OFFSHORING AND FOREIGN DIRECT INVESTMENT

By

Ahmad H Juma'h
Professor
Metropolitan Campus
Inter American University of Puerto Rico

Abastract

Discusses outsourcing overseas (*offshoring*) as a global strategy to concentrate on core business and improve efficiencies of multinational companies. O*ffshoring* implications on foreign direct investments are also discussed. O*ffshoring* contributes to a greater dynamism and intensity in the professional services as a new feature of the global economy.

Keywords: Offshoring, outsourcing, international business, information technology, decision making, strategy, and foreign direct investment.

IINTRODUCTION

Accelerating changes in technologies, communications, economic integrations, and management innovations are parte of the globalization phenomenon. The globalization is seen as a new economic phenomenon or a new economy (Stiglitz, 2003). Alliances, partnership, subcontracting, outsourcing and *offshoring* are integral part of the new economy. This new economy represents opportunities and challenges not only for multinational companies (MNCs), but also for host countries.

Offshoring is considered as an extension of *outsourcing.* It is related to the decision of companies to acquire services from overseas providers (services previously produced internally or services acquired from a local provider). The services more common to *offshoring* are programming, design, information systems, telephone operations centers (*call centers*), accounting functions, data entry, and research and development. As outsourcig, o*ffshoring* is neither a strict form of partnership or alliances nor a simple subcontracting. It is a long-term relationship where both parties are dependent on each other in seeking benefits and minimizing risks. Also, all parties have power to negotiate as arm-length parties.

Savant (2004) states *offshoring* enables companies becoming more competitive. Recipient countries benefit because they increase their exports, create jobs, acquire skills and build backward linkages. Sending countries benefit from lower prices for consumers, exports of related goods and services to recipient countries and free resources to concentrate on higher value added activities.

However, to offshore part of companies operations is not an easy task. To make a rational choice, companies consider the opportunity costs of *offshoring* strategy. Skill level of workers, connectivity, the business environment and selecting locations are examples of the complexity of *offshoring* strategy (Farrel, 2005, 2006, Doh, 2005).

Offshoring seems to have effects in the global economy, mainly in the labor markets, for example, the US is considered one of the most developed countries. However, some of the US industries have not been able to compete with the labor cost and technology in developing countries. According to Apte (1991), the US industries have lost its competitive advantage with respect to blue-collar labor during the 70’s and 80’s. During the 90’s the US industries lost some of its competitive advantage with respect to white-collar labor. Many of the US MNCs consider or actively use the *offshoring* strategy as an instrument to decrease the labor costs, to achieve new technologies and to try to stay competitive worldwide.

In evaluating the *offshoring* strategy's effects on international business, this article is organized as follows: the following section discusses issues related to the *offshoring* as a global strategy, the third section analyzes the effects of *offshoring* strategy in the foreign direct investment (FDI), and final remarks are given in the final section.

***OFFSHORING:* STRATEGY**

FDI and political economy, helps to understand how *offshoring* influence global competitive strategies adopted by MNCs. FDI helps to consolidate MNCs companies' activities in a vertical structure. *Offshoring* serve production chain of low costs regions and guarantees that through the FDI the transference of technologies from foreign countries to local countries. An example of these cases is the US import of intermediate products or services from India, China and Brazil. These countries have great technological advances and competitive human capital. In addition their legal infrastructure facilitates conducting business.

Mann and Borga (2004) evaluate the behavior of exports and imports of services in the USA during the period of 1987 to 2003. The methodology is based on an analysis of the data on the transactions of purchases and sales of services contained in the balance of payments. Also, present the sector of services, which were based on data of the Service of Customs of the Federal Government and of the "*Survey Current Business"* (2004). There was an increase in the exports and imports of services mainly in the line of other professional services (financial, safe education, services, and professional businesses and technical). One of the segments that contributed more to this increase was the "other services" (safe, professional businesses and services technicians). The imports of other services increased 14% in the year 2003, and an increase of 11% in the year 2002.

Although, *offshoring* occurs more in countries like China and India, Mann and Borga (2004) found that during the period of 1993-2003, other private services originate in Latin America and in the Western countries. *Offshoring* plays an important role in the commercial trade of the US with the rest of the world. The access to the markets is the most important factor in decisions of the MNCs to locate their production outside their national territories.

Mattoo and Swinsh (2004) and Mann and Borga (2004) indicate that the areas of greater dynamism are areas related to information technology (IT) and to businesses processes (BP). The businesses services exports originated by the countries of the OECD, are mainly from the European countries and the USA. From the 1995, the exports of developing countries, mainly India, China and Brazil, have significantly grown. This includes, for example, the reputation of India in computer programming. India is the main exporting country of IT services at world-wide level. This strong tendency of services *offshoring* motivates some countries to move towards protectionists policies.

The GAO (2004) evaluated from different perspective the impact of *offshoring* in the economy of the USA during the last years, particularly the professional services. The GAO indicates that although only 16% of the imports of the USA come from the services, the USA is the greater importer of professional services at world-wide level. Simultaneously recognizes that the USA has surplus in its service account of the balance of payments. On the other hand, GAO indicates that a series of factors affect the use of the *offshoring* strategy on many companies in the USA. These factors include: the improvement in the information technology, the diminution in the costs of data transmission and, and the manufacturing expansion in the developing countries.

According to the GAO, the imports of other private services reached to $69.4 trillions in the year 2002 compared with $23.9 trillions in the year 1992. The improvement of technology and the diminution of costs were the most common reasons for the USA companies to adopt *offshoring* as a businesses strategy. According to Hecscher-Ohlin, factor endowment differences across countries give rise to factor price differences across countries, which in turn provide a motive for firms to split (or *offshore*) their production processes across countries (Yeaple, 2006). Also the GAO indicates that *offshoring* could represent series of risks to the companies when the saving expectation is not satisfied.

Garner (2004) makes an intensive analysis of *offshoring* effects in the USA. O*ffshoring* contributes to the reallocation production in a foreign country influenced by economic, technological, and political factors. The difference in programmer wage and marginal benefits in the US and other countries, such as India, is important. Therefore, the US companies reassign intensive activities in labor to countries that have abundance of labor such as India and China, and concentrate in intensive activities in capital and services of high technological contents.

The vertical specialization is an indicator of the globalization phenomenon. The internationalization of production has contributed to the greater use of the vertical specialization. The specialization contributes to increase the relationship between the external investment policies and the international trade policies. Also, the improvement in the technologies of communications and transportation contributes to changes in the global economy (Hummels et. al., 1998). This conclusion agrees partly with the Government Accountability Office (GAO) (2004) as far as the relation of *offshoring* with technological aspect. It is also consistent with the argument of Mann and Borga (2004) that refers to the repercussions of *offshoring* for international trade.

OFFSHORING IMPLICATIONS ON FOREIGN DIRECT INVESTMENT

FDI represents the investment made by MNCs in foreign countries with the purpose of controlling production. From the 1980 to the 1997 the FDI related to 54,000 transnational companies grew to an annual rate of 13% (Shatz and Venables, 2000). During the last years, the FDI has demonstrated greater geographic concentration than the exports of goods and services. For example, the production of the affiliated USA companies in Europe is seven times more than the USA exports in Europe.

In developed countries, FDI is motivated by the existing differences in the production costs, particularly as the tariffs and the cost of transportation tend to increase product prices. The main determinants of the movement of the FDI towards other countries are: the size of markets, the costs of production, the labor flexibility, the trade liberalization, deregulation and privatization of markets.

The eclectic theory (Dunning 1993) integrates a variety of factors and determinants that help to explain why companies adopt FDI strategy instead of *licensing* strategy. This theory assumes that the companies that have better management of intangible assets (e.g. technology) derive potential control (or ownership advantage). Companies can maximize the benefits of *ownership advantages* through hiring (licensing) of a foreign company to produce these goods and services. Given the related transaction costs, MNCs can select subsidiaries or affiliates instead of making production under licensing (Dunning, 2003). Once the company makes this selection, it evaluates the variables or determinants of economies and policies necessary to determine the decision to locate its investment. The potential market is one of the investment location parameters.

Through FDI, MNCs companies seek new markets with potential growth. Those countries that have demonstrated a significant increase in GNP per capita, would allow greater levels of sales and gains for the MNCs. The market size is another factor that influences the location decisions by MNCs. Yeaple (2006) states that *offshoring* is more prevalent in capital intensive industries in relatively capital scarce countries while research and development intensity is associated with *offshoring* in relatively skilled labor abundant countries. Therefore, the importance of firm heterogeneity in the international organization of production, greater dispersion in productivity across firms within a single industry is associated with more FDI. The other remaining factors are: the degree of commercial aperture, worker's skills, and production costs. The natural resources, political, social and cultural variables are possible determinants of the FDI geographical location.

However, relative importance of each one of these factors is not static. The atmosphere of prevailing globalization that contains new strategies contributes to improve the competitiveness. This generates pressures on MNCs to search of new markets, resources and created assets abroad. The created assets include the communications infrastructure, networks, technology and innovation capacity (Mallampally and Sauvant, 1999, Caves, 2007).

FDI generates benefits to foreign countries by contributing to the increase in capital formation, to develop human capital, and to transfer technologies. The elimination of restrictions to the capital flows allows investors to reduce risks by diversifying investments. The mobility of capital has influenced on international control practices, accounting rules and legal issues.

Tuman and Emmert (2004) verify the economic factors considered by the eclectic theory. They use as the dependent variable the net flows of FDI of the USA towards Latin American countries during the period that started in the year 1979 and ended in the year 1996. The GNP per capita is used as economic factor. The countries considered are: Argentina, Bolivia, Brazil, Colombia, Chile, Costa Rica, Dominican Republic, Ecuador, Guatemala, Honduras, Jamaica, Mexico, Paraguay, Peru and Venezuela. The obtained results demonstrate that the MNCs are partially oriented to market and there are no evidences that the factors related to the creation of regional markets contribute to the decisions to locate investment in Latin American countries by the MNCs. A *proxy* of human capital (e.g., rate of registers) obtained a positive sign and it was statistically significant. This implies that those countries with greater population that have better investment in education have better opportunities to attract MNCs. However, with respect to the factors of political nature, the coefficient shows a significant negative sign.

Lall and Narula (2004) identify the role of MNCs in the industrial development; particularly they evaluate the liberalization commercial policies that have been influenced by the movement of FDI. MNCs look for favorable economic conditions to locate its investment and to find those complementary factors that contribute to the location. These are: specific assets, workers skills, transfer of technologies and industrial specifications.

The new game rules at international level diminish intervention of the governments with the FDI.

However, the liberalization not always contributes to increase the flows of FDI in the developing countries since it does not create complementary factors that the MNCs need. This allows exploring existing capacities more freely. Therefore, the liberalization is viewed as sufficient but not necessary condition to attract FDI. Determining the location of FDI of the MNCs depends on the absorption capacity (the ability of local companies to capture the knowledge that exists in other places). Capacities of a receiving country are measured by the magnitude and intensity of *upgrading* of technology. If a technological gap exists between local and foreign subsidiaries, minimum of absorption capacity is required to benefit from FDI contribution to the productivity growth. Similarly, countries should reach a minimum of workers trainings and efficiencies to benefit from technological transfers.

Cuadros, Orts and Alguacil (2004) develop a Value at Risk (VAR) model to study the relation between exports, FDI and production in a sample of Latin American countries. The obtained results demonstrate that evidence exists to maintain the effectiveness of commercial openness in countries like Mexico and Argentina. The benefits derived from the investment flows depending on the existence of open environment and macroeconomic stability.

GENERAL OBSERVATIONS

Offshoring seems to be one of the global strategies that are increasingly adopted by MNCs. Through *offshoring* strategy, MNCs can identify those regions or countries with a capacity of greater absorption. O*ffshoring* is a strategy that is consistent with the vertical activity adopted by MNCs in particular India, China and Brazil. Also, it contributes to a greater dynamism and intensity in the professional services.

It seems the Commonwealth of Puerto Rico' economy is affected by *offshoring* strategy. It is noticed that many MNCs in the last years have ceased their operations in Puerto Rico and established facilities in Europe, Asia or in Latin American countries. Therefore, it is necessary to evaluate the effects of the changes in global economy and how Puerto Rico can increase its efficiency and compete in international economy.

REFERENCES

Apte, Uday, (1991), "Global Outsourcing of Information System and Processing Services", **The Information Society**, 7, 287-303.

Caves, R. E., (2007), "**Multinational Enterprise and Economics Analysis**", 3rd ed, Cambridge University Press.

Cuadros, A., Orts, V. and Alguacil, M., (2004), "Openness and Growth: Re-Examining Foreign Direct Investment, Trade and Output Linkages in Latin America", **The Journal of Development Studies**, 40, 4, April.

Doh, J. P., (2005), "Offshore Outsourcing Implication for International Business and Strategic Management Theory and Practice", **The Journal of Management Studies**, 42, 3.

Dunning, John H., (1993), "**Multinational Enterprises and the Global Economy**", Wokingham, Berks: Addison-Wesly.

Dunning, John H., (2003) "**Making Globalization Good, the moral challenges of global capitalism, a collection of essays**". (Oxford, UK: Oxford University Press).

Farrell, D., (2005), "Offshoring: Value Creation through Economic Change", **The Journal of Management Studies**, 42, 3.

Farrell, D., (2006), "Smarter Offshoring", Harvard Business Review, 84, 6.

Felker, G. B., (2004), "Southeast Asian industrialization and the changing global production system, C.L. Shultze, Offshoring Import Competition and the Jobless Recovery", **The Brookings Institution**, August.

Garner, C. Alan, (2004), "Offshoring in the Service sector: Economic Impact and Policy Issues", **Economic Review**, Federal Reserve Bank of Kansas City, Third Quarter, 89, 5-33.

Government Accountability Office, (2004), "**Current Government Data Provide Limited Insight into Offshoring of Service**", September.

Hummels, D., Rapoport D. and Yi, Kei-Mu, (1998), "Vertical Specialization and the Changing Nature of World Trade", **Economic Policy Review of New York**, June, 79-99.

Lall, S. and Narula, R., (2004), "Foreign Direct Investment and its Role in Economic Development: Do We Need a New Agenda?", **The European Journal of Development Research**, 16, 3, 477-464.

Loungani, P. and Razin, A., (2001), "How Beneficial is Foreign Direct Investment for Developing Countries", **International Monetary Fund, Finance & Development** , 38, 2, June.

Mallampally, P. and Sauvant, K.P., (1999), "Foreign Direct Investment in Developing", **Finance and Development**, March, 36, 1.

Mann, M., and Borga, M., (2004), "US. International Services, Cross-Border Trade in 2003 and Sales Trough Affiliates in 2002", **Survey Current Business**, October.

Mattoo, A and Swinsh, (2004), "Pre-emptings Protectionism in Service, The WTO and Outsourcing", **World Bank,** March.

Sauvant, Karl, (2004) "The Win-Win-Win-challenge of offshoring", **World Trade**, Extracted from: www.ebscohost.com

Shatz, H.J. and Venables, A.J., (2000), "The Geography of International Investment", **The World Bank Development Research Group Trade**, May.

Stiglitz, Joseph, (2003), "Globalization and Its Discontents", **W. W. Norton Company**, New York.

Tuman, J.P. and Emmert, C.F., (2004), "The Political Economy of U.S. Foreign Direct Investment in Latin America", **Latin American Research Review**, 39, 3,october.

Yeaple, Estephen, (2006), "Offshoring, Foreign Direct Investment and the structure of US trade", **Journal of the European Economic** Association, April-May, 4 (2-3), 602-611, Extracted from: www.ebscohost.com