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# Outsourcing for development

## Towards a Developing Country Firm Perspective

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# Outsourcing for development

## Towards a Developing Country Firm Perspective

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### **Abstract:**

*Changes of the global economy have led to a much deeper integration of firms from developing countries. Multinational corporations are increasingly using offshore-outsourcing to maintain competitiveness and market shares. While the implications of this trend has been studied from the point of view of the multinational firm and its home economy, far less attention has been paid to the developing country firm participating in the outsourcing arrangement and its strategic options. From this point of view this paper reviews the outsourcing literature and identifies theoretical contributions that can be employed to build a platform for analyzing the strategic implications of outsourcing for local firms in developing countries.*

**Key words:** outsourcing; developing country firm; multinational corporations; foreign direct investment; global value chains.

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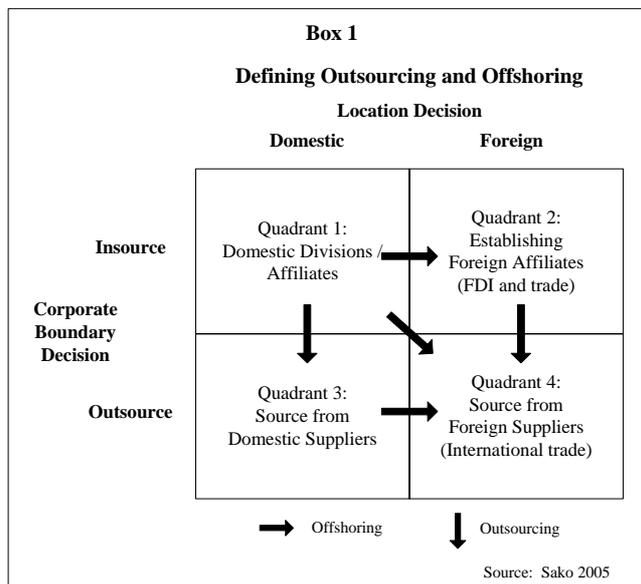
## I. Introduction

### a. The importance of a development perspective on outsourcing

Recent decades have seen profound changes in the organization of the global economy, one result of which is a much deeper integration of developing countries<sup>4</sup>. This integration is largely being orchestrated by firms that in their search for markets and global efficiencies are increasingly taking an international or even global perspective with respect to strategy and the creation of competitive advantage. Among the many manifestations of this deeper integration is the rapid growth in multinational corporation (MNC) offshoring of activities to developing countries. Sometimes this offshoring is conducted through ‘outsourcing’ to third parties, sometimes it is through ‘in-sourcing’ via firm subsidiaries, and frequently it is through combinations of such externalized and internalized modes (see Box 1). In this paper we focus on the combined offshore-outsourcing movement that ends with the involvement of the developing country firm (DCF) (in Box 1 located in quadrant 4). The box illustrates three ways of offshore-outsourcing involving DCFs, one direct from domestic firms to DCF partner firms, and two two-step ways that ends with the participation of DCFs (via quadrant 2 to 4 and via quadrant 3 to 4<sup>5</sup>). We will in the following use the term outsourcing to delineate the three generic ways of outsourcing to DCFs.

Much of the literature on outsourcing takes a developed country firm perspective. Why are firms

outsourcing activities, what are the value chain functions outsourced, what are the implications for the outsourcing firm of outsourcing, and what are the impacts on job-creation and competitiveness of the home countries of the outsourcing firms? What is more rarely discussed is the ways in which outsourcing impacts developing countries and their firms. What are the potential benefits and opportunities of outsourcing for economic and social development, and what are the strategic challenges and opportunities that outsourcing pose for developing country firms (DCF)? The point of departure of this paper is that we need a better understanding of the strategic impact on DCFs of outsourcing of activities from developed to developing countries.



<sup>4</sup> Developing countries now account for 50% of global output (PPP value), 40% of global exports and 67% of foreign exchange reserves. Moreover, between 30-40% of global FDI stock is located in developing countries (UNCTAD 2006).

<sup>5</sup> We have chosen to include equity joint ventures in quadrant 4 since it involves a partner firm in the developing country.

***b. The importance of outsourcing in development***

While precise figures on outsourcing are difficult to come by (Mol et al. 2005), there is sufficient evidence to suggest that the phenomenon is gaining in importance (see Box 2). In particular, it is evident that MNCs are increasingly re-configuring their value chains on a global scale and outsourcing ever more advanced activities in developing countries (Zaheer & Manrakhan 2001; Dicken 2003; Kotabe & Murray 2004).

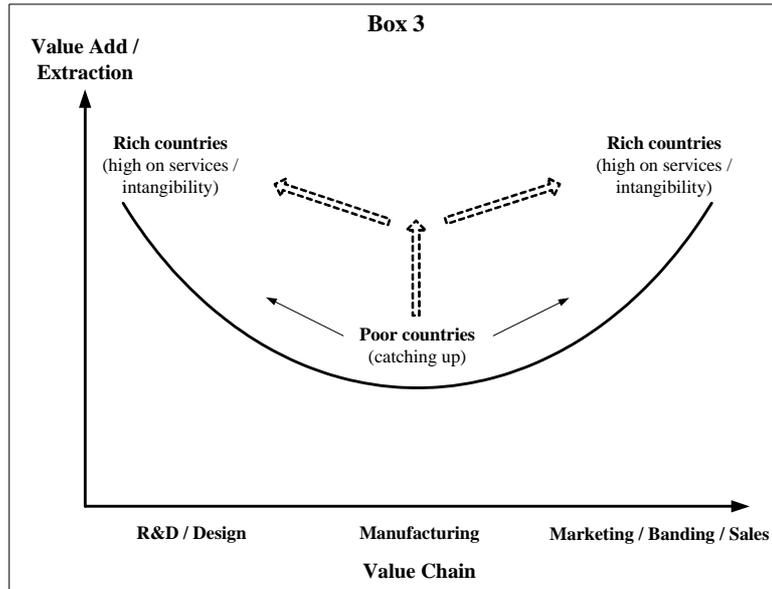
Where early outsourcing activity was mainly oriented toward exploiting the relatively undifferentiated factor advantages of developing countries (unskilled labor and natural resources), it is now increasingly advanced functions that are being outsourced to developing countries, including business services, IT and even R&D (UNCTAD, 2004, 2005).

The outsourcing surge can partly be described as a movement of industries and sectors, partly as a movement of value chain functions within firms in various industries and sectors. In terms of movement of sectors and industries, it is useful to make a distinction between outsourcing of manufacturing and outsourcing of services. According to UNCTAD (2004, p. xxiv): *“while the offshoring of services is still in its infancy, the tipping point may be approaching [and] offshoring represents the cutting edge of the global shift in production activity, giving rise to a new international division of labour in the production of services”*. The growing importance

<p><b>Box 2</b></p> <p><b>Outsourcing in numbers</b></p>
<p>Developing countries are gaining in importance in global trade:</p> <ul style="list-style-type: none"> <li>▪ 1/3 of world trade is now internal to TNCs and another 1/3 is between TNCs and their foreign alliance partners (UNCTAD 2004).</li> <li>▪ The share of developing countries in world merchandise trade rose to 31% in 2004, the highest since 1950 (World Trade Organization 2005).</li> <li>▪ The share of manufactured goods in developing country exports increased from 12% in 1960 to 65% in 2000 (UNCTAD XI 2004b).</li> <li>▪ Developing countries have expanded their exports in services four times in the last decade (UNCTAD 2004).</li> </ul> <p>Outsourcing and offshoring are gaining in importance</p> <ul style="list-style-type: none"> <li>▪ Overall growth in offshore outsourcing is expected to continue at annual rates of 30-40% at least through 2009 (UNCTAD XI 2004a).</li> <li>▪ The value of offshore outsourcing jobs created in the developing world had an estimated value of \$320 billion in 2003, and is expected to reach \$585 billion for 2005 (UNCTAD XI 2004a).</li> <li>▪ Foreign investors are rapidly expanding the share of local sourcing of inputs and services as part of their restructuring processes.</li> <li>▪ Cost factors often trigger offshoring and cost savings of 20-40% are often reported (UNCTAD 2004).</li> </ul> <p>Offshoring of IT is becoming increasingly important:</p> <ul style="list-style-type: none"> <li>▪ A projected 25% of traditional IT-related services will be outsourced to developing countries by 2010 (UNCTAD XI 2004a).</li> <li>▪ India’s share of the global market for offshore IT and IT-enabled services was around 25% in 2001, while their share of offshore IT enabled services was 67% (McKinsey &amp; Co. 2003 and Scholl et al. 2003 as cited in UNCTAD 2004).</li> <li>▪ The software industry in India employed 250,000 people in 2003 and has displayed annual growth rates in revenues and employment of 30-40% over the last 10 years. Other developing countries – for example Brazil (190,000) and China 170,000) – have also seen huge gains in employment within IT, although not at the level of India (Arora 2004).</li> </ul> <p>Outsourcing of Business Process Services is also important:</p> <ul style="list-style-type: none"> <li>▪ Offshore outsourcing of business process operations (BPOs) is expected to grow from \$1.3 billion in 2002 to \$24 billion in 2007 and the vast majority of the potential remains to be tapped (UNCTAD 2004).</li> <li>▪ Even among the 1000 largest TNCs in the world, 70% have still not offshored any business processes to low cost countries, and among the top 500 European companies only 39% have any experience with such offshoring. Overall, only 1-2% of all BPO is currently performed internationally (UNCTAD 2004).</li> </ul> <p>R&amp;D activities are increasingly outsourced:</p> <ul style="list-style-type: none"> <li>▪ R&amp;D is increasingly being offshored and outsourced to a small number of developing countries, most notably China, India, Singapore, Hong Kong, Taiwan, Korea, Malaysia, Russia and Brazil, as well as a few former CEE members (UNCTAD 2005).</li> <li>▪ The developing world’s share of global R&amp;D conducted by foreign affiliates rose from 2% in 1996 to 18% in 2002 (UNCTAD 2005).</li> </ul>

of offshoring business processes and sourcing within service industries and in particular the knowledge intensive industries, may open new opportunities for developing countries to develop new and more differentiated advantages.

In terms of movement of value chain functions, outsourcing to developing countries has traditionally focused on low value added activities related to



mass production, while high value added activities such as design, R&D or marketing has been maintained in the North (see figure in Box 3 (Mudambi, 2007)). While the historical position of developing countries and DCFs presumably is shaped as depicted in this figure, we argue that such a figure increasingly misrepresent the value that developing countries and DCFs derive from outsourcing. First, even if 'only' manufacturing functions are outsourced to firms in developing countries, the activity generated by this outsourcing has allowed a significant number of developing countries to increase their share of world trade in goods and services and attract a growing proportion of global investments. Second, we will argue that DCFs prosper from outsourcing, not only through the difficult process of climbing up the value chain in one or both directions of the figure (Box 3) (backward into broader capabilities and offerings and forward into markets and 'own brand manufacturing'), but more importantly, through increasing specialization and efficiency in manufacturing (up through the middle of the figure).

The growing outsourcing of activities and functions to developing countries has the potential of offering opportunities for economic, industrial and firm growth and upgrading in developing countries, particularly now as historical patterns of trade and investment are rapidly reconfigured away from the traditional, largely exclusive exchange between the 'quad' of US, Canada, the EU and Japan. Increasingly, developing countries and DCFs can gain technology, know-how, skills and access to foreign markets, as well as other benefits, by engaging in sourcing collaborations with Northern firms. Furthermore, the growing sophistication of sourced activities opens up additional opportunities for DCFs to engage in activities much closer to the technological frontier.

However, in spite of the huge development potential of outsourcing, the literature and debate on outsourcing is only scantily taking up the perspective of the developing country firm. Generally, the literature focuses on the strategies of Northern firms outsourcing activities to the South, and/or on the welfare and competitive implications for Northern economies. What is being underplayed is the perspective of those developing countries hosting the outsourcing arrangements, as well as the particular strategic opportunities and challenges that are created for local firms in developing

countries by the growing outsourcing by Northern MNCs. This paper makes an attempt at formulating a theoretical platform that can inform an analysis of the strategic implications of outsourcing for those local firms in developing countries linking up as partners to outsourcing MNCs.

## **II. The literature on outsourcing and development**

Given the strong and growing involvement of developing countries in most of the various facets of the outsourcing phenomenon, one might assume that this involvement would be proportionally reflected by the research being conducted in the field. However, as outlined below, while research *is* being done on the impact of trade and investment for developing countries, the vast majority of the published literature on outsourcing appears to be pre-occupied with the strategic implications for developed country firms and the potential impact of offshoring on developed economies (Quinn and Hillmer, 1994; Feenstra and Hanson, 1995; Gomory and Baumol, 2000).

Nevertheless, a number of theories already exist that may help bring a development perspective to outsourcing research to the fore. The goal of this section is to provide a brief summary of these existing theories, progressing from the macro, through the meso, and finally arriving at the micro, or firm level. Macro level theories mainly look at outsourcing in terms of the competitiveness and institutions of nations and regions. Meso-level theories mainly look at outsourcing in terms of industries and value chains, in other words in terms of agglomerations and networks of firms. Finally, micro level theories conceive of outsourcing in terms of the strategies and capabilities of developing country firms.

### ***a. Macro-level theories: Trade economics and the new institutional economics***

The trade economic literature has traditionally examined the amount and composition of trade between the North and the South. Much of this trade can be argued to be a reflection of outsourcing relations between firms in the North and the South. Trade economist have noted that trade between the North and the South is growing and that the composition is becoming more complex, e.g. as semi-manufactured goods and services are growing as share of trade (Feenstra, 1998). It has furthermore been noted that 1/3 of global trade is trade between MNCs and their foreign alliance partners, including outsourcing partners, and that another 1/3 of world trade is internal to MNCs (UNCTAD, 2006).

There is a long tradition to study the trade profile of developing countries. For instance, the literature on export processing zones (EPZs) in developing countries has given insights into the outsourcing/ offshoring of activities based on relatively undifferentiated labor, typically electronics and textiles (Cypher and Diez, 2004).

To the extent that offshoring generates trade, trade economic theories apply with respect to the gains available from increasing specialization, increasing returns to scale, and increased trade in intermediate inputs (Feenstra 1998; Gomory & Baumol 2000; Lall 1998; Markussen 2005). Thus, neoclassical trade economics would consider offshoring to be beneficial for developing countries to the extent that it helps them exploit their comparative advantages, integrates them into the global economy and promotes export oriented development.

Nevertheless, it is argued that gains from global specialization do not automatically accrue to countries as a result of market imperfections, especially in markets for knowledge and technology. Thus, it is believed that a dedicated focus on building the appropriate conditions for development enhancing trade is increasingly required. In particular, how developing countries can best capture available gains in general from the globalization of trade and investment has been the subject of considerable investigation and debate ranging from theories of national competitiveness (Dunning 1997, 1996) to research on industrial policy and the protection of infant industries (Rodrik 2004; Rodrik & Hausmann 2006; Chang 1998; Lall 1992, 1998) to national policy prescriptions for enabling the insertion of DCFs as suppliers into global value chains (GVCs) (Humphrey 2001).

Related streams of research have similarly focused on national competitiveness and been applied to issues of development, including: the national innovation system literature (see e.g. Lundvall 1998), the national learning system literature (see e.g. Viotti 2002) and the business systems literature (see e.g. Whitley 2001). These areas of research apply more generally to the host institutional environments and linkages that support or hamper technological innovation, the development of absorptive capacity and the efficient macro organization of economic activity, respectively. While all of these accounts generally agree that developing countries – as indeed all countries – must create location assets such as an educated work force, efficient infrastructure and local supply industries in order to attract more highly leveraged outsourcing, opinions diverge when it comes to industrial policy and government officials attempting to ‘pick the winning investments’ (Chang 1998; Altenburg 2000).<sup>6</sup>

Underlying much of the above competitiveness and systems literature is a renewed understanding of the importance of formal and informal institutions in determining the capacity and capabilities of national governments, the vitality of capitalist systems, and the quality of growth (North 1993; Rodrik 2000; Williamson 2000). This stream of research advocates promotion of opportunities for trade and investment by focusing particularly on those institutions that are more readily amenable to governmental intervention. This can be done by fixing the rules of the game through clearly established and enforced property rights and by regulating the play of the game through institutional arrangements that support the effective and efficient governance of transactions.

### ***b. Meso-level theories: Value chains and clusters***

At the meso level, we find several streams of development and international business research that are directly applicable to the study of the impact of outsourcing on development. Two of the most relevant streams are the GVC literature (Gereffi et al. 2005) and the global production networks literature (GPNs) (Henderson et al. 2002; Ernst & Kim 2001). Both posit the disintegration of the value chain and the subsequent geographical relocation of production. However, the GVC approach has traditionally been based on vertical governance by a lead firm rearranging the value chain, while the GPN approach assumes a much more complex and interconnected rearrangement and

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<sup>6</sup> As part of the industrial policy literature, the bargaining power of developing country governments negotiating to secure the gains from trade and investment has also been investigated (Chang 1998; Rugman & Verbeke 2000). In general, this literature has also argued for both more openness and a certain degree of control on the part of host country governments.

specifically acknowledges the multiple interdependencies of a variety of actors, not just that of buyers and suppliers<sup>7</sup>.

Within the GVC paradigm specifically, there are both opportunities and threats with respect to outsourcing for developing countries and DCFs. While countries may become sourcing platforms and firms may upgrade and/or access new markets through integration in global value chains (Humphrey 2001), the increasing capabilities demanded for entry may lead to wholesale exclusion for some (Palpacuer et al. 2005). In addition, factor-cost based competition may lead developing country industries into a lose-lose ‘race to the bottom’ where the only escape is to upgrade into new, higher value-added activities, the possibility for which is viewed rather pessimistically by much of the literature (Kaplinsky and Morris 2002). Thus, while collaboration with dominant firms within value chains may lead to upgrading, this upgrading will typically be limited to process and product upgrading and only rarely may be extended to functional upgrading (Humphrey & Schmitz 2000; Arora & Gambardella 2004).

Slightly more optimistic than Gereffis Global Value chain perspective, the GPN paradigm sees firms as embedded in a complex framework of territories, networks and institutions, and the combination of the constraints thus imposed and/or opportunities thus offered, together with a firm’s relative power within the framework, largely determine the firm’s prospects for both capturing value-added rents and upgrading (Henderson et al. 2002). Although the paradigm has yet to be widely employed, Ernst and Kim (2002) have pioneered the use of a similar framework in, for example, studying the impact of knowledge diffusion on capability formation and upgrading within emerging economy firms. While their conclusions relative to outsourcing are similar to those inherent in much of the GVC research, namely that the risk of exclusion exists and firms must upgrade or perish, they insist that development paths do exist provided the right policies and institutions are in place to promote firm absorptive capacity, an essential element of which is the availability of skilled human capital (ibid).

Finally, there has been a significant amount of research on clusters and the beneficial spillovers and opportunities for upgrading that can potentially be created by such agglomeration (Schmitz 1999; Humphrey 2001; Nadvi & Barrientos 2004). In the case of outsourcing, the results of this research apply both to those instances where governments have intentionally favored agglomeration through export process zones (EPZs), and to those instances of naturally occurring agglomeration such as the Indian IT and business process outsourcing industries. In general, spillovers due to agglomeration tend to promote firm and industry level upgrading and outsourcing attractiveness. However negative side effects can eventually include the crowding out of smaller firms and wage inflation, with the ultimate result being reduced international competitiveness unless firms are able to continually move to higher value-added activities.

***c. Micro-level theories: The strategies of firms in developing countries***

The idea that “firms are the ‘engines’ of economic development” (Teece 2000:124), and development more generally (Sida 2003; World Bank 2004), is one that has been rapidly gaining acceptance within the development community in recent years.

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<sup>7</sup> For example, governmental agencies, trade associations, NGOs, sources of innovation, as well as other buyers and suppliers are all specifically assumed to be potentially relevant within this framework.

Nevertheless, the claim can be made that this acknowledgement has yet to be fully recognized within development economics research. According to Teece (2000:105):

*Despite the centrality of the business firm to economic growth and economic development, development economics has given relatively short shrift to the firm as the agent of economic development. While firms are by no means neglected, the weight of the literature focuses on the role of macro-economic variables and the public sector in development projects. Capital availability, exchange rates, savings, and taxation issues are all well recognized and comprehensively studied, although their impact is still uncertain. The poor state of the development economics literature is possibly due to the relative neglect of the study of firms and the institutions that support firms.*

Thus, in terms of understanding the effects of outsourcing processes at the micro level, the empirical, as well the application of the theoretical, literature is surprisingly weak. While several theoretical and empirical studies analyze outsourcing from the perspective of the outsourcing firm, to our knowledge very little progress has been made in understanding the effects of outsourcing on firms in developing countries. What is needed to fill this gap is an understanding of the strategic and operational options of DCFs within outsourcing relationships. While this perspective is closely related to much of the macro and meso level research detailed above, the critical distinction is a shift in focus from the firm's environment to, given the environment<sup>8</sup>, the specific decisions, tactics, and strategies that will optimize both a firm's chances of survival as well as its eventual prosperity. In the following we outline the theoretical and empirical research that is likely to be important to such a DCF strategic perspective on outsourcing.

### **III. Toward a developing country firm perspective on outsourcing**

A number of theories and perspectives may help us develop an understanding of DCF strategy in relation to offshoring and outsourcing from MNCs located in developing countries.

#### ***a. Interfirm dynamics in global value chains***

First, while the GVC literature clearly started out as a macro or meso-level theory, it has in recent years increasingly moved towards a micro-level perspective, inspired not least by learning theory and transaction cost economics (Gereffi et al., 2005; Humphrey and Schmitz, 2004). In particular, Humphrey (2001) has recommended such firm level strategies for upgrading as market diversification, excellence in manufacturing, learning from and effectively using information contained in the GVC and ongoing investment and innovation at both the firm and cluster levels. Similarly, with respect to GVC governance, and in particular its impact on the upgrading of DCFs within outsourcing relationships, there is now greater emphasis on identifying the origins and firm level implications of a variety of buyer-supplier relationships (Gereffi et al. 2005). Nevertheless, while this research has clearly been moving towards a more micro-

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<sup>8</sup> This naturally includes the variety of ways in which the firm might influence and/or change its environment.

informed perspective, the critical point is that it has not yet truly stepped inside the DCF from a firm strategic vantage point.

Another value chain logic that might have very high relevance to the outsourcing debate is Porter's value chain thinking. Porter distinguishes between two types of value chain activities, primary activities and support activities (Porter, 1986). Much of the outsourcing manufacturing literature deals with outsourcing of upstream activities, where the DCF becomes a supplier of inputs and semi manufactured inputs to the outsourcer (*supplier relation*). Outsourcing of downstream value added activities like marketing, sales, distribution, etc. however also takes place, but perhaps to a lesser extent to DCFs (*downstream relations*). Seen in a Porter value creation perspective we can see business *support activities and process* as a third category of outsourcing activities to DCF (UNCTAD 2005). Much of the literature on outsourcing of IT tasks deals with this type of outsourcing. It also includes outsourcing of less advanced activities, for example cleaning and security services by MNC affiliates in developing countries.

One advantage of Porter's framework is that it helps us categorize outsourcing activities according to the importance in the outsourcing firm's value chain. Thus, first wave outsourcing has largely been confined to primary upstream manufacturing activities, whereas later waves have increasingly moved into more advanced value chain functions, such as IT, R&D and back office business services<sup>9</sup>. Another advantage of Porter's value chain thinking becomes evident when we contrast it with the development literature's value chain thinking. The capture of value in Gerefi's model is mainly related to DFCs moving into more advanced value chain activities, that is, move into the Northern firms' turf. In deed, from this perspective, outsourcing in global value chains is a mixed blessing, as Northern MNCs will vigorously protect their competitive advantage and only outsource routine functions to developing countries, keeping local firms in a dependent and locked in position. However, from Porter's value chain perspective, each firm consists of a value chain, also the outsourcee firm. This firm can capture more value in the outsourcee relation, e.g. by innovating, by improving marketing, by becoming more productive, etc. It cannot from this perspective, a priori, be said that the outsourcee firm will capture low value and the outsourcer high value, even if the outsourcee firm performs low value added functions in the outsourcing firms value chain.

### ***b. The FDI literature***

Within the FDI literature, several authors have taken a particular interest in the impact of FDI on developing country firms, both through fully owned subsidiaries and through equity joint venture arrangements. Beyond the direct partners in the outsourcing relationship, effects may impact unrelated local firms and local industry in general through externalities or so called spillover effects (see Blomstrøm & Kokko 2000 or Meyer 2003 for overviews of the spill over literature). Most of the FDI literature

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<sup>9</sup> There are however also limitations to Porter's value chain framework. It can thus be debated whether value chains can be described as logically progressing steps from input to output. Making this point, Stabell and Fjeldstad (1998) operate with a value shop logic and a value network logic in addition to the value chain logic. The first can be relevant to certain downstream activities while the second model emphasizing network structures and reciprocal processes certainly can be applied to outsourcing of high knowledge intensive outsourcing activities including business support activities.

focuses on spill overs from FDI that is unintended effects of FDI (see e.g. Liu et al. 2001). Obviously, much of the impact of FDI is related to local sourcing from subsidiaries of MNCs in host countries, that is outsourcing in our understanding of the word. However, a disadvantage of the spill over literature is firstly, that many of the effects of local sourcing are technically not spill overs. They are fully anticipated effects that the outsourcing company can calculate the full value of. For instance, foreign investors may invest substantial resources to ensure better quality performance or higher productivity of local partner firms in order to get better and/or cheaper inputs. Secondly, the typical spill over study, using panel data, rarely is able to meaningfully separate effects of various relationships between local and foreign firms. Thus spill overs deriving from competition and demonstration - that is arms length relations - are lumped together with effects from outsourcing collaborations and strategic alliances.

A more promising avenue of research within the FDI literature in relation to enhancing our understanding of outsourcing, is to focus on linkages between foreign investors and local firms. Thus, a major body of research within the FDI literature looks at linkages and effects of linkages on local firms (see e.g. Hansen and Schaumburg-Müller, 2006; Scott-Kennel and Giroud, 2006 for overviews of this literature). The idea of this literature is that FDI often/typically is only the top of the iceberg and that MNCs substantially foster linkages to local firms in order to obtain inputs and access local resources. It has been argued that MNCs increasingly foster linkages to local industry (UNCTAD, 2001; Hansen and Schaumburg-Müller, 2006). Many of these linkages can be seen as outsourcing, either outsourcing from the parent, or outsourcing from the local affiliate. Within these relationships the potential exists for a wide array of valuable assets and capabilities to be transferred, intentionally or otherwise, to local partner firms. These assets and capabilities include: capital, technology, market intelligence and access, improved management and organizational practices, labor and functional upgrading, as well as less tangible cultural and competitive enhancements (Dunning 1996; Lall 2000; Patibandla and Petersen 2002).

The linkage literature also points out that outsourcing linkages not always are beneficial to local firms and industries. The principal potential drawbacks include: crowding out due to competitive, capital, labor, or innovatory effects; economic lock-in at low levels of marginal productivity; capital extraction and long-term dependence; the exploitation of passive flexibility in offshoring; negative trade or BOP effects; negative environmental or cultural externalities; international 'races to the bottom'; and the potential loss of economic control.

While the FDI literature may help us to more fully understand the effects on DCFs, it is also evident that this literature is focusing on the effects of foreign direct investment *proper* i.e. fully owned subsidiaries and equity joint ventures, thereby failing to consider the development effects of other entry modes and contractual relations. In fact, we would argue that the FDI literature's methodological and theoretical preference for equity has clouded an understanding, at the firm level, of the effects of an increasingly important aspect of firm internationalization, namely outsourcing (for a similar argument see Ramamurti 2004). Moreover, while the FDI literature brings the local firm into the equation by analyzing effects on those, it is also clear that the local firm is seen as a more or less passive recipient of the strategic choices of MNCs.

### *c. Theories of developing country firms*

Where the above theories do not treat the DCF strategy in outsourcing relations in its own right, but rather mention the strategies of DCFs in connection with analysis focused on the strategies of foreign investors and/or chain leaders, a small group of theories explicitly consider the strategic space of developing country firms from the perspective of developing country firms.

#### *1. The institutional strategy literature*

The institutional strategy literature (Wright et al. 2005; Meyer & Peng 2005; Peng 2002, 1999) marries transaction cost economics (TCE) with institutional theory and may be especially germane for micro-level analyses of the internal and external competitiveness of DCFs as influenced by the characteristics of their environment. In particular, this stream of research argues that (Wright et al. 2005:2):

*...for strategy research in this area to flourish and make a lasting contribution there is a need to consider the extent to which theories and methodologies used to study strategy in mature, developed economies are suited to the unique social, political, and economic contexts as well as firm characteristics of emerging economies.*

By taking into consideration these contexts and characteristics, such analysis can readily explain, for instance, the competitive benefits of the formation of formal or informal networking alliances within certain developing countries. More generally, such strategic institutional theory may also have a great deal to say about which forms of governance are best matched to the variety of transactions that are likely to take place within outsourcing. With respect to the developing country firm, research is also highlighting the impact of the institutional environment on entrepreneurship, the importance of diversification and the viability of different growth strategies (Peng 2002). Finally, given the importance of absorptive capacity and organizational learning to any potential for self-interested upgrading by DCFs, learning theory research (Cohen & Levinthal 1990) should also be useful in assessing the management and organizational attributes of DCFs that are likely to ensure their long-term success in relation to the institutional character of both their immediate environment and their outsourcing relationships.

#### *2. Third world multinationals*

Within the broader FDI literature there is a branch that has focused specifically on outward investment by developing country firms, so called Third World Multinationals (TWMNCs) (see e.g. Beausang 2003 for a review of this literature). In recent years, the TWMNC literature has gained renewed attention due to the growing importance of FDI from developing countries (UNCTAD 2006). One of the points made by this research is that outward FDI may be a natural outgrowth of previous collaborations with TNCs in outsourcing relationships (UNCTAD, 2006). For instance, as own equipment manufacturers build internal competencies and ownership advantages through outsourcing collaborations with Northern firms, they may expand into marketing, distribution and even research and development. While this expansion may at first entail building a position in local or regional markets, eventually such firms may compete directly with the very TNCs that used to be their outsourcing partners.

### *3. Resource and knowledge based perspectives*

Resource based theory (RBT) conceives of the growth and competitive advantage of the firm as determined by its ability to mobilize, sustain, and expand internal and external resources and capabilities that are rare, valuable and difficult to imitate or replace (Barney 1998). What then are the resources and capabilities of DCFs and how are these affected within dynamic outsourcing relationships relative to the potential for upgrading and the creation of sustainable competitive advantage? To our knowledge, such questions have not been specifically and fully addressed from a DCF vantage point, although the work of Gereffi et al. (2005) has been increasingly moving in this direction. A related stream of theorizing is the knowledge based theory (KBT) of the firm (Kogut & Zander 1993; Grant et al. 2000). While KBT can be viewed as a theory of internalization, it is also a stream of research where knowledge is both the *raison d'être* of the firm and the outsourcing of competitive advantage. Here the unique resources and capabilities of the firm are often tacit, socially embedded and/or encapsulated in complex organizational routines, and this view of the firm may be particularly relevant to researching questions of organizational learning and the transfer of expertise within outsourcing relationships.

Sharing certain elements in common with each of the two previous theories, the dynamic capabilities framework (Teece et al. 1997) is a path dependent theory of competitive advantage for firms faced with rapid (technological) change, where success rests on the distinctive processes, specific assets and evolutionary path of the firm. In particular, this framework may well be relevant for analyzing the strategic options and desired capabilities of DCFs in certain industries such as electronics, IT, automobiles and perhaps even garments<sup>10</sup>.

### *4. The competitive strategies of DCFs*

Traditionally, firms in developing countries have operated in protected local markets with little competition and unsophisticated consumer demand conditions. Within such environments, firms have to a very large extent pursued protected market strategies and optimized via collusion and rent seeking activities. With economic globalization such strategies are becoming increasingly perilous for many firms, since as trade and investment barriers are removed and economies are liberalized, locally protected industries are challenged both from abroad by MNCs and from within by more entrepreneurial firms (Meyer 2005).

From that standpoint, variables which constitute the company's competitiveness and how they can be configured in competitive markets come to the forefront. Porter's (1980) generic strategies may be helpful in understanding the strategic options available to DCFs within sourcing relationships. A cost-based strategy is an obvious one for DCFs due to their clear advantages in accessing cheap factor inputs. In particular, two cost-based strategies common to many sourcing collaborations can be identified: one

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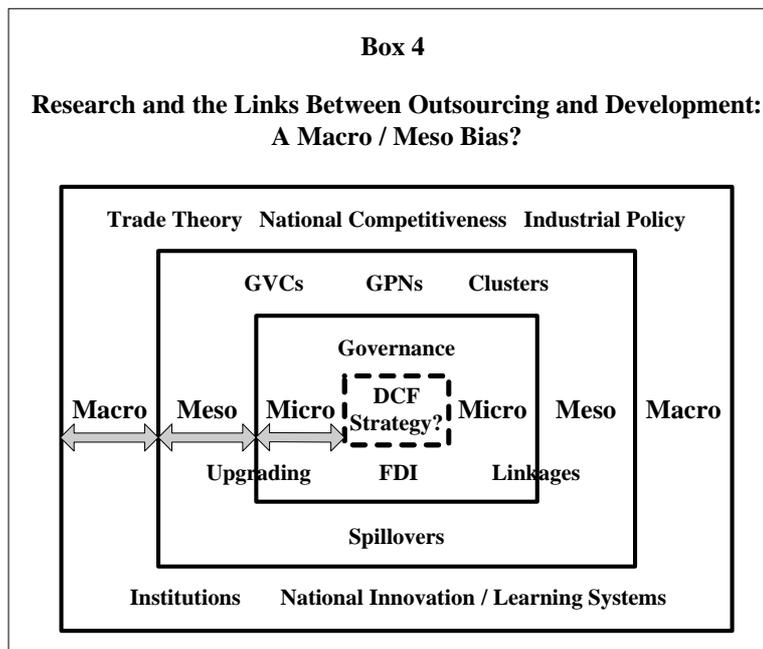
<sup>10</sup> Areas of research related to the RBT and KBT perspectives that are also likely to be relevant are the literatures on strategic alliances (Hamel 1991; Doz 1996; Das & Teng 2000), joint ventures (Hennart 1988; Kogut 1988, 1989; Buckley & Glaister 2002) and bargaining power as applied to these relationships (Inkpen & Beamish 1997; Pearce 1997; Mjoen & Tallman 1997). In particular, these streams of research may have a great deal to say about why outsourcing relationships form, what mechanisms determine the partitioning of relative gains and control, how these relationships can be managed, and when cooperation and stability may be either enhanced or undermined.

producing cheap, low quality and/or more basic products, and another producing low-priced products of high quality (Altenburg 2000). Altenburg argues that the strategies of DCF suppliers based on static advantages, such as factor cost superiority and/or passive flexibility, lead to a dead end for DCFs by limiting potential learning effects. On the other hand, supplier relationships based on firm dynamic advantages, such as enhanced productivity and/or active flexibility, are much more likely to result in upgrading due to the opportunities and demands for both technological learning and continued productivity growth. Thus, the limitations of cost-based strategies are substantial. First, foreign firms will tend pass on to developing country suppliers the burden of absorbing fluctuations in both market prices and market demand. Second, firms pursuing a cost-based strategy will soon realize that the competitive field is rather crowded as many firms from various locations are offering similar low cost products. Thus, firms in more advanced developing countries must either invest in even lower cost locations elsewhere or embark on differentiation strategies. One such differentiation strategy could be to move into specialized markets for goods and services delivered to MNCs.

Finally, given that the entire phenomenon of global outsourcing is based on the dispersion of global value chains, the actual management, optimization, and dispersion by DCFs of their *own* value chains is indeed likely to be relevant. Specifically, Porter's (1985) original research on the links between the value chain and competitive advantage is likely to be particularly useful in any analysis of the strategic opportunities facing DCFs in the presence of outsourcing.

#### IV. Conclusion

While many of the issues central to those of DCFs in the context of outsourcing have been and are being addressed either directly or indirectly by a wide array of existing research (see Box 4), there is a lack of focus on the firm strategic perspective from the point of view of the DCF. From this perspective, the essential questions thus become: 1) what are the resources and capabilities of DCFs that makes them attractive outsourcing partners, 2) how are these resources and capabilities in turn influenced by dynamic outsourcing relationships, and 3) in the presence of such outsourcing, what strategic opportunities and/or limitations do DCFs face with respect to upgrading and achieving sustainable competitive advantage? Given the importance of DCFs to development, and the importance of outsourcing to DCFs, we feel that it is time that research takes its point of



departure within the developing country firm and its strategic possibilities in order to better understand both the micro impact of this important and growing phenomenon, which will also lead to a better insight of macro-level development effects.

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