these skills, as it enhances the capability of local companies to recruit for specific occupations without requiring formal academic involvement.

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

### **Box 3. Policy and regulatory frameworks to overcome an infrastructure deficit**

Broadband networks are critical in facilitating trade in services by electronic means and thus for developing an offshored services industry. Despite positive developments in narrowing the digital divide, in the area of broadband connectivity wide gaps between high-income and low-income countries remain, which may potentially delay the transition to next generation networks and, therefore, the use of such networks as platforms to adequately support an emerging industry of offshored services.

Policies to facilitate broadband roll-out range from taxation and fiscal incentives to market liberalization and may also include universal access and market stimulation. In adapting the policy and regulatory environment, operators should be encouraged to share state-of-the-art backbone infrastructure in order to avoid duplicative and fragmented low bandwidth networks. A critical component of ensuring sufficient broadband supply at reasonable prices is exposing operators to competition.

Governments may make use of universal access service funds to respond to the challenge of achieving more widespread deployment of broadband backbones and access networks in remote and less densely populated areas. Another way to enhance broadband access is through the promotion of public Internet access points or telecentres. In the case of international broadband connections, countries must connect with undersea cable projects or, in the case of landlocked countries, build out fibre links to connect with submarine cable landing stations in other countries.

Source: UNCTAD, 2009, *Information Economy Report 2009: Trends and Outlook in Turbulent Times* (New York and Geneva, United Nations publication).

**Table 6. Spheres of action to develop skills for the ICT-enabled services sector**

Requisite skill	Objective	Possible sphere of action
English language and computer literacy	Improve these skills	Primary and secondary education
Basic customer orientation and behaviour	Improve these skills	Higher secondary education
Specific knowledge related to the ICT-enabled services function	Improve domain awareness on issues specific to the sector and provide graduates with foreign language capabilities relevant to ICT-enabled services functions	Tertiary education, for example, by including modules on international standards for finance and accounting, targeting accounting, finance and commerce undergraduates, and providing the possibility of taking one or more courses directly related to BPO functions in English or another relevant language, as well as cultural exchange programmes with countries that have successfully developed an ICT-enabled services sector  On-the-job training, for example by providing in-house or on-site training programmes
Ability to undertake more sophisticated tasks	Upgrade service offers to more sophisticated ICT-enabled services functions	Post-graduate education, for example by requesting inputs from industry leaders to develop academic programmes in careers related to research and development, such as engineering, computer-related subjects, IT and mathematics

Source: Suri N, 2005, Outsourcing and development, paper presented at the UNCTAD Expert Meeting on Strengthening Participation of Developing Countries in Dynamic and New Sectors of World Trade: Trends, Issues and Policies, Geneva, 7–9 February.

Local companies may also need to develop skills to negotiate non-equity modes and local entrepreneurs can benefit greatly from advice on how to negotiate a non-equity mode contract, including economic aspects such as the distribution of business risks, financial considerations such as taxation and legal elements with regard to contract implications. In most cases, it is not the lack of an adequate legal framework but of carefully drafted contracts that is the basis of subsequent problems and failures.

Governments may play a role, for instance by developing and publishing negotiation guidelines, checklists of issues to be considered in negotiations, codes of conduct, model contracts, including for contract farming, or benchmark prices for the

respective products or services. Promoting a contract culture, i.e. a better understanding of the merits of entering into formal contracts, is also vital. In addition, supporting collective bargaining, including the formation of domestic producer associations, can help to create a counterweight to the bargaining powers of TNCs.

A strategy to strengthen the skills required to develop offshored services would benefit from the inclusion of the following objectives:

- (a) Creating awareness of opportunities in the sector, through industry or professional associations and career counselling at high schools, colleges and universities.

- (b) Strengthening collaboration between businesses, the academic sector and policymakers to meet human resource requirements to develop the sector. This may be effected, for example, by implementing vocational training that interacts with apprenticeship systems or establishing entrepreneurship centres to serve as hubs to coordinate activities across businesses and educational institutions. Areas of collaboration between public and private sectors may consist of fiscal incentives for private sector players that provide basic and domain-specific training for ICT-enabled services sectors. Such a scheme was used, for example, to develop BPO-related skills in India (Suri, 2005).
- (c) Certifying skill levels. Ensuring appropriate levels of quality may be a challenge faced by new entrants in the ICT-enabled services sector and, to overcome it, Governments may work with industry in introducing a standard test that certifies the basic skills required in the sector, including fluency in the relevant languages, customer service orientation and teamwork ability. An annual review mechanism may be built into the certification process to keep it current with the needs of a rapidly evolving industry.
- (d) Promoting quality awareness. As ICT-enabled services have evolved in complexity, quality has emerged as a key issue in the success of ICT-enabled operations, allowing service providers to differentiate themselves and claim an edge over competitors in obtaining major global contracts. Quality certifications serve as a road map for sustained improvement in processes, adding value and strengthening relationships between vendors and clients. They also provide parameters for appraising the performance of service providers in a consistent and comparable manner, allowing clients to separate high performance vendors from those with more ordinary records. When considering the creation of a BPO business, companies in developing countries may consider building quality levels, beginning with operations involving basic skills such as data entry and then expanding to include more complex business processes. Starting at a lower skill level reduces costs and risks, allowing time for a learning curve until quality implementation has been achieved. Beginning with low-risk projects and paying special attention to the transition is critical, as is focusing on a few projects, in order to provide high-quality services and thereby learn the business mentality of BPO clients, build confidence and successfully promote endogenous capacities.
- A case study on building quality awareness and improving service offers is provided in box 4.

### Box 4. India: Strategy for building quality awareness and improving service offers

The IT industry in India undertook a conscious drive towards internationally recognized certifications and analysts consider this as an important factor in raising the comfort level of clients and in the industry's move up the value chain and sustained high-growth trajectory. The industry has moved through three distinct phases in seeking high-level certification. In the first phase, the emphasis was on the creation of basic processes to handle all activities related to order fulfilment. The International Organization for Standardization 9000 European standard served as a useful benchmark for this purpose. In the second phase, the focus shifted to more sophisticated software engineering, and IT companies attempted to align their quality management systems with the Capability Maturity Model for software of the Software Engineering Institute of Carnegie Mellon University, submitting their systems to one or more assessments at increasing levels of maturity. In the third phase, the focus again shifted to instituting processes and metrics and a framework for improvement in all areas of activity, ranging from billing, collection and sales to human resources development and after-sales support. Companies attempted to achieve this by aligning their internal practices with the People Capability Maturity Model framework, using the Six Sigma methodology to reduce quality variations and putting in place systems that ensure quality in all company operations.

Source: Suri N, 2005, Outsourcing and development, paper presented at the UNCTAD Expert Meeting on Strengthening Participation of Developing Countries in Dynamic and New Sectors of World Trade: Trends, Issues and Policies, Geneva, 7–9 February.



### *Implementing an enabling policy framework*

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

Government support measures can help ensure that the benefits of developing an ICT-enabled services industry actually materialize. Active policies consisting of fiscal and taxation incentives and cluster development programmes have proven successful in developing supply capacity and maximizing development gains of offshored services. Such policies seek to improve the location advantages of the potential winners, once these and the niches in which they can compete most effectively have been identified.

Offering taxation incentives and financial support can be an important part of a strategy to develop a local services industry for the global offshoring market. Fiscal incentives can lure investors to the production of ICT-enabled services and attract foreign affiliates. Generous financial incentive packages were, for example, determinant in attracting leading TNCs such as DHL, Honeywell, International Business Machines, Motorola and ExxonMobil to offshore services centres in the Czech Republic. India, as well, used tax breaks and other financial support measures to encourage foreign-based companies to outsource parts of their business or to develop and own businesses in India. Box 5 provides a similar example from Uruguay.

Subsidies can also contribute to domestic capacity-building. For example, the availability of support from European Union structural funds and from the central Government was critical in Poland in developing the offshoring of services performing BPO, shared services centres and research and development tasks.

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

The development of an offshoring industry is often characterized by reduced backward and forward linkages with other economic sectors, leading to little spillover effects for the local economy. Many countries also face difficulties in ensuring that offshoring activities translate into concrete opportunities for small and medium-sized enterprises and less favoured areas. These aspects may also be considered part of the sphere of policy action to maximize the potential positive effects of offshoring, and may be addressed through the creation of productive clusters. Clusters are collaborations between a diverse number of public and private sector actors, such as government agencies, firms and academic institutions, organized with a view to improving the competitiveness of one of several business sectors.

Such intrafirm cooperation contributed to the development of services associated with goods production in economic processing zones in the 2000s. Services activities were originally limited to warehousing and trade facilitation, but economic processing zones gradually began to attract other services, including call centres and medical diagnosis, business, engineering, architectural and financial services. Technology parks were also introduced, in order to provide well-developed technological support

#### **Box 5. Uruguay: Fiscal incentives to develop offshore services**

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

Source: UNCTAD, 2009, *Information Economy Report 2009: Trends and Outlook in Turbulent Times* (New York and Geneva, United Nations publication).

and infrastructure, and were successfully used by, for instance, India, Jamaica and the United Arab Emirates to increase their attractiveness as offshoring services hubs.

Other cluster initiatives seek to promote small and medium-sized enterprises by generating opportunities to link with larger national and regional and other foreign companies, as well as by providing venture capital to support start-ups and incubators. Incubators are schemes whereby small and medium-sized enterprises receive direct Government to business services in strategic sectors. ICT incubators are specially designed to extend networks, facilitate the exchange of ideas, information and knowledge and assist in management and technological development. Mauritius, for example, has used incubator schemes to finance enterprises in IT and ICT-enabled services and has also developed technology and free trade zones. Such initiatives contributed decisively to the evolution of the outsourcing industry during the period 2008–2012. Starting with basic data services tasks, Mauritius developed supply and export capacity in increasingly knowledge process outsourcing complex processes, and is recognized as a centre of excellence in the areas of finance, accounting and IT services (Conboy, 2012).

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

### **Implementing an enabling regulatory framework**

Promoting and facilitating services offshoring and ensuring development gains from services offshoring depends on clear and stable rules on a number of regulatory issues, including the following:

(a) Business facilitation. Facilitating business activities and avoiding cumbersome administrative laws contribute to attracting non-equity modes, for example through the simplification of administrative steps to launch a new business, which may be effected through one-stop shop initiatives that concentrate registration procedures in a single agency, thereby reducing the time and costs needed to launch a company. Communication campaigns on existing regulations via media such as

websites can also contribute to business facilitation.

- (b) A strong and stable commercial contract law. Non-equity modes are essentially a contract-based form of TNC engagement in the host economy, and non-equity mode parties need to be advised of, for example, which domestic rules govern their contract, the extent to which these regulations constrain their contractual discretion, whether and to what extent they have the right to choose the law of a third country to apply to the contract, the consequences of a breach of contract and which procedures apply in the event of a dispute.
- (c) Protection of private data. Growing concerns over privacy issues and the fear of sensitive personal information falling into unauthorized hands could have a disproportionate effect on the offshoring of data and services. In an environment marked by periodic attacks on data by hackers and computer viruses, the issue of information security and data privacy is increasingly important to assure companies in ICT-enabled services and their customers of the safety of their data.
- (d) Protection of intellectual property. Non-equity modes are, in essence, a transfer of intellectual property to a host-country firm under the protection of a contract, and intellectual property protection is therefore important and can contribute to the acquisition of knowledge and a gradual move towards more sophisticated services production, especially in areas that are research- and development-intensive.
- (e) Labour policies and regulation. Governments play an important role in influencing working conditions and defining, communicating and enforcing labour legislation.
- (f) Competition. If TNCs engaged in non-equity modes acquire dominant positions, they may be able to abuse their market power to the detriment of their competitors, both domestic and foreign, as well as their own trading partners. Therefore, policies to promote non-equity modes need to be implemented along with policies to safeguard competition.

## 2. Promoting exports

### Marketing

Promoting the export of offshored services is mainly achieved through marketing. Key areas for action in this regard relate to the effective promotion of existing opportunities to potential investors, public relations and the building of partnerships and the reputation of local service providers, in order to be able to capture offshoring opportunities. Investment and export promotion agencies play a key role in this respect, providing information, facilitating projects and developing brand awareness and recognition in export markets. Activities regarding information-sharing range from undertaking market research, business partner searches and individual market visit programmes, to participating in international fairs and organizing special marketing missions. The facilitation of projects in the area of services offshoring involves business matchmaking, i.e. establishing partnerships between foreign and local companies. Developing brand awareness, or branding, involves creating an image that is recognizable in terms of the quality of services provided. A case study on such promotional activities is provided in box 6.

### Services offshoring and trade

In recent years, advances in telecommunications technology and the evolution of business models have created strong interdependencies and linkages between the individual modes of trade in services: cross-border trade, consumption abroad, commercial presence and presence of natural persons. Offshoring is usually viewed as supply mode 1. However, there is a view that it should be considered as consumption abroad and therefore fall under mode 2. From a business perspective, particularly in the ICT-enabled services sector, modes 1, 3 and 4 are closely intertwined.

For example, in Peru, companies in the engineering consulting sector export such services using modes 1, 3 and 4 of supply. Mode 3 exports of engineering consulting services have become increasingly linked to mode 4 in Peru. Peruvian companies are establishing branches and offices in several Latin American countries to seek business opportunities and creating specialized project teams with local companies for work in the region or are opening offices in foreign markets with Peruvian personnel and gradually including local personnel (UNCTAD, forthcoming).

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

There are indications that the rapid growth of mode 1 offshored services may also act to a certain extent as a substitute for mode 4. Since many internationally traded services tend to be labour and/or knowledge intensive, the cross border supply of such services can reduce the need for individuals to traverse physical distances in order to provide services.

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

#### Box 6. Peru: Export promotion strategies for offshored services

The Commission for the Promotion of Peru in Export and Tourism (Promperú) is the investment and export promotion agency of Peru. In recent years, it has actively engaged in efforts to develop an export offer of services in Peru and sectors to capture greater offshoring opportunities in high value added segments.

Although there is little information available regarding the effectiveness of these promotion efforts, they have certainly contributed to creating a positive framework for developing export potential by creating and promoting brands to identify services that Peru offers abroad, creating partnerships and clusters among local companies and ensuring the participation of local companies in international industry events, as well as through the development of information brochures to highlight the achievements of service sectors. These efforts have especially favoured small and medium-sized enterprises.

The software sector in particular has been continuously supported by the Commission, which was instrumental in the creation of the sector's business association. As part of initiatives to support the sector, the Commission provides commercial intelligence services to identify export opportunities and promotes the participation of Peruvian businesses in a variety of commercial missions and in domestic and international fairs to make the country's offer known to potential clients in target markets

Source: UNCTAD, forthcoming, *Services Policy Review: Peru* (United Nations publication).

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## CONCLUSION

There are two main challenges for countries that wish to capture greater opportunities from the global services offshoring market: attracting clients and maximizing the potential positive effects while minimizing the potential negative effects. Research conducted by UNCTAD shows that Governments have a fundamental role to play in ensuring that companies in developing countries benefit from existing opportunities in outsourcing and offshoring markets.

To ensure that services offshoring can contribute to achieving development objectives, strategies aimed at the promotion of such services should be embedded in a broader development strategy. Support for services offshoring may fall under different policy spheres such as investment, industry, technology and innovation. In order to maximize benefits, these policy spheres should be coherent.

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

- (a) Providing access to competitively priced high-speed Internet connectivity lines.
- (b) Promoting the requisite skills to develop the sector, establishing a standard to certify the quality of skills provided and attracting candidates for certification and deployment in the sector. At the personal level, such skills may include languages, computer literacy, basic customer orientation and behaviour and knowledge that is specific to ICT-enabled services functions, as well as other skills that enable the undertaking of more sophisticated tasks. At the business level, such skills may include entrepreneurship and managerial competencies, as well as problem-solving and communication skills and legal skills for negotiating offshoring services contracts.
- (c) Implementing support measures, which can help ensure that the benefits of developing an ICT-enabled services industry actually materialize, and may include fiscal incentives and financial support or cluster development policies.
- (d) Implementing an enabling regulatory framework that facilitates business operations, defines and enforces labour standards, promotes competition and ensures contract stability, the protection of private data and the protection of intellectual property.

Promoting the export of offshored services mainly involves marketing. Key areas for action to capture offshoring opportunities include promoting existing opportunities to potential investors, building business partnerships and developing awareness of the offers of local service providers. In promoting exports through offshoring, recognition of increased interlinkages among service supply modes is necessary. This aspect is also relevant for trade negotiation strategies and the identification of barriers to trade in these services, in order to address them effectively.

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