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# PCG Policy Briefing: Offshoring

## Introduction

Currently, many organisations are offshoring work out of the UK, to take advantage of lower cost bases abroad. Offshoring is particularly significant in IT but occurs across a number of sectors in which PCG members operate, including engineering. This paper will focus on IT, but many of its conclusions can be extended to other sectors.

The case for offshoring has not been proved. Not only has it yet to be shown that it benefits the UK, but evidence is increasingly emerging that it may be harmful. Unless and until the economic benefit of offshoring to the UK has been proved conclusively, government policy should not promote or encourage it.

## A closer look at offshoring

Offshoring in Britain entails the transfer of large amount of work to lower-cost locations and is particularly a feature of the IT sector. It is now relatively cheap to create computer networks that span the world. Computers and servers in one country can be accessed easily and cheaply by staff in other countries. Many of the West's major companies have recognised this fact and have started moving hitherto expensive IT development work to countries with a much lower cost base.

## Does offshoring bring real benefits?

Offshoring has, on paper, numerous positive effects.

- UK based companies will become more profitable. This profit can be invested for growth. The additional growth could create new jobs
- UK based companies are able to reduce charges to customers creating more wealth in the economy, and therefore more jobs and higher GDP
- The Treasury will see an increase in income due to increased GDP, increased profits and lower unemployment
- There will be lower Treasury expenditure due to lower unemployment.

Many of these potential benefits are mirrored by potentially detrimental effects.

- The loss of GDP due to work being moved offshore
- An increase in unemployment due to work moving offshore
- An increase in the trade deficit. This in turn could have a negative impact on exchange rates and interest rates
- The loss of investment: companies are investing abroad and are less likely to invest in the UK due to cost and lack of skills
- The loss of Treasury income due to reduced GDP and higher unemployment
- An increase in Treasury expenditure due to higher unemployment.

The way in which possible benefits and disadvantages seem to mirror each other leads to the critical question: what determines whether the net impact on the wider economy will be beneficial or not?

Does any cost reduction, no matter how small, that a company achieves by offshoring always necessarily benefit the wider economy? This is one of the most important, but least well-researched questions in economic offshoring theory.

All the evidence is that relocating work to countries with a lower cost base without sufficient cost savings is actually harmful to the economy as a whole, both in the short-term and the long-term. As, however, the cost saving, measured as a percentage of the value of the work offshored, increases, the resulting enhanced profitability starts to outweigh the negative economic impacts until a point is reached where the net overall effect on the economy, in the long term, is beneficial.



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PCG continues to research this question in further detail and has presented its findings so far to the Government. These are that companies that offshore but do not seem to gain any noticeable performance advantage over those that do not offshore. Indeed, a trend is emerging of companies who have experimented with offshoring being dissatisfied with the results and bringing their operations back onshore.

Detailed information from offshoring firms on the cost and savings outcome of their decisions to offshore their IT functions is lacking. This may be because the decision to offshore has been costly and firms are naturally reluctant to admit that their strategy has failed to deliver the expected benefits.

A recent survey by research and consultancy firm AT Kearney for leading blue-chip companies found wide variations in the results achieved by the firms offshoring business operations. Sixty per cent of firms surveyed failed to meet their operational performance expectations while thirty-four per cent failed to meet their savings expectations. Cost savings ranged from nought to seventy-five per cent, and while some firms achieved improvements across most of the operational performance areas studied, others saw a decline in performance in many areas. They did not go on to consider the wider issues of offshoring, however, such as broader social and economic impacts.

#### **Problems with offshoring in practice**

Although offshoring may have some beneficial effects if a sufficiently large cost saving can be made - which often it cannot - offshoring IT almost invariably provides fewer savings than seem likely on paper.

Why are these paper cost savings of offshoring IT not materialising? The information available suggests that several practical difficulties have been encountered:

- Although the offshore staff are cheaper they can be less experienced, and hence less productive
- External offshore staff often do not feel as accountable for the work as their onshore counterparts, reducing the quality of the work delivered
- It is not possible to offshore the whole of the IT function: it would also be too much of a risk. UK resident staff therefore have to be retained who themselves became demotivated and less productive due to job insecurity
- Communication can be very problematic. Design and program specifications may be mistranslated and misunderstood by offshore staff resulting in a high proportion of re-work and problems in live systems.

All of these problems have been encountered in practice by companies who have experimented with offshoring.

#### **PCG Position: Offshoring**

It can be seen that if a significant cost saving can be achieved by offshoring, wider benefits to the economy will be generated. The risk to the economy, though, is of only relatively small cost savings being realised as significant amounts of work are offshored by more and more companies. The Government itself has accepted that offshoring causes short-term job losses. Unless and until the economic benefit of offshoring to the UK has been proved conclusively, PCG believes that government policy should not promote or encourage it.

#### **Work permits: the government's new approach**

The work permits scheme - commonly known as "Fast Track Visas" - was launched in January 2000, allowing firms to bring in non-EU workers with skills in short supply, without first having to advertise in the UK. Critics argued the scheme was being abused to bring in cheap labour, undercutting UK contractors and employees. A campaign headed by Gurdial Rai, PCG's representative on the Work Permits UK IT Sector Panel, produced a wealth of evidence to convince the panel that home-grown IT skills were not in short



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supply. All IT skills were removed from the shortage list in 2002: firms must now show they have advertised vacancies in the UK before seeking work permits.

The new work permits system proposed by the Government in 2006 represents an improvement on its predecessor and allows for better application of the principle that the number of work permits issued needs to reflect economic conditions. The new system should allow the UK to respond to economic circumstances much more effectively than it could previously and therefore manage migration more effectively.

### **Intra Company Transfers**

There has been concern in many quarters, however, that there remained a loophole in the old system through the abuse of Intra Company Transfers (ICTs). ICT work permits were originally intended to allow a company to bring into the UK an employee based outside the EU, without having to go through the time-consuming hoops of advertising, when that employee has company-specific skills not available in the UK.

For example, if the person who designed BA's ticketing software is the only one who can deal with problems in that system, and that person happens to live in South Africa, then there would be little point in the airline advertising for those skills in the UK, and the employee could enter on an ICT. But since the closure of the IT skills shortage list, there is evidence to suggest that many firms are now abusing the ICT system.

These work permits are often obtained by a company in order to up-skill their overseas workers, as part of the preparatory work for offshoring their operations out of the UK completely. In short, ICT work permits are being obtained in order to train overseas staff so that work can be taken out of the UK.

Work Permits UK has admitted that ICT workers are coming into the UK without genuinely company-specific skills, indeed that they are often trained in the UK after arriving. The Government has made it clear, however, that it would like to allow this practice to continue.

### **PCG Position: Intra Company Transfers**

It is the Government's prerogative to acquiesce to the continued offshoring of work from the UK through the use of easily available ICTs. PCG believes this to be an unwise policy, however, given the lack of evidence regarding any positive impacts that the offshoring of work in vital sectors will have on the economy. Indeed, the Government itself has accepted that offshoring causes short-term job losses, and sectors such as IT where offshoring has been more widespread have seen record unemployment in the UK.

There is also a potentially huge implication in the rapid deskilling of the UK based workforce in the specialised IT sector. Because of the rapid advances in technology, an IT professional who is out of work for a relatively short time may not be able to find work again and these skills are not easily kept up to date without investment in and commitment to retraining and upskilling. Thus, there is a real prospect of the UK's competitive edge being seriously blunted by the continued offshoring of IT and other services.

It is far from the case that those operations currently being offshored all involve low-skill, non-critical work. Increasingly, entire projects are being offshored, and firms are looking at offshoring as a long-term strategy rather than just a short-term cost-cutting exercise.

If employers continue to have easy access to ICTs to allow them to offshore high-skill jobs, there will be little incentive for them to provide the necessary investment in training for domestic workers in order to upskill domestic skill levels as desired by the Government. This will have serious long-term consequences as the UK is de-skilled and foreign competitors' staff are trained in new technologies, which in turn assists the process of taking entire IT projects outside the UK.



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Therefore, the Government's migration strategy can potentially be seen as conflicting with its policy to keep Britain competitive by maintaining and increasing skill levels in the UK's labour force. ICTs allow firms to move work offshore while upskilling overseas workers at the expense of domestic ones. If this phenomenon continues, entire businesses or industries could be offshored.

PCG therefore believes that the ICT system needs to be altered, so that it better takes into account the economic interests of the UK. While the long-term effects of offshoring remain unclear, ICTs should only be available in sectors where there are shortages in the UK's workforce, not in sectors, such as IT, where there is an abundance of workers. The provision of ICTs should therefore be altered in line with skill levels, labour market trends and general economic interests. The Government's aim should be to ensure that in the future there are no shortages in high-skill occupations, by continually increasing skill levels. If this aim is reached, there should be no need for ICTs to be used in the future to offshore work in high-skill areas.

#### **The Migration Advisory Committee**

PCG responded in early 2007 to the consultation on establishing a Migration Advisory Committee. We feel that the committee can have a useful role to play in ensuring that the Government's migration strategy more closely takes into account the country's long-term economic interests. We believe that educationalists should be represented on the MAC, perhaps through the Department for Education and Skills. In conjunction with the advice received by skills sector experts on shortage occupations, educationalists will be able to advise the committee on whether shortages can be filled easily through the re-training of domestic workers rather than recruiting from overseas. They will also be able to help advise on what training and education needs to be provided to accommodate the country's future skill needs.

#### **Key PCG Analysis:**

- Offshoring represents a major risk to the economy if only relatively small cost savings are realised as significant amounts of work are offshored by more and more companies
- The use of ICTs to facilitate offshoring represents an abuse of the work permits system. PCG feels that the Government is unwise to acquiesce to this practice while the long-term effects of offshoring on the economy remain unknown
- Continued offshoring of work could have serious long-term consequences on the economy as the UK is de-skilled and foreign competitors' staff are trained in new technologies
- It would be more beneficial to the UK if companies retrained domestic workers to fill shortage positions. However, while there remains a source of cheap migrant labour, UK firms will have little incentive to invest in UK workers.