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ECLAC

SIXTY YEARS WITH LATIN AMERICA AND THE CARIBBEAN

Offshore corporate services in Latin America and the Caribbean
ECLAC, Santiago

Background paper for the seminar to be held on November 18, 2008
(see www.cepal.org/ddpe for information on the seminar)

Comments and suggestions welcome

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The global offshore corporate services (OCS) market includes a broad range of activities, from call and contact centers to business processes to software development. New, more knowledge-intensive services have started to be successfully offshored on a large scale in recent years, whether through outsourcing or through in-house operations. The increasing size, diversity and complexity of this market have generated opportunities for a growing number of developing countries, including in Latin America and the Caribbean. This industry has thus been at the top of investment promotion priority lists for many countries in the region.

1. Global trends in the offshore corporate services industry

The definitions of offshore corporate services (OCS) vary according to analytic perspectives. Market estimates and corporate rankings vary accordingly. For the purposes of this seminar, offshoring refers to the practice of providing services through operations situated in a country other than where the customer is located. Here we will refer to the following as OCS, unless otherwise specified:

IT services	Software development; Application testing; Content development; IT infrastructure management; IT consulting.
IT-enabled services	Call and contact centers; Business processes (BPO when outsourced): ⇨ Horizontal business processes or back-office services: purchases, logistics, marketing and sales (other than contact functions); human resources; finances and accounting; ⇨ Vertical business processes: services specific to certain industries, such as claims and payments processing for financial institutions, insurance management for healthcare, network maintenance in telecommunications services, passenger flow management for airlines; Knowledge process offshoring (KPO): intellectual property research, equity, financial and insurance research, data search, integration and management, analytics and data mining, research and information services in human resources, engineering and design, animation and simulation services, remote education and publishing, research and development, vertical functions (services to medical, legal, biotech, pharmaceuticals industries).

Adapted from Boston Consulting Group (2007), Castillo (2007), UNCTAD (2004), Evalueserve (2004).

Measuring the OCS industry is no easy task as official statistics do not allow for a precise quantitative assessment (López et al, 2008; Arora et al., 2006). Market estimates, on the other hand, use different methodologies and taxonomies. According to one survey-based estimate, in 2006, the market for OCS similarly defined was estimated at 65 billion dollars, of which approximately 35% referred to IT services and 65% to IT-enabled services. The market was expected to grow to over 280 million by 2010, with higher proportional growth expected in IT-enabled services (Boston Consulting Group, 2007).

The OCS industry underwent a growth spurt starting in the mid-1990s, motivated by enabling factors and push factors. Examples of the former were developments in software and telecommunications solutions; investment in infrastructure in the years leading up to the dot.com crisis; and the standardization of management practices. Examples of the latter were the insufficient number of skilled professionals in the United States to face the Y2K crisis; and competition and economic recessions that put pressure on corporate costs (Friedman, 2005; López et al., 2008).

In more recent years, it is likely that a significant share of growth has been inertial: as buyers, vendors, captive offshorers became familiar with offshoring practices they expanded the volume and nature of activities undertaken offshore. As labor markets in low cost destinations matured, an increasing range of services, even towards the higher-end of value chains, started to be offered offshore. Moreover, competition among outsourcing vendors contributed to offshoring by reducing profit margins and making cost and scale critical, especially in the traditional segments such as call centers and business process outsourcing (BPO). As the Indian vendors (TCS, Infosys, Wipro, Satyam and Genpact), that had their main operations in India (and thus offshore), started playing a greater role as competitors, outsourcing companies from higher-cost countries that hadn't yet explored the full potential of offshoring were forced to do so to maintain cost competitiveness (Aggarwal et al., 2006).

India is by far the main location for OCS operations, with approximately 84% of IT services market and 46% of the IT-enabled services market (The Boston Consulting Group, 2007). An estimate of the number of jobs created by FDI in "business services" (a category that encompasses many of the services included in the definition of OCS) shows that in 2006, India and the Philippines were the top destinations, accounting for 33% and 19% of total jobs, respectively (IBM Global Business Services, 2007).[1]

Nonetheless, a combination of changes may be altering the logic behind location decisions in OCS, making non-cost factors more important than in the past, and thus making it feasible for other countries to compete for FDI in this industry.

First, as the offshoring of higher-value added, less standardized services, has grown, non-cost factors such as specific skills and strategic locations have become increasingly important in companies' decisions on where to invest. Companies wanting to offer competitive services to their clients have established bases in different time-zones to provide 24-hour work cycles, thus reducing time to market in product development. They have tapped into specialized talent pools and have benefited from creativity gains associated with working with groups from different backgrounds with different problem-solving approaches (Couto et al., 2006; Evalueserve, 2007).

Secondly, increasing importance has been attributed to factors such as geographical and cultural proximity to major markets, in what has been named *nearshoring*. In the call and contact center and BPO markets, as more companies compete, service quality is enhanced and more value is placed on differentiating aspects of service. Beyond language proficiency, customers (or companies offshoring their own operations) require accents that are more palatable to the user, as well as cultural sensitivity. In the KPO segment, many services require more frequent interaction, or are more sensitive to time zone

[1] These estimates do not necessarily reflect offshore operations as business services can also be provided to local customers. Nonetheless, in these two countries the bulk of business services are notoriously offshore operations.

proximity, making nearshore destinations complementary to the onshore and those situated in more distant places. Latin America and the Caribbean has been considered an important nearshore destination for United States customers for certain functions, while several countries in Eastern Europe are natural nearshore candidates for customers in Western Europe.

Thirdly, the need to diversify the location of operations to hedge against risks – natural, geopolitical and other – has made alternative destinations attractive for both outsourced and in-house investments.[2]

Finally, analysts have observed the first signs of saturation in traditional labour markets, namely India. As wages rise, reduced cost savings in the traditional markets have been pointed out as an opportunity for other destinations (ATKearney, 2007). Views on this are, however, not unanimous. First, it is unclear to what extent increasing wages in these markets are effectively leading to relocation towards other destinations as, even with increasing costs, these destinations still have advantages among which are skills, know-how, and the confidence of service providers and their customers. On the other hand, some observers believe that the symptoms of saturation that might affect location decisions are not rising costs but falling quality, high attrition rates (which makes activities that involve technology transfer especially difficult), and inflexibility in tending to clients' needs. These factors are leading companies to look for alternatives or complements to the traditional destinations, despite the fact that the traditional ones remain cost-competitive, especially for large scale operations.

In summary, as the OCS industry has become more sophisticated and more diverse, location decisions have become more complex, and non-cost factors have increased their weight in the location-decision equation. Networks of complementary service centers are being developed as countries try to benefit from diversity – in many aspects – as well as from low cost. A greater spectrum of countries, including several in Latin America and the Caribbean, could benefit from these trends.

2. OCS in Latin America and the Caribbean

Existing official statistics do not adequately reflect the offshoring phenomenon. An assessment of Latin America and the Caribbean's importance in the global OCS industry must rely on complementary indicators that reflect different aspects of this market. According to trade statistics, as of 2005, the region was responsible for 1.2% of international trade in computer services, compared to China's 2.3%, and India's 14% (ECLAC, 2007). In terms of jobs created by FDI in business services, together, Costa Rica, El Salvador and Mexico account for 10% of the world total. Relative to population size, El Salvador and Costa Rica are the top recipients of jobs created by FDI in business services (IBM Global Business Services, 2007). Countries in Latin America and the Caribbean host a smaller number of the top service providers than India, China, and the Philippines. Nonetheless, some of the largest countries rival others in Asia and Eastern Europe (Boston Consulting Group, 2007). Finally, The ATKearney Global Services Location Index (see table) shows the countries in the region that are attractive for future investments. Although the Asian countries still top the list, this index seems to reflect increasing interest in Latin America and the Caribbean. This is corroborated by estimates of relatively high growth in this market in the region compared to other regions (The Black Book of Outsourcing, 2008).

Latin America and the Caribbean presents a range of common advantages for companies in the OCS industry, among which are geographical and cultural proximity to the United States; opposite time-zones from Asia, allowing for complementary, 24-hour work cycles; destinations with relatively low

[2] One example illustrates the importance of diversifying offshore operations: with the energy blackout on the North American East Coast in 2003, that happened outside Asian business hours, companies with offshore centers in Latin America were able to more rapidly react and run emergency procedures ("La tercera vía empresarial", América economía, September 8, 2008).

political, economic and natural risks, providing a good hedging alternative; talent and technology hubs with lower attrition rates (making it safer for operations where knowledge transfer is involved), and established markets for many segments (highly influenced by the presence of transnational corporations and the growing internationalization of local companies).

ATKearney Global Services Location Index

	2004	2005	2006/2007
1	India	India	India
2	China	China	China
3	Malaysia	Malaysia	Malaysia
4	Czech Republic	Philippines	Thailand
5	Singapore	Singapore	Brazil
6	Philippines	Thailand	Indonesia
7	Brazil	Czech Republic	Chile
8	Canada	Chile	Philippines
9	Chile	Canada	Bulgaria
10	Poland	Brazil	Mexico
Others in the top 50	Mexico, Argentina, Costa Rica (in top 25)	Mexico, Costa Rica, Argentina	Uruguay, Argentina, Jamaica, Costa Rica, Panama.

Source: atkearney.com

Nearshore and linguistic advantages combined with relatively low cost have consolidated the Caribbean, Central America and Mexico as preferential destinations for call and contact centers. The English-speaking Caribbean has hosted United States-oriented call centers since the 1980s. The growth of the Hispanic community in the United States has created demand for Spanish-speaking operators, to the benefit of Central America and the Dominican Republic. At the same time, the bilingual workforce in Latin America and the Dominican Republic has grown both through educational efforts and through the return of people who had previously worked, or been raised, in the United States. Moreover, some of the countries in the region have significant numbers of professionals who are fluent in other languages, and can cater to other destinations, including several European countries.

As companies have scaled up from call centers and lower-end BPO activities towards higher-end BPO, so have some of the countries that have hosted these players, such as Argentina and certain Central American countries (ATKearney, 2007). Several countries in the region have been seen as providing an attractive combination of low cost and availability of skilled professionals for relatively large BPO and shared services operations in several countries. New jobs have been created recently by the major players – among which Accenture, EDS, IBM, Wipro, Infosys, as well as by regional companies such as Softek (IDC, 2008). As the industry expands, destinations that are relatively new to this industry, such as Colombia and Peru, are becoming increasingly attractive.

The larger markets, Mexico and Brazil, host a wide range of service centers, although their role as offshore destinations is relatively recent.[3] Companies established service centers in these countries to cater locally to both local and global clients. In doing so, they acquired infrastructure (the fixed costs of which were gradually depreciated), knowledge and experience in the local business environments. As IT developments made offshoring technical and economically feasible and companies became more

[3] In Brazil, particularly, service operations are still predominantly dedicated to the local market, although trade statistics suggest that the offshore, or export-oriented, operations that do exist are substantial compared to other countries in the region.

experienced in offshoring, some took advantage of their bases in these countries and started catering simultaneously to the local market and to offshore customers (or their own corporate headquarters). One differentiating aspect of these two countries is the fact that both have important IT manufacturing industries. This has contributed to creating a pool of engineers that are employable in the services industry. Another link between the manufacturing and services industries has been the shift in the core activities of Original Equipment Manufacturers (OEMs) (of which there are several in Brazil and Mexico) from manufacturing to service (or “solutions”) provision. When they outsourced manufacturing, these companies took advantage of their infrastructure and decades-long experience in these countries to base service centers where they previously manufactured. IBM in Brazil is an example of this (ECLAC, 2008a).

Smaller countries with pools of qualified professionals but in relatively low scale, such as Chile, Costa Rica, and Uruguay have started to target and receive investments at the higher end of the OCS scale, namely in KPO and certain IT services. At the same time, clusters have developed in specific areas within the larger countries, such as the province of Córdoba in Argentina, smaller cities on the outskirts of São Paulo city in Brazil, and Monterrey, Mexico City, and Guadalajara in Mexico. These have benefited from a trend for companies to explore the advantages of locating away from the large capital cities and moving towards smaller urban centers where they enjoy access to important talent pools with lower attrition rates, among other benefits.

Thus, although none of the countries in the region are first-tier players in the OCS industry, and although a large share of services are at the low end of the value chain (López et al., 2008) there are pockets of highly sophisticated activity centers catering to global customers and OCS operations in the region seem to be growing, at least partly motivated by the global trends mentioned above. Some of the hurdles for further expansion, according to interviewed companies, have been the availability of human resources, market stability to allow for long-term projects, and cost in the segments where competition is mainly price-based.

3. Impacts

Benefits from FDI in the OCS industry, as identified by governments, have included greater, more diversified, and higher value-added exports,[4] employment with relatively high remuneration rates, and some degree of skills and technology transfer. Better employment perspectives, especially for young graduates, have had the important social function of reducing brain drain in some countries, which is especially relevant in countries with a young population. In others, the perspectives of developing this industry have also contributed to the financial feasibility of telecommunications infrastructure projects.

However, it is still unclear to what extent the dynamic benefits of FDI in this industry, such as the leveraging of local companies and the upgrading of local activities within service value chains, will effectively materialize on a substantial scale and for a significant number of countries in the region. Although there are important exceptions, it has been observed that in general linkages with local companies have been relatively weak, and that service functions performed in the region by transnational corporations are largely on the lower end of the skills and technology spectrum, offering scarce perspectives of upgrading. On the other hand, given that entrance barriers to global markets are high, and few local companies are likely to break into them significantly in the foreseeable future, upgrading would seem to depend on transnational corporations (López et al., 2008).

[4] OCS development has been one of the key objectives of countries trying to diversify away from low-value added manufacturing activities increasingly threatened by competition from China (ECLAC, 2008a, 2008b).

4. Policy

Country strategies to attract FDI to the OCS industry have followed three main patterns or a combination of all three: consolidating a critical mass of operations in low-end functions; upgrading from those low-end functions; or targeting strategic segments, based on the comparative advantages of the country and the role each segment can play in policy objectives. Alongside general business environment and FDI attraction measures, the instruments to promote investment in this industry have mainly consisted in (i) measures to develop human resources; and (ii) financial and tax incentives.

Companies and governments have reported that a major bottleneck for the development of several OCS segments on a larger scale in the region is the relatively small number of professionals that have both the required technical skills and are fluent and functional in other languages, and especially in English. Thus strengthening English language skills has been one of the most common goals in the policies directed at developing the OCS industry in Spanish-speaking Latin America. Solutions have been the elaboration of rosters of bilingual professionals and the financing of English-language training. Chile has directed specific initiatives at developing English language skills among IT professionals. Other countries have gone beyond English to include other languages in their programmes. As far as technical skills are concerned, initiatives vary as widely as targeted sectors. They have included the enhancement of mathematical and IT skills in primary, secondary, technical and university curricula, as well as training programmes for specific technical careers (such as call center operators) and efforts to increase the numbers of qualified engineers and of certified IT professionals. Interviewed companies have also expressed that more flexible policies in the intraregional migration of human resources may enhance the attractiveness of the region – or of sub-regions – as a competitive FDI destination in this industry.

Apart from policies geared at developing human resources, most countries offer tax and financial incentives to companies investing in the OCS industry. The forms and specific tax-related instruments used vary widely, and include the waiver of duties on equipment and components; the waiver of export tax; income taxes; VAT; and free-zone regimes. Countries seeking to attract investment in more knowledge-intensive sectors (IT services, KPO), tax incentives are complemented by direct financial incentives. In Chile, subsidies are offered to finance pre-investment studies, set-up costs and specialized training.

5. Topics for discussion

In light of the above trends, issues that warrant discussion are the following:

1. How can Latin America and the Caribbean take advantage of global trends in the OCS industry?
    - What are the opportunities presented by new trends in the global market and what are Latin America and the Caribbean's advantages in that context?
    - What are the main bottlenecks for the expansion of this industry in the region?
    - Is there potential for Latin America and the Caribbean to advance up in services value chains, more than it has in manufacturing?
    - To what extent are countries in the region complementary to each other and to those in other developing countries (such as India) for OCS activities and how can these complementarities be explored?

2. What impacts has the OCS industry, and more precisely FDI in OCS activities, had on local economies?
    - Static vs. dynamic benefits

- Are expected benefits materializing? If not, what are the bottlenecks?
- Are there negative impacts? How have these been addressed?

3. What are the characteristics of country strategies in place to develop the OCS industry and what role is attributed to FDI?
    - In practice, what instruments have been used? What segments have been targeted and based on what criteria?
    - How is the effectiveness of these policies being monitored?

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Survey answers for Antigua and Barbuda, Bahamas, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Guyana, Honduras, Saint Lucia, Saint Vincent and the Grenadines and Trinidad and Tobago.