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**OUTSOURCING MARKETS IN SERVICES:
INTERNATIONAL BUSINESS TRENDS, PATTERNS
AND EMERGING ISSUES**

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LIST OF ABBREVIATIONS

- 3PL – Third Party Logistics**
- BTAs - Bi-lateral Trade Agreements**
- BPO - Business Process Outsourcing**
- CAGR - Compound Annual Growth Rate**
- CIP - Competitive Industrial Performance**
- DISK - Data, information, statistics and knowledge**
- FDI - Foreign Direct Investment**
- FMSS - Foreign Market Servicing Strategies**
- GATS - General Agreement on Trade in Services**
- GSCs - Global Supply Chains**
- GVCs - Global Value Chains**
- HCLs – Higher Cost locations**
- HQs – Headquarters**
- ICT - Information Communications Technologies**
- IGF - Integrated Global Factory**
- IOR - Indian Ocean Rim**
- IP - Investment promotion**
- IPAs - Investment Promotion Agencies**
- IINs - Integrated International Sourcing, Technology, Production, Marketing and Servicing Networks**
- ISIC – International Standard Industrial Classification**
- LCLs - Lower Cost locations**
- LSAs - Location Specific Advantages**
- MNEs - Multinational Enterprises**
- MVA - Manufacturing Value-added**
- OO - Offshoring and Outsourcing**
- PIs – Policy Instruments**
- R&D – Research and Development**
- RTAs - Regional Trade Agreements**
- SOO - Services Offshoring and Outsourcing**
- UNIDO - United Nations Industrial Development Organization**
- VIIT - Vertical inter-industry trade**

OUTSOURCING MARKETS IN SERVICES: INTERNATIONAL BUSINESS TRENDS, PATTERNS AND EMERGING ISSUES

ABSTRACT

The global context and estimates of the market for outsourcing, within the framework of Multinational Enterprises' (MNEs) Foreign Direct Investment (FDI), are reviewed. The examination of geo-economic spatiality of MNEs international involvement, including outsourcing, shows stark gravitational asymmetries with the Triad economies of North America, European Union and Japan as core and South and East Asia as periphery – particularly China and India. The impacts of outsourcing on policy issues, and responses, are scrutinised to expose the key variables of policy craft.

PREAMBLE

This working paper discusses the various dimensions of using direct investment and contractual modalities to service global markets by firms in their internationalisation. We find that, while Foreign Direct Investment (FDI) continues to dominate international business, international contracting -- as outsourcing -- is growing rapidly in significance as one of the key cost-reducing elements in the strategic options of Multinational Enterprises (MNEs).

While outsourcing markets are difficult to estimate, due to the escalating digitisation of the knowledge-based economy, there is an expectation that they will expand at compound annual growth rates (CAGR) of between 15% and 40% with China and India taking the Lion's share of contracts to the developing countries. We find considerable variation not only in the spatial distribution of FDI and outsourcing but also in the relative location specific advantages (LSAs) of China and India with respect to outsourcing.

Finally, the correlation of outsourcing to firm performance, which carries serious implications for the crafting of host policies, is moderated by significant gaps between expectations and actual results of outsourcing. The correlation between outsourcing and firm performance is determined by complex non-monotonic relationships at the level of certain key factors of what is outsourced namely: asset specificity; transaction frequency; technological uncertainty; as well as process and product innovativeness. At relatively lower factor levels, outsourcing is positively correlated with firm performance. At relatively higher factor levels, outsourcing is negatively correlated with firm performance. Host policy to prevent this inflexion in firm performance -- and hence the potential of the outsourcing of higher levels of activity not being carried out by firms -- requires attention to the upgrading of domestic industry and local firm capabilities to enable them to execute progressively higher value-added outsourcing.

1. INTRODUCTION

This working paper deals with the related phenomena – ‘offshoring’ and ‘outsourcing’ (OO)¹ (terms which represent changing preferences in terminology regarding the internationalisation of business). It does so using the well-established principles in the discipline of international business as well as the ‘lens’ provided by the empirical evidence of Foreign Direct Investment (FDI) by Multinational Enterprises (MNEs). This permits firstly, a view of offshore production as a general case of FDI involving entry modalities and governance structures ranging from hierarchies to markets - from full ownership to control without equity, and arm’s length relationships. Secondly, outsourcing can be viewed in terms of market-based, or intermediated, transactions through contract [Williamson (1975)]. This is in contrast to transactions (or transformations - i.e. adding value to products or services) which are ‘internalised’ within the organisational boundaries², thereby inside the internal governance structure of the MNE and thus occluded from markets [Buckley (1988)]. Internalised transactions are therefore subject to transfer pricing modalities (arm’s length to manipulative) that are far removed from market-based contractual relations [Yeaple (2003)].

It is increasingly apparent that despite the predominant role of MNEs FDI in integrating global industrial dynamics, and the lexicon of managerial economics in explaining globalisation [Bartels and Pass (2000)], nuances are noticeable in the general characteristics of FDI. This is especially so with regard to the evolving spatial distribution of FDI and the value and supply inter-linkages within cross-border business transactions and trade. These nuances range from emergent ‘new’ properties in the international, and inter-regional, division of labour and vertical inter-industry trade (VIIT) [Yeats (2001)] to concerns about the externalities from, and impact of, the decentralisation of MNEs’ corporate functions³. The nuances also reflect the changing nature of competition. This represents a shift from competitiveness as a uni-dimensional interpretation of business conflict to a multi-dimensional view of competition as a spectrum of (national and cross-border) co-operation (strategic alliances, equity and non-equity joint ventures, sub-contracting) [Dunning (1997); Doz and Prahalad (1989)] and public-private sector partnerships within state-

¹ The terms offshoring and outsourcing will be used interchangeably with offshore outsourcing.

² To avoid the transaction costs of Williamsonian market failure i.e. the intractableness of; complexity and dynamism in the real world economy, the problem of small numbers (oligopoly), opportunism, information impactedness and asymmetries, asset specificities, and bounded rationality.

³ This decentralisation of operations is from the ‘core’, or headquarters (HQs), to the periphery, or subsidiaries (subsidiarity) via mandates. See Birkinshaw (1996) for an analysis of HQs-subsidiary mandates in FDI and international location of production *within the organisational boundaries of MNEs*; and The Boston Consulting Group (2004) for a structural analysis of the international relocation of operations and services *between the organisational boundaries of MNEs*.

MNEs contentions [Stopford, Strange and Henley (1991)]. This rapidly changing nature of competition is co-evolving with shifts in tariff and non-tariff barriers to trade as well as a general fall in the level of protectionism⁴. And finally, there are the subtleties of the so-called knowledge-based economy and globalisation, and their impact on the increasingly spatial distribution of economic activity, which display simultaneous concentration of higher value (capital) activities and dispersal of lower value (labour) operations⁵.

The remainder of this paper is organised as follows. Section 2 - The Global Context, Taxonomy and Estimates, sketches the major trends in FDI that shape the emergent nuances in offshore outsourcing. It also addresses the definitional issues and attempts to quantify the markets for outsourcing. Section 3 – The Macro-economic Context, delineates the key global trends of services offshore outsourcing (SOO) as international contracting co-evolving with FDI. Section 4 – The Spatiality of Offshore Outsourcing, maps the variety of OO activity and the distribution of that activity as patterns across geo-economic space. It highlights the widening asymmetries within the landscape. Section 5 – China and India Compared and Contrasted, examines the current attention on these two hosts and their relative competitiveness in terms of location specific advantages (LSAs) with respect to OO. It draws out salient features of the respective investment climates and challenges therein. Section 6 – Service Offshore Outsourcing Impacts and Implications, looks at the phenomena of SOO from the host perspective. It points to the domestic structural adjustments necessary to attract and capture SOO. Section 7 – Policy Issues, looks at the framework for policy objectives and related policy instruments to capture increasing shares of the global market for SOO. Section 8 – Concluding Remarks, reviews the emerging global policy arena for SOO.

2 THE GLOBAL CONTEXT, TAXONOMY AND ESTIMATES

The world is envisaged “as a grid of potential locations for value-adding activities, connected by flows of information and products.” [Buckley and Hashai (2004, p. 33)] Within this grid seven major interrelated factors -- akin to paradigm shifts -- are shaping the emergent nuances in internationalisation [Laudicina (2004)]. They are:

⁴ The decreasing barriers to factor movements is partly a result of structural adjustment pressures for increased economic liberalisation. The number of countries making regulatory changes to FDI regimes between 1991 and 2001 is cumulatively 652, averaging 59 per year. The number of pro-FDI changes is cumulatively 1315, averaging 120 per year whilst anti-FDI changes number cumulatively 78, averaging seven per year [UNCTAD, 2002, World Investment Report: Transnational Corporations and Export Competitiveness, Geneva: UNCTAD, Box 1.2, p.7].

⁵ See American Electronics Association, 2004, Offshore Outsourcing in an increasingly competitive and rapidly changing world: A high-tech perspective, March, for the countervailing currents in the global division of labour.

- (i) accelerations in technological advances; globalisation; demographic bifurcation in population dynamics between the industrialised and developing countries;
- (ii) fragmenting consumer behaviour;
- (iii) increasing demand on the environment and natural resources; ‘complexification’ of the regulatory environment; and
- (iv) increased stakeholder activism.

The long-term impact of population ageing in the industrialised world⁶ -- labour shortages at competitive productivity-adjusted cost -- can only be met by technology and immigration or ‘exporting jobs’. That is the offshore outsourcing of increasingly sophisticated business operations to the increasingly skilled labour pools of the more advanced emerging markets and developing countries in Asia.

Offshoring and outsourcing -- FDI hierarchies and markets -- need to be appreciated for the purposes of economic and, consequently, industrial policy objectives, from the perspective of FDI (host investment climate issues) and markets (host domestic industrial structures). Definitions of FDI and contracting [Bartels (2004); Buckley and Casson (2002); Dunning (2000); Buckley (1999)] are readily available in the literature⁷. And in essence these definitions will suffice to explain offshoring and outsourcing. However, the widely accepted terms offshoring⁸ and outsourcing -- and their coupling -- require refining to assist the appreciation of the emergent nuances in global production and servicing. Despite the long-term growth in FDI, the growth in offshore outsourcing may be attributed to MNEs perceptions and management of risk in international business.

MNEs with predictably structured divisions locked into rigid linkages with other parts of the *same* firm have evolved into a new international structure in an environment that is very different from earlier times. This is very challenging from a policy perspective. With competitive pressures increasing relentlessly, the questions asked by MNEs are first, where to locate productive assets and

⁶ See Global Demographic Change: Economic Impacts and Policy Challenges, Proceedings of a Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 26 – 28 August 2004. The 21st century will experience unprecedented structural demographic change that could transform the world economy over the next several decades. Developed countries will experience increases in older age, while developing economies are likely to see a large increase in their working age populations.

⁷ See *inter alia* Dunning J. H., 1958, *American Investment in British Manufacturing Industry*, London: George Allen and Unwin; UNIDO, 2003, *Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries*, Vienna: UNIDO; and *The Future of Foreign Investment in Southeast Asia*, Nick J. Freeman and Frank L. Bartels, Eds., London: RoutledgeCurzon, 2004.

⁸ This term should not be confused with *offshore* which is used to describe the tax minimising location of banking and financial legal entities. Of course the resulting spatial distribution of economic activity across sovereign borders enables international transfer pricing to contribute to MNEs global tax minimisation strategies.

source contract manufacturing activity and services in a manner that efficiently differentiates between locations and maximises the difference between manufacturing value-added (and, ultimately, sales), services and locational cost structures? Secondly, how should the assets and contract activity be co-ordinated and controlled as a system? And thirdly, should the spatially differentiated manufacturing plants producing similar products use similar technology and production processes. In other words, how should capital/labour intensities be distributed across the system?

The location decision concerns the relative merits of the cost and market-related advantages between different locations. The control decision concerns whether or not to own, or to have *an option* on ownership [Trigeorgis (1996)] through collaboration (for example outsourcing, sub-contract, joint venture, strategic alliance with different firms). The similar manufacturing process decision concerns horizontal integration and the effective technology transfer between subsidiaries and service providers so as to enable rapid response to competitors and market changes. In the new economic environment, MNEs desire for flexibility militates against the rigid backward and forward vertical integration into input factors or into distribution of the earlier era of MNEs organisation. The more advantageous alternative is to sub-contract production and servicing, and franchise sales through OO (thereby distributing the associated risk profiles).

The new economic perspective for MNEs in managing international operations concentrates managerial attention on: (i) the characteristics of volatility and uncertainty in markets; (ii) the value of options and flexibility in entry modes for FDI; (iii) alliances, collaborative and network forms of co-operation and competition; (iv) entrepreneurship within networks; (v) managerial competence; and (vi) corporate and organisational cultures that are progressively more adaptable to the demands of change. This set translates into flexibility of operations. This is the ability to orchestrate the allocation, and re-allocation, of resources efficiently, smoothly and rapidly in anticipation of, and response to, change. The greater the amplitude and frequency of change in the business environment, the greater this need for organisational and operational flexibility. Table 1 – Regional FDI Inflows 1980 – 2003 (US\$ Millions), shows the persistent pattern of FDI which underscores structures of OO.

**REGIONAL FDI INFLOWS 1980-2003
(MILLIONS OF US\$)**

Region	1980	1985	1990	1995	2000	2003
Industrialized Countries	46,481	42,044	172,261	224,776	1,284,177	421,584
North Africa	132	1,422	1,135	866	2,600	2,215
Central Africa	184	681	-354	296	902	n.a.
Western Africa	-507	473	892	1,653	744	413
East & Southern Africa	305	168	514	953	1,807	721
Western Asia & Europe	-3,349	955	2,587	157	3,560	7,075
Latin America	6,434	5,734	819	30,393	78,708	35,688
South & East Asia	2,480	4,387	16,987	65,328	135,990	80,521
TOTAL	52,160	55,864	194,841	32,4422	1,508,488	548,217

SOURCE: UNIDO Statistics compiled from International Finance Statistics (from International Monetary Fund) according to UNIDO list of countries & areas included in selected groupings in the International Yearbook of Industrial Statistics 2004.

Table 1 – Regional FDI Inflows 1980-2003 (US\$ Millions)

The analysis indicated above highlights the issue of accelerated dynamic market entry and exit as the strategic preference for MNEs. In a volatile environment, FDI can be seen as a high-risk strategy - particularly in the absence of location specific compensating factors such as a transparent and coherent business climate with the provision of both the ‘hard’ and ‘soft’ infrastructure to do business. Reflecting the flexibility inherent in spatially distributed production networks, the ‘hub’ and ‘spoke’ strategies employed by MNEs enable responsiveness to market decline by OO and divesting distribution assets to local partners (exercising one of the options in joint venturing), while retaining production capacities with high appropriabilities⁹ the output of which can be diverted to other markets. The implications for developing countries are that their Investment Promotion Agencies (IPAs) need to fully understand the dynamics of these decisions by MNEs and incorporate them fully into their development policy and FDI promotion strategy. Table 2 – Regional FDI Inflows 1980 – 2003 (% of Total), reflects again the predominant pattern of international involvement. Since the mid-1990s this pattern has been hallmarked by the dominance of the industrialised countries and Asia.

⁹ Due to monopolistic-oligopolistic advantages that are derived, *inter alia*, from technological functions.

REGIONAL FDI INFLOWS 1980-2003
(% OF TOTAL)

Region	1980	1985	1990	1995	2000	2003
Industrialized Countries	89.11	75.26	88.41	69.28	85.13	76.90
North Africa	0.25	2.55	0.58	0.27	0.17	0.40
Central Africa	0.35	1.22	-0.18	0.09	0.06	0.00
Western Africa	-0.97	0.85	0.46	0.51	0.05	0.08
East & Southern Africa	0.58	0.30	0.26	0.29	0.12	0.13
Western Asia & Europe	-6.42	1.71	1.33	0.05	0.24	1.29
Latin America	12.34	10.26	0.42	9.37	5.22	6.51
South & East Asia	4.76	7.85	8.72	20.14	9.01	14.69
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00

SOURCE: UNIDO Statistics compiled from International Finance Statistics (from International Monetary Fund) according to UNIDO list of countries & areas included in selected groupings in the International Yearbook of Industrial Statistics 2004.

Table 2 – Regional FDI Inflows 1980-2003 (% of Total)

Taking departure from taxonomies in the international business literature, offshoring is the location, or relocation, of business activities or functions abroad. When the transfer occurs to a subsidiary of the firm, i.e. FDI takes place, this can be regarded as ‘captive offshoring’. Outsourcing is the buying in, from a third party, of business activities or functions which were hitherto provided by the firm itself, i.e. contracting takes place. The outsourcing may occur across international borders – in which case we have an example of offshore outsourcing. However, “the use of the term outsourcing has not been standardized.” [Amiti and Wei (2004, p. 4)] A taxonomy of offshoring outsourcing is provided in Table 3 - A Taxonomy of Offshoring Outsourcing, below¹⁰.

Table 3 - A Taxonomy of Offshoring Outsourcing		
Location of Activity	Hierarchy-based (Internalised)	Market-based (Externalised)
Home Country	In-house At Home	Outsourced to Third party Provider
Foreign Country	Within MNE Subsidiary of Firm (Captive Offshoring) <ul style="list-style-type: none"> ▪ Equivalent to FDI 	Outsourced to Third party Provider (Local Firm or Subsidiary of other MNE) i.e. Offshore Outsourcing

¹⁰ It is germane to question whether these recent terms are significantly more useful in describing international business. The increased use of the terms may be a reaction against the empirical rigour and theoretical complexities in the literature on FDI and MNEs found in the leading, and more econometric, international business journals. It is arguable that the terms can lead to confusion and may actually obscure issues in managerial economics and industrial organisation concerning the firm’s ‘make’ or ‘buy’ and FDI decisions.

Elaboration of this taxonomy from the perspective of relocation to lower cost locations (LCLs) is provided, *inter alia*, by Amiti and Wei (2004), Kirkegaard (2004), van Welsum (2004) and Mann (2003). The definitions, and taxonomy, permit an attempt at estimating the global markets for services offshoring outsourcing (SOO), within the US\$1,700 billion global services export market [Morgan Stanley (2004, p. 8)].

However, the problematics of what exactly constitutes a service -- and thereby SOO -- various limitations and balance-of-payments measurement issues suggest caution in any such estimation. Estimates of the value of SOO are also complicated by definitional delimitations, double counting and exclusion of some services [and inclusion of others not strictly services – more akin to manufacturing (as manufacturing services)]. Table 4 – Estimates of Services Offshoring Outsourcing 2005-2015 (US\$ billion), below provide some preliminary guides and indications.

Source of Estimate	Year		
	2005	2010	2015
Gartner (2005)	160		
McKinsey (2005)		142	
Hewitt (2005)			135
Deloitte (2005)	200 ²	356 ³	
Amity and Wei (2004)	181 (2002) ⁴		

Notes 1 Compiled from RTTS Statistics related to offshore outsourcing, <http://www.rttswb.com/services/outsourcing/stats.cfm>, 31 March 2005. The Compound Annual Growth Rate (CAGR) ranges from 20 to 38 percent.

2 Business Process Outsourcing.

3 Financial Services.

4 The top six outsourcers (business services, computer, information services) in 2002 compiled from IMF Balance-of-Payments Statistics Yearbook.

The suggested range of estimates, and the range of annual growth rates indicate potential for error in calculating the value of the global offshoring outsourcing market in services¹¹. Within these estimates, however, the market size for China is expected to grow from US\$317 million [at Compound Annual Growth Rate (CAGR) of approximately 18%] in 2005 to US\$451 million in 2007¹² [A. T. Kearney (2004a)]. In contrast, India's market share, for example, of Business Process Outsourcing (BPO) was estimated at US\$2.4 billion in 2002-2003 [Ernst and Young (2003)]; and is

¹¹ According to Gartner, Inc., the global Information Technology services market grew by 6.2% in 2003 to US\$569 billion [Gartner Dataquest, June 2004].

¹² The total growth figures (offshore plus domestic outsourcing market) for China are expected to be respectively US\$905 million (2005) to US\$1,289 million (2007).

projected for approximately 17% CAGR to US\$3.7 billion by 2008¹³. By similar token, the growth in BPO offshoring by U. S. firms is anticipated to grow by CAGR of approximately 26% from US\$24 billion to US\$136 billion between 2005 and 2015 [A. T. Kearney (2003)].

A positive, as opposed to a normative, economic perspective is adopted for analysis of trends, patterns and emerging issues in SOO. However, this is not to deny the developmental impact, and hence, normative implications of job ‘losses’ and ‘gains’¹⁴ as a consequence of an industrialised country firm selecting strategically to either ‘go offshore’ and establish an overseas subsidiary or to outsource (production) processes or (BPO, distribution) services to a foreign service provider¹⁵. It is fair to indicate that relatively little controversy surrounds FDI and market-based transactions (domestic or international). Nevertheless, associations with job ‘losses’ that accompany coverage of offshoring and outsourcing in general, and SOO in particular -- especially that of services from the Triad economies; and OECD states to developing countries -- elicit detectable emotional responses which attempt to defy the efficiency arguments and logic of markets. These responses are sometimes framed into legislation to restrict public sector SOO and services importation¹⁶.

From a FDI or international contracting perspective, offshoring and outsourcing are nothing new – with one exception. The increasing complexity of techno-economic activity, which enabled the ‘componentisation’ of production -- that is, the slicing up of industry stages of production and firm value chains into different sub-stages, and their subsequent global distribution¹⁷ over geo-economic space *but within* the organisational boundaries of MNEs, is now having the same impact on services [through digitisation of data, information, statistics and knowledge (DISK) and information communications technologies (ICT)]. The relocation of international production beginning *circa* 1975 is being added to by the international relocation of services provision. This latter trend began in earnest *circa* 1990 and is continuing apace¹⁸.

¹³ India Infoline, 2004, IT Happens Only in India, <http://www.indiainfoline.com>

¹⁴ See Outsourcing: ‘The logic is inescapable’ why India believes commercial imperatives will help it beat the offshoring backlash, Financial Times, 28 January 2004, p. 11.

¹⁵ Dehaven T., 2004, There They Go Again: The Truth About “Exporting Jobs”, National Taxpayers Union, NTU Policy Paper No. 115, 29 September; and te Velde D. W., 2004, The Wider Developmental Impact of Offshoring of Services, ODI Mimeo, September.

¹⁶ According to the National Foundation for American Policy at least 36 States in the U. S. have introduced over 100 legislations to restrict the importation of services [Dehaven (2004, p. 12)].

¹⁷ G. Abonyi, “Linking Asia Together”, The Asian Wall Street Journal, 5 December 2000, Editorial page, for an elucidation of the dynamics involved in the spatial distribution of manufacturing value-added.

¹⁸ See Outsourcing: Service industries go global how high-wage professional jobs are migrating to low-cost countries, Financial Times, 20 August 2003, p. 11; The New Global Job Shift: A new round of globalization is

The problem is that the impact – no longer on labour intense manufacturing (blue-collar work) – is now increasingly felt on labour intense servicing (white-collar work)¹⁹. There is a range of socio-economic consequences and implications. Some of these are analysed well, quite a number are weighed somewhat sensationally²⁰ without due acknowledgement to the macro-economic case for either the efficiency and welfare gains that arise from contracting or the trade gains of FDI that arise from the empirics of revealed comparative advantage. The economic ‘assault’ on white-collar service work is not trivial in consequence. Service offshore outsourcing represents, at a global level, dynamic structural change in the allocation of resources and the international re-division of labour because of the relative cost profiles of different competitive advantages [Porter (1990)]. Underlying this change are certain ‘drivers’ reinforcing the seven major factors referred to earlier. They are:

- (i) the relatively rapid ageing profile of Triad economy populations;
- (ii) rising skills profile²¹ of emerging markets economies in terms of productivity adjusted costs of labour²²;
- (iii) digitisation of services, and services provision, as ICT enabled services;
- (iv) massive increase in ICT capacity²³;
- (v) widespread use of networked computers as a consequence of falling price of computing power²⁴; and
- (vi) increased market access.

The impact on white-collar jobs may be viewed as serious²⁵. However, when the balance-of-payments dynamics of SOO is subjected to rigorous econometric analysis the evidence does not

sending upscale jobs offshore, *Business Week*, 3 February 2003, pp. 36-48, p. 72; and *The Economist*, *A World of Work: A Survey of Outsourcing*, 13 November 2004 for analyses of the dynamics of offshore outsourcing which is involving, *inter alia*, research, silicon chip design, engineering and financial analysis.

¹⁹ Between 2003 and 2004, 221,000 high-tech U. S. jobs were ‘lost’ to outsourcing according to the U. S. Department of Labor Bureau of Labor Statistics [cited in *Electronic Design*, Vol. 53, No. 8, 14 April 2005, p. 25].

²⁰ Daniel Daianu, *Who Fears Outsourcing and Offshoring?*, *Southeast European Times*, 31 January 2005.

²¹ According to the U. S. National Science Foundation the world distribution of engineering graduates in 1999 was: China (21%); European Union (15%); Japan (11%); Russia (9%); India (9%); and U. S. (7%).

²² Low cost countries have average hourly wage rates of less than US\$5 compared to US\$20 in OECD countries according to *The Boston Consulting Group* (2004).

²³ As a direct result of the telecom infrastructure investment boom of about US\$300 billion in the 1990s in anticipation of demand for the ‘information super highway’.

²⁴ This steady drop in the price of computing power has been going on since at least 1910. Computing speed per dollar has doubled every three years (1910-1950), then every two years (1950-1965), and then every year (1966-2000). Accompanying this has been the falling costs of telecommunications hardware such as fibre optic cabling – in India, for example, this has fallen by 90% since 1997 [*The Economist*, *A Survey of Outsourcing*, 13 November 2004].

²⁵ To give an idea of the attention being focused on SOO, from January to May 2004, there were 2,634 reports in U. S. newspapers mostly highlighting the potential job losses. The U. K. had 380 reports in the same period [Amiti and Wei (2004, p. 2)]. According to *Gartner Inc.*, 30% of technology jobs in the U. S. are ‘at risk’ from offshoring and

support the anxiety over job ‘losses’. In fact, the empirical data confirms that the industrialised countries dominate overwhelmingly the ranks of SOO providers as well as the ranks of insourcing i.e. in both the exports and imports of services²⁶ [Amiti and Wei (2004, Tables 2 and 4, pp. 20, 22)]. In other words, industrialised countries, far from outsourcing, are in the position in which the rest of the world outsources more to them than the reverse²⁷.

3 THE MACRO-ECONOMIC CONTEXT

There is little doubt that services offshoring and outsourcing (SOO) has become increasingly complex not only in terms of business decision making but also in terms of the consequent organisational articulation and configuration necessary for implementing SOO decisions and strategies²⁸. It is crucial to realise that the SOO phenomena is not new and has been an integral part of industrial logic since the antecedents of the modern industrial revolution *circa* 1750 AD [Moore and Lewis (2000)]. It is beyond the scope of this present paper to trace either the classical and neo-classical economic arguments for specialisation leading to wealth creation or the benefits of ‘Schumpeterian’ competitiveness, strategy and innovation. There is a sufficiency of literature on this subject [Ricart et al., (2004); Ghemawat (2002)]. Suffice it to say the macro-economic case for offshoring and outsourcing (OO) lies in arguments that point to increased trade in manufactures and services²⁹, cost reduction and increased productivity [Swenson (2004); Dunning (2003); Williamson (1975)].

FDI, international sub-contracting³⁰, and OO represent the growth of international specialisation in the world economy in general and increasing Vertical Intra-industry Trade (VIIT) within, and between, MNEs in particular [Antràs and Helpman (2003)]. To illustrate this reality of industrial economics, the production of an “American” car is now so spatially distributed -- using

outsourcing [Information Week, Vol. 1033, 4 April 2005, p. 16]. The potential losses are not confined to the U. S. – reported production shifts out of the EU amounted to over 40,000 in the first quarter of 2004 [Institute for International Economics, Working Paper, WP 05-1, March 2005, Table 3, p. 31].

²⁶ The U. S. and U. K. have run the world’s largest and second largest surpluses in services trade recently.

²⁷ To put this into perspective, the U. S. services exports amounted to US\$300 billion in 2002 compared to US\$62 billion in services exports by both China and India combined [Dehaven (2004)].

²⁸ See Paul J. Davies, Get a grip on all the links in the chain: Outsourcing, Financial Times, 18 April 2005, p. 5 for a view of the difficulties in managing risks in offshore outsourcing; and William R. King, Outsourcing becomes more complex, Information Systems management, Vol. 22, No. 2, pp. 89-90, 2005 for an appreciation of the increasing value-added capabilities of third party services providers and the management challenges these impose for outsourcers.

²⁹ Deloitte Research, 2003, The Macro-economic Case for Outsourcing.

³⁰ UNIDO SPX programme [www.unido.org/spx] encourages the formation of sub-contracting networks and clustering to enhance the rates and levels of specialisation in developing countries thereby enabling leading industrial sectors and their firms to premium price as a function of specialisation.

various modalities of FDI, foreign market servicing strategies (FMSS) and SOO – that 30% of the car's value is generated in South Korea, 17.5% in Japan, 7.5% in Germany, 4% in Taiwan Province of China and Singapore, 2.5% in the U. K. and 1.5% in Ireland and Barbados. This means that “only 37 percent of the production value is generated in the United States” [WTO (1998, p. 36), cited in Antràs and Helpman (2003, p. 1)]. This is the reality of the integrated global factory [Bartels (2005a); Buckley (2003)].

The rate of growth in the international disintegration of production and services, that is an increase in intermediate inputs [Fukao, Ishido and Ito (2003); Ito and Fukao (2003)], now outpaces world trade growth. The disintegration, spatial distribution of production and SOO, through technological advances and digitisation respectively [Bartel, Lach and Sichernman (2005)], is counter-balanced by the integration of global trade³¹. The integrating vectors of the global economy are fourfold:

- (i) since the 1960s the rate of world trade growth has outpaced that of world output growth;
- (ii) between 1980 and 2000 the rate of FDI growth outpaced that of world trade growth;
- (iii) approximately three-quarters of world trade are held *internally* within the international operations of MNEs³². This is manifest as geo-spatially distributed and operationally integrated, and managed as cross-border collaborative intra- and inter-firm relations;
- (iv) the growth of vertically integrated intra-industry trade, which accounts for about 30% of world trade, at about 40% since 1975, has outpaced that of FDI growth³³.

MNEs, FDI and export-import trade in intermediate products and SOO have therefore become the preponderant integrating factors in the world economy. Furthermore, trade in intermediate products and SOO resulting from FDI have become significant in improving the

³¹ Usefully described in terms of global value (or supply) chains as integrated international sourcing, technology, production, marketing and servicing networks with fourth to first tier suppliers under the (hierarchical) governance of leading buyer or supplier MNEs that constitute international trade.

³² Approximately 61,000 MNEs with over 900,000 subsidiaries spatially distributed within geo-economic space operationally constitute 65% to 75% of international business and world trade according to UNCTAD, 2004, World Investment Report 2004: The Shift Towards Services, Geneva: UNCTAD; and UNCTAD, 1995, World Investment Report 1995: Transnational Corporations and Competitiveness, Geneva: UNCTAD. This geo-spatiality is operationalised in part as cross-border collaborative inter-firm relations (mergers and acquisitions, joint ventures, strategic alliances, etc.)

³³ Dicken P., 2003, *Global Shift: Reshaping The Global Economic Map in the 21st Century*, London: Sage, p. 53; David Hummels, Jun Ishi and Kei-Mu Yi, 1999, *The Nature and Growth of Vertical Specialization in World Trade*, FRBNY, Mimeo; and UNIDO, 2003, *Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries*, Vienna: UNIDO for the growth of vertical specialisation as share of exports at between 26% and 82% from Australia, Canada, France, UK and USA from 1970 to 1990.

efficiency of resource allocation, specialisation, value-chain disaggregation and productivity in higher cost locations (HCLs) as well as lower cost locations (LCLs) [Feenstra (1998)]. Within this overall set of vectors, and given the increased levels of liberalisation in the world environment for investment and trade, empirical evidence -- which points to the shape of things to come -- suggests that the rate of growth of OO by U. S. firms since 1999 has outpaced the growth of their foreign intra-firm sourcing [Antràs and Helpman (2003)].

Discussion of the macro-economic context for SOO needs to consider also the internationalisation of firms and the ‘conflict of markets’ [UNIDO (2003b)] in intermediating international involvement of firms³⁴. This means that, in parallel with the profusion of regional trade agreements (RTAs) from less than five in 1960 to over 250 in force in 2002, harmonisation and integration of regional policies as well as national employment, training and their associated fiscal policies are crucial for the effective attraction of SOO. The gradual reduction of barriers to factor mobility has given rise to integrated international sourcing, technology, production, marketing and servicing networks (IINs) -- referred to as the integrated global factory -- in which SOO takes place. Empirical studies [Antràs and Helpman (2003)] indicate that higher productivity MNEs source intermediate inputs from developing countries – lower cost locations. In contrast, lower productivity firms outsource to industrialised countries. The implications for the spatial distribution of SOO are an overall reduction of the trading costs of intermediate products.

The asymmetries in global inward FDI flows reflect those in SOO, and *vice versa*, and the growth trends in SOO are unmistakable – notwithstanding the definitional issues and measurement problems mentioned earlier. The partial migration of services from relatively HCLs to LCLs, taking into account relative labour flexibilities and productivity adjusted costs of labour across LCLs, is set to continue. And the general agreement on trade in services (GATS) is bound to accelerate the phenomenon. The current, and changing, spatiality of industrial activity and its distribution across geo-economic space presents global, as well as national, policy challenges for the role of FDI in general and especially that of SOO in industrialisation.

³⁴ Whereas capital and financial markets are truly global in space and time, markets for goods and services are overwhelmingly regional. In contrast labour markets are predominantly national. Therefore SOO are predictably regional, or inter-regional, and are correlated with the regional characteristics of FDI flows and stocks. This carries major implications for policy.

4 THE SPATIALITY OF OFFSHORE OURSOURCING

Mapping the world of services offshoring and outsourcing (SOO) is not an easy task. According to Antràs and Helpman (2003, p. 2) “a systematic analysis of this trend is not available.” Various proxies can be evoked to illustrate the overall pattern and spatiality of the activity. One such proxy is the number of industrial sectors in which firms operate. For U. S. manufacturing firms, the number of four-digit ISIC sectors has declined from an average of 2.72 to 1.81 between 1979 and 1997 [Fan and Lang (2000)]. This means less concentration and an increased dispersion of industrial activity. The aggregate services that can be subject to OO range from items such as call centres, shared service centres, BPO, value-added distribution and logistics, and R&D, to *any* ‘knowledge work’ [Drucker (1989)] that can be digitised using ICT enabling services (itself a service that is subject to OO). Each item has its own organisational propensities in terms of strategy, operations and management, and relations between principal and agent. It is the technological dimensions of these items which make circumscribing SOO so prone to multiple difficulties. Technologies, and innovations, are continuously expanding, and thus changing, the range of economic activities that can be digitised and therefore subject to OO.

Most probably the most accurate indicators, or predictors, of the patterns in SOO are world flows of inward FDI; and the balance-of-payments identities of trade in services. However, these rather dry statistics arguably reflect neither the characteristics of locational dynamics nor the evident asymmetries in the different spatial distributions of items of SOO across the world. Furthermore, they do not reflect well the fact that FDI and international sub-contract are subject to different policy and regulatory regimes across countries hosting SOO.

Nevertheless, such a view of global FDI flows demonstrates ‘gravitational’ asymmetries with transatlantic and transpacific economies as global centres while South and East Asian economies dominate as centres in the global periphery [Krempel and Plümper (2003); UNIDO (2005, 2003a)]. This view also reflects the internationalisation and spatial distribution of economic activity of MNEs which has been sequential both in the ‘nationality’ of MNEs and in the geo-economic space occupied by them³⁵. This sequential distribution has dynamised South and East Asia to the point that China, India and Southeast Asian economies have begun to capture most of the market for

³⁵ A long perspective of the international business of FDI (and manufacturing and services offshoring and outsourcing) since 1960 indicates stylistically (notwithstanding resource-seeking FDI in the Middle East and Africa) that these sequences are respectively MNEs from (a) North America, (b) Europe, (c) Japan, (d) Southeast Asia, and (e) Brazil, Russia, India, China and South Africa; to areas of the (i) Transatlantic, (ii) Transpacific, (iii) South and East Asia (including the Indian Ocean Rim), (iv) Latin America.

manufacturing and SOO [Balasubramanian and Padhi (2005); Gandossy and Kao (2005); Meredith (2005); Deloitte Research (2003)].

The gravitational asymmetries [Anderson and Wincoop (2001a, 2001b)] manifest at the global level are reflected, at the micro-industrial level, by the functional integration of MNEs HQs-subsidary management according to mandates for operations within IINs across regional economic space [Giroud and Mirza (2004); Giroud (2003)] and the consequential cluster of linkages that characterise industrial activity in Southeast Asia [Fukao, Ishido and Ito (2003); Ito and Fukao (2003)]. In recent years, we have seen increasing competition for diminishing levels of global FDI³⁶. Simultaneously, there is increasingly dynamic cross-border configuration, reconfiguration and articulation of the manufacturing assets and servicing operations of international investors. The increasing complexity of FDI is demonstrated by the integrated international sourcing, technology, production, marketing and servicing networks of MNEs as inter-connected systems which are geoeconomically and spatially distributed. Furthermore, the distribution and performance of these networks are operationally and contemporaneously managed through strategic relations (co-operation with, co-ordination, command and control) between subsidiaries and third party suppliers using information and communications technology.

The systemic nature of MNEs networks leads to the emergence of asymmetric properties of, and synergistic relations between, the constituent elements (HQs, Regional HQs, Subsidiaries and out-source partner firms, etc.). In concert, the various network nodes responsible for manufacturing value-added (MVA) transformations; and the inter-relationships accountable for economic transactions, comprise what has been referred to as the 'integrated global factory' (IGF) [Buckley (2003)]. This is illustrated stylistically in Figure 1 below.

³⁶ Global levels of inward FDI have fallen since the peak of US\$1,400 billion in 2000, through US\$800 billion (2001) and US\$700 billion (2002) to US\$560 billion (2003); and preliminary estimates suggest a modest increase to US\$612 in 2004 according to UNCTAD [UNCTAD/PRESS/PR/2005/002, 11 January 2005].

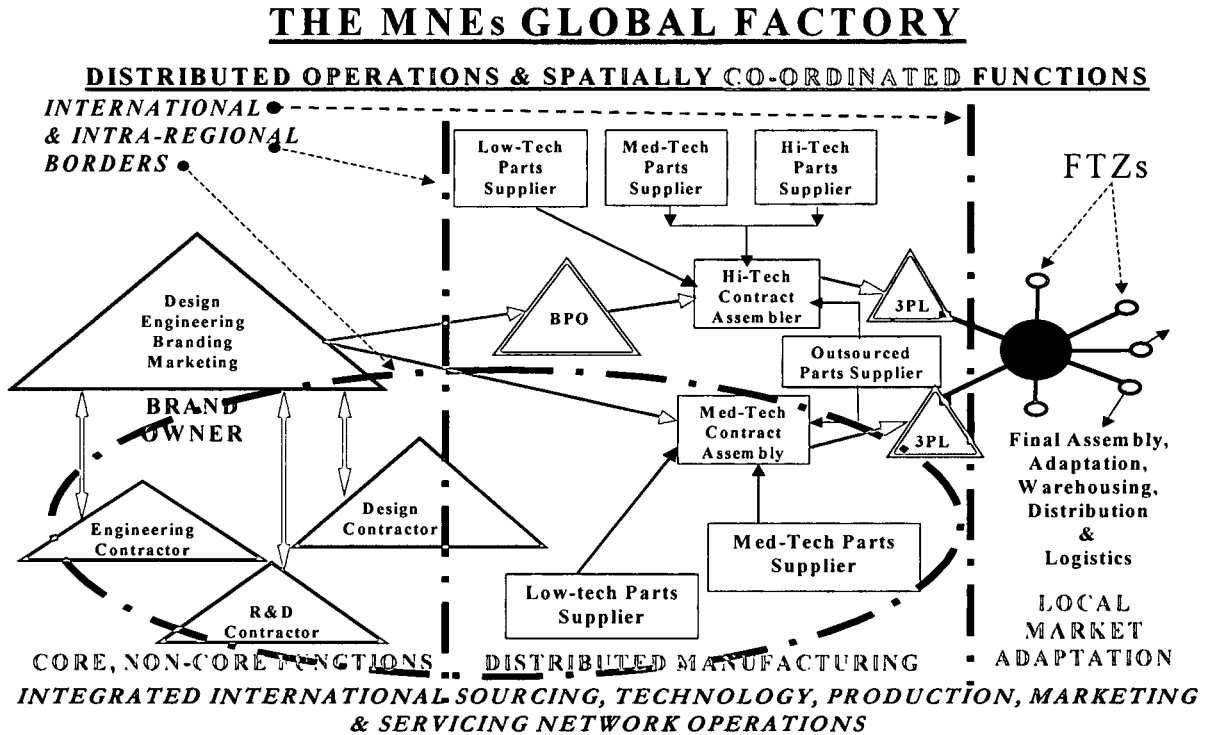


Figure 1 - The Integrated Global Factory

From the perspective of SOO the key aspects of the IGF are the intermediation of design, R&D and engineering contracting, as well as BPO and 3PL³⁷ in enabling the flow of competitive innovation from supplier to market. The IGF is co-evolving with the policy environment. It is characterised by inter-changeability and is in dynamic tension with its internal constituents as well as with external forces of competition and co-operation. Thus the shape, boundaries and extent of the IGF and the industrial landscape it inhabits (and forms) are continuously changing resulting in a highly complex system that approaches 'self-organisation'³⁸ [Dagnino (2004); Fioretti and Visser (2004); Price (2004); Urry (2003); Walby (2003); Krugman (1996)].

The complexity of the IGF is therefore increasingly difficult to view through isolated economic and management disciplines. It is even more testing to capture in terms of data and information as well as policy research and analysis; investment promotion (IP), policy design and implementation. This is especially so for developing countries and is due partly to the rapidly changing characteristics of industry competition and factor markets; and partly to the inadequate levels of capacity building in some developing countries. Competition is evolving into more

³⁷ Depicted within the triangles of Figure 1.

³⁸ Phenomena which appear to determine their own form and processes.

internationally collaborative forms [Dunning (1997)]. Developing countries in general, and particularly those marginalised from FDI flows and SOO, often lack high-resolution instruments to calibrate and recalibrate their policies fast enough to keep pace with the rapidly changing context and dynamics of the IGF, international production and markets.

The dynamic changes in the spatial distribution of SOO are both absolute and relative, with industrialised and developing country vectors. Given the IGF, and its IINs relationships, in absolute terms the biggest outsourcers are the U. S. and E. U. and U. K. (they are also the biggest insourcers) [Amiti and Wei (2004)]. China and India, the focus of so much recent economic press coverage, are surprisingly ranked 14th and 6th respectively as hosts to SOO [Amiti and Wei (2004)]. In relative terms, that is, outsourcing (or insourcing) as a ratio of source (host) Gross Domestic Product (GDP), China and India as hosts to SOO are ranked 79th and 21st respectively. This shows that despite press attention to SOO, the shift, or export, of jobs to China and India³⁹ is not occurring at a rate which a casual examination of the literature suggests as very rapid. This situation is exemplified by Table 5 – Outsourcers, which shows the predominance of the relatively HCLs of the industrialised countries.

OUTSOURCERS, 2002

RANK	COUNTRY	BUSINESS SERVICES (BP) US\$ Million	RANK	COUNTRY	COMPUTER & INFO SERVICES US\$ Million
1	USA	40,929	1	GERMANY	6,124
2	GERMANY	39,113	2	UK	2,602
3	JAPAN	24,714	3	JAPAN	2,148
4	HOLLAND	21,038	4	HOLLAND	1,586
5	ITALY	20,370	5	SPAIN	1,572
6	FRANCE	19,111	6	USA	1,547
9	UK	16,184	9	FRANCE	1,150
11	INDIA	11,817	10	CHINA P.R.	1,133
18	CHINA P.R.	7,957	14	RUSSIA	592
20	RUSSIA	4,583			

SOURCE: IMF BALANCE-OF-PAYMENTS YEARBOOK, CITED IN AMITI & WEI, 2004, FEAR OF SERVICE OUTSOURCING: IS IT JUSTIFIED?, NBER

Table 5 - Outsourcers

³⁹ M. Leanne Lachman, The New Exports: Office Jobs, Issue paper Series, Urban Land Institute, Columbia Business School, 2003/04.

Nevertheless, the emerging markets of the Indian Ocean Rim (IOR) and China are beginning to attract SOO significantly; and this represents a potentially huge rate change in the next decade. In this regard, RTAs and bi-lateral trade agreements (BTAs) entered into by these countries have to be very carefully implemented and cohered in order to avoid regulatory inconsistencies and the 'spaghetti bowl' problem of rules of origin and harmonisation of investment and trade provisions across the free trade areas which impact SOO [Bartels (2004); Soesastro (2003)]. To illustrate that the industrialised countries also dominate insourcing, Table 6 – Insourcers, indicates again the relatively lower rank of China with respect to India.

INSOURCERS, 2002

RANK	COUNTRY	BUSINESS SERVICES (BP) SERVICES	RANK	COUNTRY	COMPUTER & INFO SERVICES
		US\$ Million			US\$ Million
1	USA	58,794	1	IRELAND	10,426
2	UK	36,740	2	UK	5,675
3	GERMANY	27,907	3	USA	5,431
4	FRANCE	20,864	4	GERMANY	5,185
5	HOLLAND	20,074	5	SPAIN	2,487
6	INDIA	18,630	10	FRANCE	1,191
8	JAPAN	17,401	11	JAPAN	1,140
14	CHINA P.R.	10,419	12	CHINA P.R.	638
29	RUSSIA	2,012	25	RUSSIA	137

SOURCE: IMF BALANCE-OF-PAYMENTS YEARBOOK, CITED IN AMITI & WEI, 2004, FEAR OF SERVICE OUTSOURCING: IS IT JUSTIFIED?, NBER

Table 6 - Insourcers

The gravitational asymmetries of world trade, and the cluster of hosts to SOO, indicate trends with three broad patterns in the spatiality of OO. First, the Triad economic spaces have a persistent predominance in outsourcing and insourcing. This is unlikely to change in the short-term. Secondly, there is a continuing shift in the global functions of the IGF -- oriented to both manufacturing and services -- to South and East Asia. The rate of this shift in terms of CAGR of SOO is between 20% and 40% depending on the specific type of service⁴⁰ (it should be borne in

⁴⁰ BPO CAGR is calculated as being approximately 9% by NASSCOM, India.

mind that while these figures seem high, we are starting from a relatively low level)⁴¹. The bulk of market share is likely to be taken in the future by China and India – with China specialising in manufacturing services and ICT servicing while India specialises in BPO, ICT and back-office functions. Thirdly, apart from a few exceptions⁴², the developing countries of sub-Saharan Africa, Latin America and the Least Developed Countries will remain largely marginalised and isolated from this ‘third wave of globalisation’ [Moore and Lewis (2000)]. These trends and patterns in SOO are underpinned by the industrial logic of FDI. The ‘drivers’ of SOO referred to earlier are the imperatives of achieving operational cost savings -- which in turn are a function of the productivity adjusted cost of labour in LCLs -- and gaining increased competitiveness⁴³.

As competitiveness is ultimately a function of the combination of costs (resource utilisation efficiencies) and technological applications (innovation effectiveness), no wonder that SOO is presently dominated by OECD countries and the emerging economies of South and East Asia. These demonstrate superior performance⁴⁴ in both categories of competitiveness relative to others [UNIDO (2002)]. This is not to say that countries such as South Africa and Australia, for example, are not significant in the spatial distribution of SOO [Deloitte Research (2003, p. 4)].

With respect to South and East Asia, and the IOR, different countries are beginning to specialise, with different policy objectives and policy instruments, in different types of SOO. Regarding front/back office operations SOO, China, Malaysia, Philippines (and Australia) are significant hosts. As with call centres and shared service centres, the dominant hosts are found on the IOR. Financial SOO are hosted, in the main, by China, Hong Kong, Singapore and the United Arab Emirates. The imperative to simultaneously reduce costs and move up the value added ladder, means that MNEs are increasingly using market and quasi-market mechanisms to transact product development research. As a result, contract R&D (for product adaptation and development – rather than fundamental R&D) is increasingly performed in Australia, China, India, Singapore and Taiwan Province of China.

⁴¹ See statistics related to offshore outsourcing (RTTS), <http://www.rttsweb.com/services/outsourcing.stats.cfm> 31 March 2005; and McKinsey Global Institute, 2003, *Offshoring: Is it a win-win game?* August, San Francisco: McKinsey & Co.

⁴² Francophone call centres in Senegal for example.

⁴³ According to Roland Berger Consultants/UNCTAD, 2004, *Service Offshoring Takes off in Europe – In Search of Improved Competitiveness*, a survey of 20% of EU top 500 firms by revenue, more than 80% of respondent firms report cost savings of between 20% and 40% as a result of SOO.

⁴⁴ See UNIDO Competitive Industrial Performance Index for various countries in UNIDO (2002).

This concentrated spatiality for routine office operations, financial services intermediation and product R&D is in contrast to the wider spread of SOO regarding HQs⁴⁵. As a reflection of the different market strategies pursued by different MNEs, HQs are not as spatially concentrated. And again, with SOO oriented to distribution and logistics, the spatial distribution is globally not as concentrated as BPO services and its associated business functions. The predominant pattern in SOO reflects the underlying pattern of global value chains and supply linkages of the nodal points in world FDI and trade flows. This is a persistent pattern, which has recent nuances in the flows of FDI to China and outsourcing to India. Despite the contrast in terms of FDI to China and India⁴⁶, these two countries appear to dominate discussion about SOO⁴⁷.

5 CHINA AND INDIA COMPARED AND CONTRASTED

A detailed socio-economic and technological ‘bench-mark’ comparative analysis of these two emerging market economies is beyond the scope of this present working paper. This section points out the relative evolving merits of the two locations as hosts to SOO along a few key macro- and micro-economic dimensions which represent:

- (i) the ability to do business in the location – that is the comparative transaction costs;
- (ii) the comparative investment climates;
- (iii) comparative investor perceptions;
- (iv) SOO decision-making; and
- (v) UNIDO’s Competitive Industrial Performance (CIP) Index⁴⁸.

The comparative analysis presented yields a number of broadly contrasting findings between reality and perception⁴⁹. This has major implications for policy objectives, the policy regime and

⁴⁵ According to UNCTAD, 2004, *The Impact of FDI on Development*, TD/B/Com.2/EM.16/2, 7 December, between 2002 and 2004 over 1000 product R&D projects were offshored (involving both FDI and contract transactions). Most (739) were offshore outsourced to developing countries and economies in transition; of which 563 were relocated in South and East Asia – with China and India gaining significantly. However, it should be recalled that the spatial distribution of R&D subsidiaries in 2004 favours numerically and overwhelmingly the industrialised countries: EU (1,387); U. S. (552); Japan (29); compared to Africa (4); Latin America and the Caribbean (40); South and East Asia (423).

⁴⁶ Notwithstanding some measurement issues, China is hosting about US\$50-60 billion FDI annually in contrast to India’s US\$4-5 billion which in 2000 translated respectively, in net FDI terms, to 3.9% GDP and 0.5% GDP [A. T. Kearney (2003); *The Economist*, A Survey of India and China, 5 March 2005].

⁴⁷ See “India and China spar over FDI like David and Goliath”, in A. T. Kearney, 2004b, *FDI Confidence Index*, The Global Business Policy Council, Vol. 7, October, p. 4.

⁴⁸ UNIDO, 2002, *Industrial Development Report 2002/2003: Competing through Innovation and Learning*, Vienna: UNIDO, Tables A3.1 and A3.2, pp. 177-180.

⁴⁹ The volume of publications and bench-marking studies on China and India sometimes present contradictory assessments of respective performance.

policy instruments for attracting SOO. From the outset, the complexities of China and India should not be underestimated either in economical or institutional terms. Both countries are emerging through economic transition towards the social market with legacies that are, to day the least, challenging from a policy perspective. The complexities caution against simplistic interpretation of quantitative statistics and call for a deeper understanding of the underlying socio-economic factors that determine business behaviour and the efficiencies of the commercial environment in both countries.

As FDI and associated SOO are ultimately business decision executed by independent economic actors, the transaction costs, and perceptions of transaction costs, of the host locations are of paramount importance to the decision. Across a selected range of key variables pertinent to transaction costs⁵⁰, China outperforms India. On average the indices for China are twice as better than India's. In some cases such as cost (% of per capita income) of starting a business, cost (% of property value) of registering property and time to resolve bankruptcies (years) China's indices are over three and four times better than India's. On the face of it, therefore, the regulatory environment constrains business much more in India than in China, thus raising transaction costs to higher levels in India relative to China⁵¹. This is contrast to some reports on institutionally related transaction costs in China [Clissold (2004); Morgan Stanley (2004)]. Sub-contracting to China faces some challenges that put upward pressure on transaction costs⁵².

Comparing the two locations from a FDI climate perspective tends to confirm the relative transaction costs across a selection of variables that capture the efficacy and effectiveness of the investment climate. Again, China outperforms India in governance (controlling corruption, political stability, time spent by senior management with government) but not in the category rule of law. In terms of cost of capital, infrastructure (% share of firms with own generator) and availability of SOO suppliers, China outperforms India over twice and five times as better [World Bank (2003)]. China's apparently superior performance, in transaction costs and investment climate, is further consolidated by the FDI Confidence Index [A. T. Kearney (2004b)] which places China in first place to India's third position in the ranking.

⁵⁰ Starting a business, employing staff, property registration, contract enforcement, and closing a business (resolving bankruptcies) [World Bank, 2005, Doing Business, <http://rru.worldbank.org/DoingBusiness>]

⁵¹ As an example of relatively higher transaction costs in India, The Economist, Special Report: Outsourcing and IT in India, 23 April 2005, refers to the Bangalore paradox of booming SOO and poor infrastructure adding to transactions costs.

⁵² See Financial Times, Laying a false trail, 22 April 2005, p. 13 for an analysis of some of the problems for consumer MNEs sourcing from China.

And yet, the investor perceptions of senior corporate strategists from the world's 1000 largest MNEs suggest that India outperforms China across the variables of location specific advantages crucial for business and which reflect human resources, managerial capacity and capability, the rule of law, transparency, socio-cultural barriers and the regulatory environment⁵³. The contrast of China in first place in the FDI Confidence Index to its position relative to India in the 'where to locate offshore business processing' is stark [A. T. Kearney (2004d)]. In all 11 cross country comparisons⁵⁴ of composite cost, environment and people factors, India is rated first to China's 11th. In terms of BPO India outpoints China 3.4 to 3.1; so too on environment scores 1.6 to 1.1. And again on the people factor alone, India is first with a score of 2.3 in contrast to China's 11th position with a score of 1.0. Again, in contrast to transaction costs and investment climate comparisons, in which China outperforms India, the perception by investors of risk variables are greater for China than India. Table 7 – Investor Perceptions of Risk in China and India, shows the better performance of India.

Rank High Risk	FDI Confidence Variable	% of Investors Perceiving High Risk	
		China	India
1	Legal, Regulatory Environment	73	58
2	Corruption, Lack of Transparency	66	36
3	IPPRs ¹ , Piracy	56	35
4	FOREX ² , Capital Controls	51	27

Notes 1 Intellectual Property Protection Rights.

2 Foreign Exchange.

Source: A. T. Kearney, FDI Confidence Index, 2004b

The contrasts in comparisons of China and India in which China outperforms India in quantitative measures and *vice versa* in qualitative measures of location specific advantages raises interesting questions and points for consideration. Notwithstanding methodological issues of reliability, reproducibility and validity in these measures, do the quantitative statistics conceal inconsistencies or rigidities in China's implementation of policy? Are there quantitative differences between officially communicated variable measures and actual measures? Does the 'on-ground' actual business experience of MNEs and investors influence their responses to surveys? What is the extent of intra- and inter-country correlation among the relevant variables across the bench-marking

⁵³ 57% of investors perceive India as having a more conducive and hence attractive, regulatory environment in contrast to 43% for China [A. T. Kearney (2004b, p. 4)]; Ernst & Young, 2003, Survey on Offshore Outsourcing in India, which refers to India as "the preferred outsourcing destination".

⁵⁴ India, Canada, Brazil, Mexico, Philippines, Hungary, Ireland, Australia, Czech Republic, Russia, and China.

surveys⁵⁵? The answer to the last question would point to the significance of the FDI and SOO inflow elasticities of the variables [Christiansen (2004)] for policy decision-making. And to what extent do the qualitative statistics conceal managerial and operational flexibilities in India's business environment? In the business of FDI and SOO what is relatively more valuable – efficiency (doing things right) or effectiveness (doing the right things)? Investor perceptions of variables not related to market size suggest that effectiveness may be the more valuable, at least in the short- to medium-term⁵⁶. Perhaps a more revealing comparative dimension of relative performance in SOO regarding China and India is the offshore decision itself. Table 8 – Offshore Decision-making Location Performance, indicates the relative performance of the two locations on key decision variables.

Offshore Decision-making Variable	China	India
Human Resource Skills ('People' Score)	1.36	2.09
Business Environment ('Business' Score)	0.93	1.31
Financial Structure ('Financial' Score)	3.32	3.72
Employee Retention	NA ²	0.13
Language Skills	0.07	0.21
Education	0.21	0.25
Labour Market Availability	0.60	0.47
BPO Experience	0.48	1.03
Intellectual Property Protection Rights	NA ²	0.18
Cultural Adaptability	0.10	0.10
Infrastructure	0.15	0.20
Country Risk	0.68	0.83
Tax and Regulatory Environment	0.09	0.30
Infrastructure Costs	0.23	0.23
Compensation	3.00	3.19

Notes 1 measured on a Weighted Likert Scale 1 to 4 (1 = Poor and 4 = Good) hence some scores below 1.

2 Not Available.

Source: A. T. Kearney (2004c)

⁵⁵ See A. T. Kearney, 2004b, *FDI Confidence Index*, Global Business Policy Council, Volume 7; A.T. Kearney, 2004, *A.T. Kearney's 2004 Offshore Location Attractiveness Index: Making Offshore Decisions*, Chicago; Fraser Institute, *Economic Freedom of the World: 2004 Annual Report*, Vancouver; Heritage Foundation, 2005, *2005 Index of Economic Freedom*; IMD, 2003, *The World Competitiveness Yearbook 2003*, Geneva; Transparency International, *Framework Document: Background Paper to the Corruption Perceptions Index*, Passau; UNDP, 2003, *Human Development Report: Millennium Development Goals: A compact among nations to end human poverty*, New-York; UNIDO, 2002, *Industrial Development Report 2002/2003: Competing through Innovation and Learning*, Vienna; UNIDO; WEF, 2000, *Global Competitiveness Report*, Geneva; World Bank, 2005, *Doing Business in 2005*, Washington D.C.: IBRD/World Bank/OUP.

⁵⁶ At a broader level China's specialisation in manufacturing FDI and India's on SOO carries different implications for structural adjustment and the ability of industry to manage assets and the periodic transitions up the value-added ladder [See Martin Wolf, India and China, *Financial Times*, 23 February 2005, p. 13]; and according to *The Economist*, A Survey of Outsourcing, 13 November 2004, p. 8, in the global market for white-collar work India "rules supreme".

China outperforms India in the eyes of the investor SOO decision-making in only one category -- labour market availability -- notwithstanding emerging labour shortages in China's Pearl Delta Provinces [A. T. Kearney (2004b)].

In considering the UNIDO Competitive Industrial Performance (CIP) Index, Table 9 - Ranking of Economies by basic indicators of industrial performance and by Competitive Industrial Performance (CIP) Index, 1998 and 1985. This table discloses the competitiveness of the respective national industrial capabilities -- in terms of industrial capacity (quantity of output performance) and industrial complexity (ability to upgrade the quality of output performance) -- indicates the superior performance of China over the decade 1985 to 1995. While India outranked China in the 1980s, by the mid 1990s China had begun to outpace India in industrial complexity. This implies a potential for China to continue adding to its ability to attract especially manufacturing OO and to a lesser extent SOO for the reasons indicated earlier.

Table 9 - Ranking of Economies by Basic Indicators of Industrial Performance and by Competitive Industrial Performance (CIP) Index, 1998 and 1985				
<i>Index of Competitive Industrial Performance 1998</i>				
Economy (Overall CIP Index Rank in 80 Countries)	Manufacturing value added per capita index (a)	(a)+ Manufactured exports per capita index (b)	(b)+ Share of medium-and high-tech activities in manufacturing value added index (c)	(c)+ Share of medium-and high-tech products in manufactured exports- final index (d) – Overall CIP Index
China (37 th)	0.034	0.019	0.017	0.126
India (50 th)	0.007	0.004	0.004	0.054
<i>Index of Competitive Industrial Performance 1985</i>				
Economy (Overall CIP Index Rank in 80 Countries)	Manufacturing value added per capita index (a)	(a)+ Manufactured exports per capita index (b)	(b)+ Share of medium-and high-tech activities in manufacturing value added index (c)	(c)+ Share of medium-and high-tech products in manufactured exports- final index (d) – Overall CIP Index
China (63 rd)	0.024	0.012	0.011	0.021
India (50 th)	0.009	0.005	0.004	0.034

Source: UNIDO Scoreboard data set, UNIDO Industrial Development Report 2002/2003.

These findings points to the complexities involved in assessing the relative merits of China and India as SOO destinations. Two further comparisons, with qualifications, assist in drawing some tentative conclusions. A measure of the attractiveness as offshore destinations of 25 countries' correlation of 'Business' and 'People' Scores with 'Financial' Score places China in

quadrant High Financial-Low Business/Low People⁵⁷. In contrast, India is in the High Financial-High Business/High People quadrant [A. T. Kearney (2004c, p. 4)] – and is the only country out of the 25 in this quadrant. Out of 115 leading MNEs 67% have offshore operations in India in contrast to 35% in China⁵⁸. The risk perception profile appears higher for China than India.

However, an alternative, and perhaps an even more useful, view of China and India is not at the country level but at the level of dynamic cities – in the sense of *Marshallian industrial districts*⁵⁹ -- which are the actual hosts to SOO. This view reduces the two giants to a handful of dynamic cities which dominate SOO in the South and East Asian developing countries⁶⁰. At this *industrial district* level of analysis, the metropolitan differences between China and India, across the variables examined, are most probably much less than the quantitative statistics and qualitative perceptions suggest. And this seems to converge with the view that in overall macro-economic performance China has advantages over India but in micro-economic performance India has advantages over China⁶¹.

6 SERVICE OFFSHORE OUTSOURCING IMPACTS AND IMPLICATIONS

The impacts and implications of the vector dynamics in SOO are potentially profound for developing country hosts. These are essentially the same as for FDI for which there is a rich body of literature dating from the late 1950s available to inform policy⁶². The impacts and implications are invariably, firstly, oriented to the balance of costs and benefits of, and to the policy regime requisite for attracting, SOO. Secondly, they are oriented to the social, technological, economical and political environmental pre-requisites for SOO. Thirdly, from the perspective of the separation of ownership and control in outsourcing, they are oriented to the assets and input factors necessary

⁵⁷ Along with (in descending order of attractiveness) Malaysia, Brazil, Mexico, Argentina, Philippines, Russia, Thailand, Turkey and Vietnam.

⁵⁸ The industries include: communications; high-tech; automotive; chemicals; consumer goods; and financial services [A. T. Kearney (2004c)]. This is notwithstanding the acknowledged role of FDI in China's export performance which is approximately six times that of India.

⁵⁹ Alfred Marshall, 1920, *Principles of Economics*, 8th Ed., London: Macmillan.

⁶⁰ China's Beijing, Dalian, Hong Kong SAR, Shanghai (in which about a 1,000 start-ups in 2002 were in services industries), Shenzhen, Taipei TPC; and Cheng Du, Hangzhou, Wuhan, Xi'an. India's Bangalore, Chennai, Delhi, Hyderabad, and Mumbai.

⁶¹ See Newsweek, Fareed Zakaria, *China's Might*, 9 May 2005, p. 22.

⁶² See *inter alia* Dunning J. H., 1958, *American Investment in British Manufacturing Industry*, London: George Allen and Unwin; Dunning J. H., 2000; *The Eclectic Paradigm as an Envelope for Economic and Business Theories of MNEs Activity*, *International Business Review*, Vol. 9, No. 1, pp. 163-190; UNIDO, 2003, *Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries*, Vienna: UNIDO; and *The Future of Foreign Investment in Southeast Asia*, Nick J. Freeman and Frank L. Bartels, Eds., London: RoutledgeCurzon.

to provide the services. Given the relationships in SOO between principal and agent, empirically evidence of contract enforcement in China (and India) shows relatively lower levels of enforcement in Southern Coastal areas and relatively higher levels in the North [Feenstra and Hanson (2003)].

The SOO continuum, from hierarchies to markets, at the level of contracts carries implications for employment (notwithstanding the balance-of-payments merchandise trade statistics). The employment statistics for SOO are not known accurately. Estimates in 2004, partly based on output of graduates, range from 980,000 in China to 650,000 – 750,000 in India with CAGR of 18.5% and 17.5% respectively⁶³. We make no assessment of the quality and conditions of employment within SOO. Such evaluations go to the heart of the issue of whether the jobs created are capable of being upgraded not only through the competitive evolution of service providers but also via the transfer, from outsourcer to outsourcee, of progressively higher levels of technologically intense operations. This possibility depends on a raft of policies that comprise the host FDI and domestic investment regimes as well as policies for upgrading ‘soft’ and ‘hard’ infrastructure, and the knowledge base of the economy.

FDI and SOO ultimately represent economic competitive exchange as individual firms in HCLs relocate non-core activities to LCLs, in order to capture scale and scope economies [Alvarez et al., (2003)]. These comprise advantages of:

- (i) access to supplier expertise;
- (ii) improved quality; and
- (iii) cost reductions.

The exchange produces learning effects in the developing country host and accelerates the pace of globalisation⁶⁴.

However, the most important impact (and implication) of SOO concerns the ‘cascading’ of industrial capacity across developing countries in South and East Asia [Boston Consulting Group (2004, Exhibit II)]. This increases the rate at which the forces of competition operate⁶⁵ [Porter

⁶³ Dirk te Velde, 2004, *The Wider Development Impact of Offshoring on Services*, Overseas Development Institute (ODI), Mimeo, September; Rafiq Dossani, 2004, *The Impact of Services Offshoring*, Asia-Pacific Research Centre, Stanford University, Mimeo, indicate that these employees deliver service work of which 80-90% outsourced to India alone comes from the U. K. and U. S.

⁶⁴ The learning results and increased capacity of India hosting significant amounts of SOO is that local firms like TCS, WIPRO, INFOSYS, HCL Tech and Satyam are sufficiently competitive to make FDI in the EU and North America [The Economist, A Survey on Outsourcing, 13 November 2004, pp. 10-12].

⁶⁵ The correlation of GDP/capita growth and time since the beginning of industrialisation tracks the countries of South and East Asia onto an ‘S’ curve with four distinct transitions in the structure of GDP: primary resource driven development; labour intensive manufacturing (with FDI) driven development; capital intensive manufacturing (with

(1990)]. First, this leads to issues of – which policy objectives, and what kind of policy instruments should be designed to attract SOO? Secondly, how and when should the policy instruments be sequenced in time and economic space?

7 POLICY ISSUES

There is intense policy competition for the benefits and positive externalities of FDI and SOO [Oman (2000)]. The international business of SOO cannot be fully addressed without reference to two aspects of the IGF that determine policy at macro- and micro-economic levels. First, previously mentioned, are global value chains (GVCs) [or global supply chains (GSCs)]. Global value chains enclose the sequential intermediation of related production and servicing activities that deliver products to end-users. The spatiality of GVCs gives rise to overlapping networks of production and servicing already depicted in Figure 1 - The Integrated Global Factory, of which OO are increasingly key real options in the business strategies of MNEs⁶⁶. For MNEs managing their international operations means concentrating on: (i) volatility and uncertainty; (ii) options and flexibility; (iii) network forms of co-operation and competition; and (iv) entrepreneurship managed partly with OO operations.

The second concerns the firm level managerial performance and challenges of SOO. At the macro-economic level, the policy challenges revolve about the question of how to insert local suppliers into the interstices of GVCs and the IGF of MNEs? A comprehensive understanding of firm relationships is vital for this purpose [Vestring, Rouse and Reinert (2005); UNIDO (2004)]. The IGF is co-evolving with the policy environment and the MNE organises its global production through spatially co-ordinated functions. This is characterised by inter-changeability and is in dynamic tension with its internal constituents as well as external forces of competition and co-operation. This context and process are highly complex and its comprehensiveness, with respect to intra- and inter-firm transactions, requires attention by policy makers. The understanding of this phenomenon appears to be vitally necessary for host countries in order for them to put in place effective policies. There is indeed an increasing need for the host policy environment to reflect the IGF of MNEs.

FDI) driven development; and innovations and services driven development [Morgan Stanley (2004, p. 6); UNIDO (2003, p. 18)].

⁶⁶ See the real options approach [Roemer (2004); Chen and Funke (2003); Xiuyun (2003); Nordal (2000); Trigeorgis (1996)].

At the micro-level, policy makers have to bear in mind that, while the global strategies of MNEs are evolving and manifest in the configuration and reconfiguration of the IGF, the previous separated patterns of FDI by firms (in sequential time and place and, hitherto, more predictable modes of entry) have been replaced by parallel modes of market entry and servicing in multifaceted international patterns of inter- and intra-firm co-operative arrangements described as ‘alliance capitalism’ (which includes SOO modalities of Joint Ventures, Strategic Alliances, Co-production and Marketing, co-R&D, Contract Design and Manufacturing with Equity and Non-equity formalities). This is stylistically illustrated in Figure 2 below.

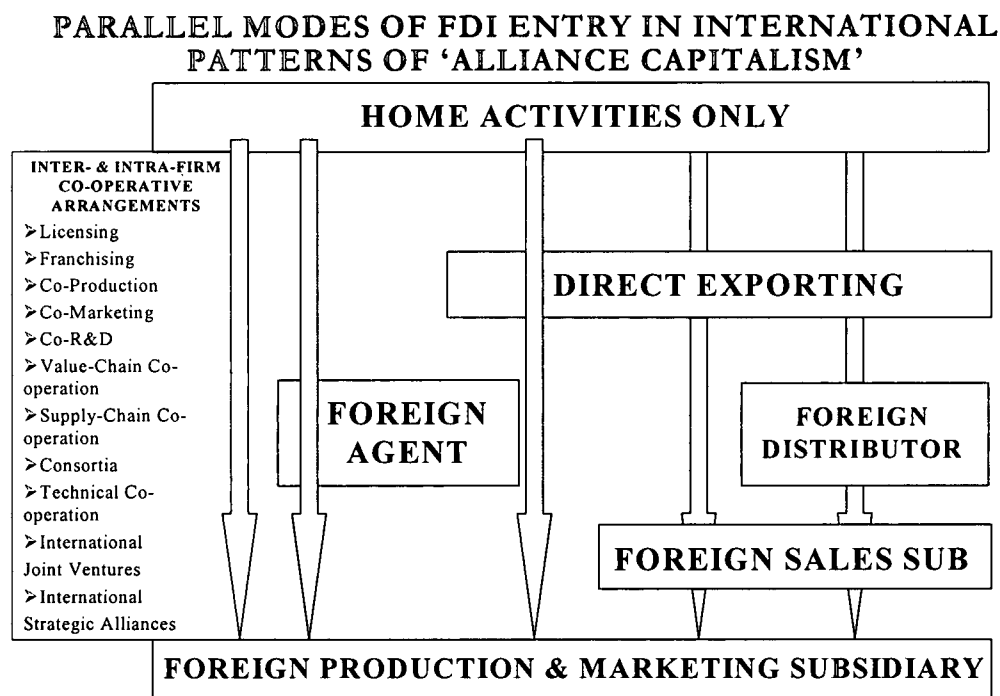


Figure 2: Parallel Modes of FDI Entry in International Patterns of ‘Alliance Capitalism’

In this context, policy makers need to move beyond the idea of attracting FDI and SOO with the lure of cheap labour and unsophisticated tax incentives⁶⁷. These new operational patterns are characterised by international networked systems of industrial sourcing, technology, production, marketing and servicing, and place a serious challenge on policy-making. Economic and industrial policies of the host countries have to be both appropriate and well sequenced if they want to succeed in capturing the kind of FDI and SOO that would boost their industrial development.

⁶⁷ The productivity adjusted cost of labour skills, and the credibility and predictability of the tax system (both direct and indirect), inter alia, is what is increasingly taken into account in location decisions of MNEs.

These policy issues are related to the trends and patterns of the spatiality in FDI in which MNEs not only consider home and host country characteristics when they decide to invest, but also third locations [Blonigen et al. (2004)]. In fact, there is a spatial correlation between FDI in a particular country and in alternative countries or regions. There is empirical evidence that regions surrounded by large markets tend to capture more FDI⁶⁸. It is worth noting that third locations acquire significance in MNEs' decision-making especially when their investments deal with vertical integration, as they will be motivated to take advantage of the comparative advantages of different localities. Since FDI decisions are multilateral and multivariate by nature, the interdependence between host destinations is gaining magnitude in MNEs decision-makings and hence should be increasingly factored into the crafting of developing countries' (policy instruments) PIs as well as their implementation.

The relationship between outsourcing and the firm's market performance, measured by rate of revenue growth and return on sales, is not uni-directionally simple. Some 50% of large North American, European and Asian firms are "dissatisfied" with the results of outsourcing. Only six percent are "extremely satisfied" [Gottfredson and Puryear (2005)]. To a certain extent, this must reflect the balance of host location specific advantages (and policy disadvantages); as well as corporate strategic deficiencies in formulating outsourcing operations comprehensively. The view from the alliance, GVCs and GSCs perspectives suggest that, within OO in general, and particularly in SOO, durable arm's length supply relationships and strategic partnerships (i.e. quasi-markets and quasi-hierarchies respectively) are not cohered well by firms in terms of contractual specificities, contingent adaptabilities and contractual obligations [Dyer, Cho and Chu (1998)]. These incoherencies expand as the strategic salience of what is outsourced increases; and as the host location specific disadvantages multiply especially in the dimension legal system [Luo (2005)].

Furthermore, at the micro-economic level, apart from the risk factors in the business location environment, a number of issues require attention⁶⁹. Some are within the control of host policy makers; others are the concern of SOO managers. However, because of co-evolution of policy and action, there can never be an unambiguously clear-cut separation of responsibilities. It should be recalled that many SOO fail to meet expectations [Alvarez et al., (2003)]. The differences

⁶⁸ This carries major implications for PIs and FDI law operationalised at the regional level and various dimensions of FDI policy, which exploit differentiated factor conditions and costs across the geo-economic space of the region. In addition, robust regional institutions are crucial to workable PIs.

⁶⁹ Infrastructure quality, security, labour skills, geo-political climate, cultural adaptability, linguistic barriers, the principal-agent problem, site accessing, trust, increasing switching costs, home labour backlash.

between expected and actual results of SOO across a range of variables are illustrated in Table 10 – Services Offshoring and Outsourcing (SOO) Expectations and Actual Scale Differences.

Rank	SOO Variable	% Scale Point Difference Between Expectation and Actuality
1	Access to Vendor Expertise	-26
2	Improved Delivery Quality	-24
3	Cost Reduction	-17
4	Increased Focus on Core Business	-13
5	Improved balance Sheet	- 5

Source: Alvarez et al., (2003)

Table 10 conceals inherently contra-indicative variation which point further to the challenges of SOO. The appealing rationale given for OO is to reduce costs – and this should feed through to the balance sheet of the firm. However, it is in the variables which enable reduced costs that we see the greatest gaps between expectations and results; and yet the gap for improved balance sheet is the smallest. Those for accessing vendor expertise and improved delivery (the just-in-time dimensions of lean production and servicing) -- which should be the elements of innovation at lower cost -- have the largest gaps between expectation and actuality.

The key reasons for this remarkable contra-indication and difference between expectations and the reality of SOO are due to the moderating influence and impact of factors of asset specificity or inseparability, transaction frequency, technological uncertainty and production process innovativeness on outsourcing for the market performance of the firm in question. Evidence indicates that SOO is non-monotonic with respect to the firm's market performance moderated by the level of asset specificity, or inseparability, in services provision and frequency of transaction [Murray and Kotabe (1999)]. In other words, at lower levels of asset specificity, market performance (market share, revenue growth rate, return on investment, and return on equity) increases with increasing SOO. Also higher transaction frequency of relatively lower levels of asset specificity of what is outsourced tends to be non-monotonically related to market performance. However, at relatively higher levels of asset specificity, market performance decreases with increasing SOO.

Further recent empirical research points to the factors of technological uncertainty and innovativeness having a non-monotonic relationship on outsourcing performance. On the one hand, at relatively low levels of technological uncertainty (i.e. with industry mature technologies) increasing the amount, or rate, of outsourcing is positively correlated with firm performance.

However, with relatively higher levels of technological uncertainty, increasing the amount, or rate, of outsourcing becomes negatively correlated with firm performance. On the other hand, at relatively low levels of product, or process, innovativeness (i.e. with low appropriability and low tacit assets) increasing the amount, or rate, of outsourcing is positively correlated with firm performance. But, at relatively higher levels of innovativeness (in what is outsourced) outsourcing becomes negatively correlated with firm performance. The gaps in expectations and reality may therefore be attributed: firstly to the inability of SOO managers to judge accurately and price the extent of outsourcing; secondly, to what should, and should not, be outsourced; and thirdly, to the inability to assess accurately the business characteristics of the outsourcee [Murray, Kotabe and Zhou (2005)].

Supporting this failure of SOO to live up to expectations is Table 11 – Most Critical Challenges in SOO⁷⁰.

Rank	Critical Challenge Variable	% of Respondents
1	Weak Control of Costs and Operational Performance	32
2	Excessive Standardisation (i.e. high inflexibility of operations)	31
3	Outsourcees Unresponsive to Changing Business Needs	28

Bearing in mind the indications from Table 11 above, the problems herein are to do with the fact that the whole point of SOO is to delivery economies of scale -- and hence cost reductions -- however the business set to achieve this is in several instances incompatible with the ability to deliver economies of scope -- which are to do with operational flexibility and the ability to apply what is learnt in one business dimensions to another business dimension. Host policy makers cannot micro-manage this aspect of SOO. This is the responsibility of managers doing the SOO. Nonetheless, policy making needs to be informed of these challenges as they may point to, for example, underlying deficiencies in host industry technological training incentives and schemes, infrastructure ‘bottle-necks’ or a commercial regulatory regime that is overly restrictive in dispute settlement (see Section 5 regarding the variables on which China and India perform relatively less well.

We now proceed to analyse the policy dimensions of PIs. It is important to note herein that governments of developing countries choose policy instruments -- generalised as incentives⁷¹ -- to attract FDI and SOO in relation to their overall economic development goals. Thus, different

⁷⁰ Booz Allen Hamilton Survey of 100 U. S. companies, 2002, cited in Booz Allen Hamilton, 2003, Business Process Outsourcing and Offshoring.

⁷¹ Not to be confused with the special category of incentives named fiscal or financial incentives.

dimensions of incentives can be depicted. Firstly, incentives can be either *general* or *specific* (with discretionary functions). A second dimension is the durability of incentives. Indeed, according to the host country's priorities, incentives could be either *permanent* or *temporal*. However, pragmatically speaking, PIs related to incentives need to change in their duration so as to encourage the kinds of FDI, SOO and industrial specialisation the country wants. Therefore it is useful to think of PIs as windows of opportunity which open and close.

Notwithstanding *Marshallian districts*, another dimension exists at the geographic -- or spatial -- level since investment policies can target FDI and SOO either at a *national* level or at a *regional* or *local* level. Local incentives can be used to promote specific regions of a country that are poorer or in greater need of development. Further, incentives can be used to attract foreign investors to the whole *economy* or only to certain *sectors* or sub-sectors, according again to specific needs. In the past, this has carried the rubric 'negative' or 'positive' lists which cordoned off strategic sectors of the economy to foreign investors and reserved others for national firms⁷². Finally, at the firm level, incentives can focus either on *all FDI*, or only on *specific investors*. These dimensions are depicted in Figure 3: A Framework for Operationalising FDI Policy Dimensions and Instruments.

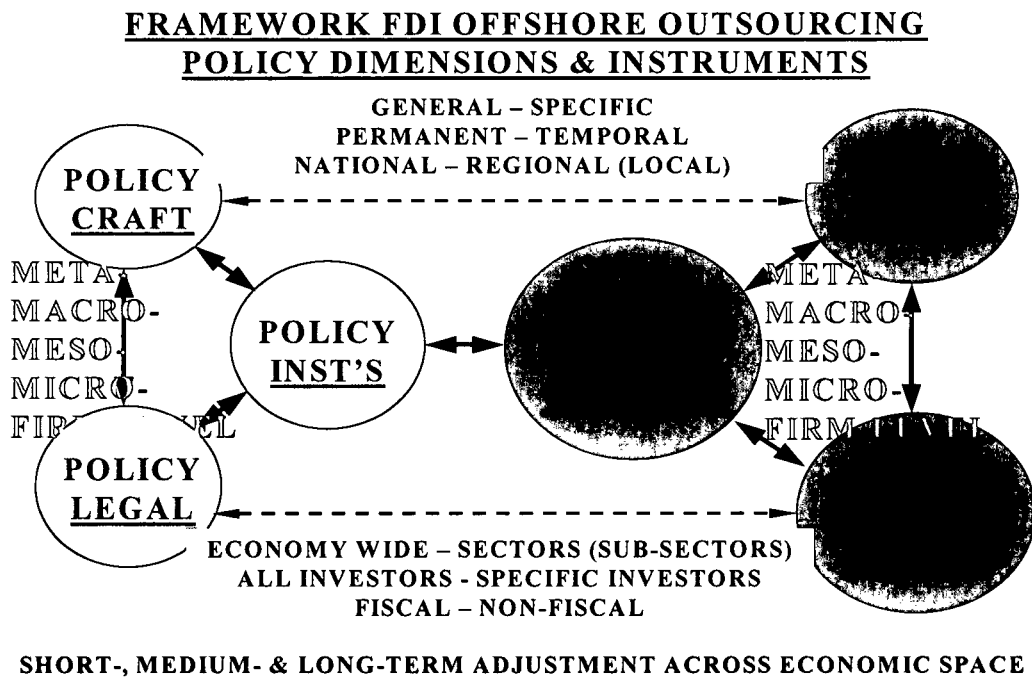


Figure 3: A Framework for Operationalising FDI Offshore Outsourcing Policy Dimensions and Instruments

⁷² See Arkady Ostrovsky and Kevin Morrison, "Foreign Groups Face Ban from Bidding for Russian Resources", *Financial Times*, 11 February 2005, p.1 for a contemporary illustration of this phenomenon.

To say that policy craft – creating policy coherence out of the conflicting demands from modal neutrality, market contestability⁷³, as well as scaling and measuring the factors and variables which must be considered in policy research and analysis – is a challenge, is an understatement. This paper makes early reference to the growing importance of investment and business climate benchmarking as a guide to policy making. However, econometrically, as every factor or variable (or their combinations) has its own FDI inflow-elasticity and FDI stock-elasticity, IPAs and policy makers with limited resources should concentrate their policy craft on those FDI and SOO factors and variables with the highest FDI-elasticities [Christiansen (2004)]⁷⁴. In rank order, these are: (i) growth-competitiveness, which combines macro-economic and technology variables, with a FDI inflow-elasticity of 0.63; (ii) economic freedom, combining government intervention, property rights, wages/prices and regulation variables, with a FDI inflow-elasticity of 0.56; (iii) taxation and regulation with a FDI inflow-elasticity of –0.50; (iv) quality of telecommunication services with FDI inflow-elasticity of –0.28⁷⁵; and (v) labour market regulation with FDI inflow-elasticity of –0.26. Furthermore, these elasticities have short- medium- and long-term adjustments rates. This approach begins to lay out the choices available to policy makers in making viable PIs in a systematic manner based on rigorous analysis. Hence, from a fourth generation IP perspective [Bartels (2005b)], a focus on the macro-economic environment stability and technology policies to increase the rates of innovation and transfer by PIs that facilitate licensing and franchising for example would be needed. In a similar vein, harmonising taxation regulation across regional space would be a viable policy.

All these elements and issues in Figure 3 reflect the need for sequencing and switching PIs and incentives, both in space and time. In other words, while the FDI policy-making is increasingly more complex and diverse, host governments, according to their development needs, have to adapt to the MNEs dynamic activities by sequencing and switching (in a predictable manner) their FDI and SOO policy instruments. Moreover, these different policy dimensions also indicate the

⁷³ Policy coherence refers to the degree of internal consistency of objectives, FDI and SOO policies and interpretation of policies, in their regulatory form, across a range of issues and at different level of government. Modal neutrality describes policies that allow foreign investors to decide for themselves how best to serve the markets they enter. Market contestability embodies the ability of both foreign and domestic investors to compete on a level of playing field for all the factors of production.

⁷⁴ For example, the FDI stock elasticities of GDP per capita range from 0.89 to 0.96 implying that a 10% increase in a country's GDP per capita would result in a 10% increase in inward FDI stock. Likewise, the FDI inflow-elasticity of a host country's competitiveness (scaled 1 to 5) at 0.63 implies that an increase of 1 point in the scale would result in an increase of 88% inward FDI ceteris paribus. See Christiansen (2004, pp. 32-37) for other FDI-elasticities (economic freedom, taxation, regulation, infrastructure, human resources).

⁷⁵ The measurement scale is from 1 to 5 representing increasing poor quality, hence the negative sign on regression coefficient.

importance for host governments to create different levels of policies: the meta- or supra-national level, the macro- or national level, the meso- or regional and cluster level, the micro- or industrial sector and sub-sector level and the firm level of organisational strategy and competitiveness [UNIDO (2005)]. The complexity of FDI host policy-making is obviously high nevertheless policy dimensions have to be chosen and established in harmony with the general development goals set up by the government.

Ultimately, it could be argued that all these dimensions collapse into one dimension regarding incentives. In fact, incentives can be *fiscal* or *non-fiscal* [Oman (2000); UNIDO (2003a)], as selectively illustrated in the Table 12 - Fiscal and Non-Fiscal Incentives, below. As we can notice, non-fiscal incentives are constituted by *financial* and *non-financial* incentives.

Table 12 - Fiscal and Non-Fiscal Incentives	
Fiscal incentives	Non-Fiscal incentives
Tax Holidays	Depreciation Methods
Tax-Free Imports	Development Banks' Loan Policies
Tax Exemptions	R&D Support
	Environmental Standards Support
	Labour Training Support
	Government Subsidies

Whereas industrialised countries typically utilise financial incentives such as grants, developing countries usually use fiscal incentives, such as reductions in the base rate of corporate income tax, tax holidays and import-duty exemptions and drawbacks [Oman (2000)]. Incentives are widely used to attract MNEs and thus create a climate of policy competition for FDI. Fiscal incentives might be successful for attracting MNEs but incentives-based competition also creates some problems. Indeed, the first problem of incentives is that they represent opportunity cost of resources to host governments. Secondly, there can be a significant lack of transparency regarding incentives, which leaves space for corruption and other kinds of rent-seeking behaviour. Finally, given the dimension choices in Figure 3, incentives also provoke market distortions. Among them, the major ones are the fact that incentives tend to favour large corporate investors at the detriment of small ones as well as foreign over the domestic companies because of their lower risk profile and higher bargaining power. The distortion would tend to disappear (over time) in countries adopting fourth generation IP, as they would treat foreign and domestic firms equally with regard to incentives.

The policy craft for capturing SOO is therefore contextualised by an overall reference to industrialisation strategy and the roles of industrial (and trade) policies [UNIDO (2002)]. The policy response to the challenge of attracting SOO encompasses a combination of short- and long-term legislation, upgrading of the ‘people’, ‘business’ and ‘financial’ infrastructure of an economy in order to reduce the transactions costs of doing business on the one hand. And, on the other hand, of increasing the level of transparency to avoid rent seeking and regulatory capture. This policy posture enables the economy to structurally adjust as competitively as possible.

First on the list of policy measures is boosting innovation and skills – to enable the domestic economy to intermediate in SOO provision for GVCs and the networks that cohere the IGF. Secondly, as SOO represents the processing of intellectual capital, for example in the form of BPO, policies to strengthen intellectual property rights protection are crucial to attracting SOO and FDI [Atkinson (2004)]. Thirdly, selective fiscal incentive policies should be designed to accelerate capital asset restructuring, through accounting identities such as depreciation and training exemptions. Together these will facilitate the increasing transfers of R&D services⁷⁶.

8 CONCLUDING REMARKS

The highly complex dynamics of FDI, OO and SOO present the challenges of a rapidly changing global industrial landscape for policy makers. Over the past four industrial development decades, the international involvement of MNEs in business and economic development [UNIDO (2000)] has shifted from ‘stand-alone’ FDI to network forms of collaboration; and from managing the ownership of assets (capital and technologically intense) to managing the ownership of relationships (trust and contractually intense). This has been accompanied by a shift to the East for labour intensive activity and, along with technological advances of digitisation, an increased reliance on OO of non-core business functions. We are now witnessing globally both increased competition and collaboration within the industrial relationships of FDI, MNEs, their GVCs and IINs.

The trends and patterns identified in OO point to significant changes in what is outsourced and where it is offshored. The 1970/80s witnessed OO of labour intensive production, particularly an international relocation of labour intensive manufacturing. The 1980/90s saw the international relocation of services (starting with labour intensive activities). During the 2000s, the relocation of

⁷⁶ This is notwithstanding the mixed results from analytical studies on the utility of tax incentives as policy measures to attract FDI and SOO to developing countries [See Hall and van Reenen (1999)].

more value-added business processes and services, such as architectural sub-contracting, customer management and contract R&D began significantly [Narayan (2004)].

The implications of SOO for host locations attempting to change the composition of their GDP and upgrade their industrial and service sectors to enable them to act as services providers to MNEs are serious. Without policy attention to the variables on which MNEs are surveyed, with respect to their internationalisation, policy craft will be severely constrained. The overarching enabling conditions for attracting FDI and SOO are ultimately oriented towards modal neutrality⁷⁷ and asset security (due to the ownership of capital and intellectual assets). And, as MNEs increasingly shift the basis of their international involvement from owning assets to owning relationships -- the essence of collaborative forms of internationalisation and hence of outsourcing -- the operational conditions for attracting FDI and SOO will need to be increasingly focused on market contestability⁷⁸ and contracting security (legal and regulatory environment).

The debate on externalities (spillovers) of FDI relative to those of SOO is essentially an argument on the extent of spillovers and their distribution. Of course, crucial questions shape the discussion. Who benefits? And, at what level of aggregation? Are the spillovers captured by outsourcer (investor) or outsourcee (host local firm providing the service)? And in what relative amounts? Whatever the answers, and their qualifications, first it is beyond question that SOO is set to grow significantly as a key cost reducing element in the international strategies of MNEs. This provides a series of evolving higher-level service value-added opportunities for emerging market economies and especially the so-called 'BRICS'⁷⁹ as well as some other more advanced developing countries. However, most developing countries, without rapid structural adjustment to enhance the performance of their domestic sectors, will miss out on the international relocation of services. Secondly, the increasing digitisation of knowledge intense activities means that key SOO for R&D, regional HQs location, call centres and shared services, and distribution and logistics will continue to be technologically relatively easy. The corollary of this is that developing countries need to accelerate their output of knowledge workers (while preventing a brain-drain to the Triad economies) able to handle digitised knowledge work, as well as upgrading their 'soft' and 'hard' infrastructure. Thirdly, the relationship between activities subject to outsourcing, from where it is

⁷⁷ Modal neutrality describes policies that allow foreign investors to decide for themselves how best to serve the markets they enter.

⁷⁸ Market contestability embodies the ability of both foreign and domestic investors to compete on a level of playing field for all the factors of production.

⁷⁹ Brazil, Russia, India, China and South Africa.

outsourced and where it is offshored will remain complex. It will depend on the evolution of the types of business processes, their core value to the outsourcer (and potential value to the outsourcee – as a potential competitor), evolving cost structures, and the efficiency of the service provider. It will also depend on the risk adjusted location specific advantages and the attractiveness of the business environment of the host economy.

The policy responses of developing countries to the new shift in international business need to incorporate the dynamics of the integrated global factory, which now represents the role of MNEs in the world economy [Bartels (2005a)]. And a crucial aspect of this understanding concerns the governance structures⁸⁰ of the international operations of MNEs. This issue is evident for example in the case of SOO which involves technology transfer to the service provider in order to overcome the “liability of foreignness” by upgrading quality for example [Zaheer (1995)]. Internationalisation of firms’ operations is taking on nuances brought on by the increased risks of globalisation, increased corporate vulnerabilities and higher frequency volatility in the competitive landscape. There is also increasing outward FDI and SOO by MNEs from the more advanced developing countries [UNCTAD (2002)]. The MNEs’ corporate response to these increased risks is a redistribution of assets and relationships. Capital is being concentrated in Triad economies while relationships (supply and non-core business functions) are being relocated, through real options, in South and East Asia.

The key issue on the policy agenda for developing countries from other regions is how they craft domestic industrial policies, sufficiently rapidly, to enable local firms to grow, and be assisted to grow, in technological capacity and knowledge-based capability to perform increasingly sophisticated corporate business functions once carried out as white-collar work in industrialised countries.

⁸⁰ These involve the allocation of rights (sourcing, technology, production, marketing, servicing); inter-organisational interface management; and co-ordination and control of operations.

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