The Offshoring of IT Work and the Government's New Immigration Strategy

Gurdial Rai
John Kell

October 2005

Executive Summary

- This paper is an empirical analysis of the advantages and disadvantages of offshoring IT work. It suggests that the widely-predicted benefits of this strategy seldom, if ever, emerge. This has important implications for the government's current review of immigration policy.
- Much more work is needed to build on the findings of this study. PCG urges the government to undertake a thorough empirical investigation of these issues as a matter of urgency.
- Offshoring and work permits are conjoined issues: it is common practice for workers to come to the UK on work permits for the purpose of knowledge-transfer, to enable IT operations to be moved offshore.
- PCG believes that immigration should be managed for the economic benefit of the United Kingdom: if offshoring is of no benefit, or even harmful, work permits intended to facilitate it should not be issued.
- PCG believes that government policy should be evidence-based. Immigration and offshoring policy has hitherto largely been based on economic theory, itself not uncontroversial.
- Economic theory predicts that offshoring will result in large cost savings which will be sufficient to off-set the short-term damage to the economy caused by the loss of work in the UK. This study strongly suggests that this theory is wrong.
- The analysis in this report compares companies in the following sectors: Banking, Insurance / Assurance, Supermarket / Retail, Water Utility, Gas / Electricity Utility, Telecoms.
- The results suggest that companies who offshore their IT operations usually fail to make the cost savings hoped for and have no clear advantage compared to those who do not offshore. They are in fact often out-performed by their non-offshoring competitors.
- When offshoring does result in costs savings, they tend to be negligible.
- This study utilises publicly available accounts and financial statements.
- No empirical study of the impact of offshoring has previously been undertaken. The data available are seriously limited and although it is possible to undertake some useful investigation, it can only currently be taken as indicative rather than definitive.
- This study demonstrates that the case for offshoring has absolutely not been proved.

The Offshoring of IT Work and the Government's New Immigration Strategy

CONTENTS

The Offshoring of IT Work and the Government's New Immigration Strategy

Introduction

This paper examines some of the evidence available on the cost benefits of offshoring IT work and considers how these findings can be used when determining work permit policy for the Government's new five year immigration strategy.

The data available concerning the impact of offshoring and work permits on the UK's economy are extremely limited and haphazard. There are widespread concerns, however, that what evidence there is indicates that the economic theory on which government policy has traditionally been based is seldom vindicated in reality. This is the first such study of the available evidence ever undertaken.

This paper will argue that policy decisions should be made on the basis of economic evidence rather than pure economic theory and that this approach may lead to a significant change in the government's policy approach.

Work permits should be deployed for one reason only: to benefit the economy. To date, most of the policy determining the issue of work permits has been based on the broad economic principles of promoting free trade and trying to increase the global competitiveness of UK industry.

Using these principles as a high level framework for formulating policy makes sense but it must also be understood that the economic models which predict the benefits of free trade have to make many assumptions and that this may limit their practical utility.

Studies such as those by Jeffrey Sachs and Andrew Warner of Harvard and David Dollar and Aart Kraay of the World Bank are enough to convince most economists that trade does indeed promote growth. But they cannot be said to settle the matter. If the application of econometrics to other big, complicated questions in economics is any guide, they probably never will: the precise economic linkages that underlie the correlations may always be too difficult to uncover.

It is, however, possible to argue that the theory does not actually work in the real world: Dani Rodrick from Harvard University makes such an argument cogently in his paper 'Feasible Globalizations'. A good number of economists, including some of the most distinguished advocates of liberal trade, are therefore unpersuaded by the more radical arguments for globalisation. For every regression 'proving' that trade promotes growth, it is too easy to tweak a choice of variable here and a 'period of analysis' there to 'prove' that it does not. As well as Dani Rodrik, economists such as Jagdish Bhagwati and T.N. Srinivasan, both celebrated advocates of trade liberalisation, have also questioned the regression evidence.

There would seem to be a limit to how far globalisation can be (and should be) pushed. Factors such as different types of capitalism or differing forms of global and national institutions may mean that the nation-state system, democratic politics and full economic integration are mutually incompatible.

Immigration policy, and particularly work permit policy, has assumed that granting work permits to offshoring companies will be economically beneficial because it allows companies to make substantial reductions in costs and therefore become more profitable in the long term.

This paper questions this argument on both levels: it suggests that the cost savings to which companies aspire in fact tend not to materialise; and that the extremely limited savings made by these companies are not of sufficient benefit to the UK's economy.

Analysis

Note on definitions

Outsourcing and offshoring are related but distinct phenomena which are often confused. When a company outsources work it closes its own department and purchases the service in question from another company. When a company offshores work it moves the physical location of the work overseas. Thus it is possible both to outsource within the UK and to offshore without outsourcing, if the offshore operation is still part of the same company. This paper is concerned with efforts to make cost savings by moving work to locations with cheaper labour costs: in practice, these operations tend to be outsourced as well, but, for clarity, the following discussion will use the term "offshoring" exclusively.

Work Permits and offshoring

The majority of IT work permits are granted specifically to companies facilitating the offshoring of IT work. Typically, overseas workers will be brought to the UK for a period of between six months and two years, before returning to their country of origin and using the knowledge and expertise they have acquired to facilitate the offshoring of work there. The issues of work permits and offshoring are therefore inextricably linked and policy towards one ought to be influenced by analysis of the other.

Available evidence

No serious independent research or study has ever been commissioned in the UK to look at cost savings arising from offshoring IT work. Nor has any study or investigation been conducted by either the Home Office or DTI to ascertain whether IT offshoring has reduced company costs and, if so, by how much.

In spite of this, over twenty thousand work permits are granted to IT offshore companies each year, based on the assumption that it is economically sound.

An assumption has been made, based largely on figures from consultancies such as McKinsey, who are themselves actively involved in offshoring, that cost savings are substantial and the long term economic benefits will outweigh the short term loss of jobs, investment, tax revenue and so on.[1]

There is very little quality information available from which definite conclusions can be drawn about the cost benefits of outsource-offshoring. Of course, companies engaged in offshoring will not make such information publicly available because it is commercially sensitive data. In order for policy to be sensibly formulated, these obstacles must be overcome.

Indications offered by previous studies

A few case studies have been undertaken and show little cost saving. BT have recently sent more than one thousand work permit staff back after deciding that their experiment with offshoring was not realising the cost benefits originally envisaged. Individual case studies based on internal budget data for TRANSCO and Barclaycard show a similar picture of negligible cost savings.[2]

[1] McKinsey & Company – *Offshoring: is it a Win-Win game?* (August 2003)

http://www.mckinsey.com/knowledge/mgi/reports/pdfs/offshore/Offshoring_MGI_Perspective.pdf

[2] Gurdial Rai – Economic Impacts of Offshoring - www.pcg.org.uk

A study by Computer Weekly of major companies shows that only 21% of CEOs expect to make a saving from offshoring IT work.[3]

A recent survey by DiamondCluster Consulting, a Chicago based consulting firm, shows that the number of offshore contracts terminated before expiry doubled to 51% last year.[4]

A report sponsored by the Australian Computer Society, on 'Labour Market Impacts on ICT In Australia' concluded that there has been an overall negative economic impact resulting from offshoring IT work.[5]

The current paper seeks to make a substantial addition to this discourse. It is the first stage of a comparative study into the profitability of companies that offshore and do not offshore IT work, based on published accounts.

---

[3] *Computer Weekly* June 28th 2005

[4] DiamondCluster International's 2005 Global IT Outsourcing Study http://today.reuters.com/Stocks/QuoteCompanyNewsArticle.aspx?view=CN&symbol=ACN.N&storyID=73678+07-Jun-2005+RTRS

[5] RT Kinnaird and Associates - *On The Labour Market Impacts of ICT Immigration Policies in Australia*. (copy available on request from PCG)

Methodology

This study is based on analysis of the published accounts and financial statements of numerous companies operating in the United Kingdom. Companies that offshore do not separate their offshore costs in their financial statements. Instead they normally combine these under the general heading 'other operating costs'. A comparative analysis of profitability for companies that do and do not offshore work can, however, nonetheless reveal significant patterns.

Identification and Grouping

A number of companies that offshore and do not offshore IT work were randomly selected and are listed below. Their press offices were contacted to verify their offshoring policy.

Companies that offshore work
3
Abbey
Admiral
Amazon
AXA
BT
Barclays
BUPA
Centrica
DHL
Eagle Star (Zurich)
HSBC
Lloyds TSB
NTL
Norwich Union
Powergen
Prudential
Safeway
Sainsbury's
Sky
Standard Chartered
Tesco
Thames Water
Transco

Companies that do not offshore work
Alliance and Leicester
Carphone Warehouse
The Co Op
Direct Line
Halifax
Kwik Save
Legal & General
Nationwide
Natwest
Orange
Royal Bank of Scotland
Severn Trent Water
Somerfield
Standard Life
T-mobile
United Utilities
Welsh Water

The companies were then each allocated to one of the following six sectors or discounted from the study due to a lack of comparable data or useful comparators:

Banking
Supermarket/Retail
Insurance/Assurance
Water Utility
Gas/Electricity Utility
Telecommunications

The following rules were then applied to ensure that comparisons between the selected companies within each category would be meaningful:

- UK Listed PLC companies – therefore operate under the same tax / cost framework. For global companies employee cost ratios were derived purely from UK subsidiary.
- Financial Statements available for similar period (year end 2004)
- Operate within a similar market (ie comparable customer base)
- Offer the same or similar products
- Similar sized operations

The following is a list of the companies that were identified for each sector as being suitable for comparative purposes:

Banking

Offshore work	**Do not offshore work**
Barclays	Royal Bank of Scotland
HSBC	
Lloyds TSB	

Insurance/Assurance

Offshore work	**Do not offshore work**
AXA	CIS
Norwich Union	Legal & General
	Standard Life

Supermarket/Retail

Offshore work	**Do not offshore work**
Sainsburys	The Co Op
Tesco	Morrisons
	Somerfield/Kwik Save

Water Utility

Offshore work	**Do not offshore work**
Thames Water	South West Water
	Severn Trent Water
	Welsh Water

Gas/Electricity Utility

Offshore work	**Do not offshore work**
Centrica	Scottish Power
	United Utilities

Telecom

Offshore work	**Do not offshore work**
3	Orange
	T-Mobile

Source Data

The financial statements for each of these companies for year ending 2004 were studied and the following data extracted :

Total Income
Total gross costs
Gross Profit
Employee / Other operating costs

Any 'abnormal', one off costs were discounted, for example redundancy / restructuring / acquisition costs. Therefore operating costs used for the study were, as far as possible, normal year-on-year operating costs. Additionally, any one off abnormal income was also discounted.

The following ratios were then calculated:

Cost / Income
Profit / Income
Employee costs / Total cost
Employee costs / total net income

These ratios give a company's relative profitability, cost gearing and what proportion of its costs are employee-related. Offshoring costs are generally included in 'other operating costs' so this figure has to be included in the employee and other operating cost / total net income cost ratio. Since 'other operating costs' can include different items for different companies this ratio means comparisons are not statistically useful. Nevertheless, since common accounting practices lead many companies to put the same entities into the 'other operating cost' account line, the comparison can add some value and so has been included.

The second set of calculations undertaken for the study focuses on the statistically relevant and verifiable measurement of increases in profitability. The growth in profitability for a company over a period of time is easily measurable and can then be compared to other companies in the same sector. Profitability increases are presented as a percentage for each year in three sectors and, in two of these, changes over the whole timescale are compared, again as a percentage. Difficulty in obtaining genuinely comparable figures meant that these figures could not usefully be compiled for two further sectors: Assurance / Insurance and Telecoms.

Results By Sector

Key
Companies that offshore
Companies that do not offshore

Banking Comparison

Bank	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Emp. Cost/ Total cost %
Barclays	13.9	8.3	52	5.5	39	53
HSBC($)	50.5	27.7	54	22.8	45	48
Lloyds TSB	9.4	4.8	51	3.1	32	51
RBoS	22.7	9.6	40.8	13.1	57	44

Growth in Profitability (%)

Bank	2004
Barclays	39
HSBC	45
Lloyds TSB	32
RBoS	57

Explanatory Note

i. The years from 2000 to 2003 were a period of considerable change in the banking sector, with many banks making multiple acquisitions. This high number of complex one-off costs makes it impossible to compile profitability figures that can be meaningfully compared for these years.

Analysis

i. Royal Bank of Scotland, the only one of the banks studied not to offshore work, had the lowest cost-income ratio, highest profit-income ratio and lowest proportion of employee-related costs.
ii. RBoS also had the highest growth in profitability.

PROFESSIONAL CONTRACTORS GROUP

Life Assurance / Insurance Comparison

Company	Gross Income £x10⁹	Cost £x10⁹	Cost/ Income %	Profit £x10⁹	Profit/ Income %	Employee costs/ Net total costs %
AXA (€)	70.7	68.1	96	2.6	3.6	48
CIS (Co-op) (2003)	0.67	0.61	91	0.06	9.0	42
Legal & General	16.8	15.4	91.6	1.4	8.3	43
Norwich Union	31.6	29.3	92	2.3	7.0	46
Standard life	20.1	17.6	87	2.5	8.7	41

Explanatory Notes

i. AXA is owned by a French-based parent company.
ii. Ratios are different from other sectors because these companies manage funds and pay out on claims.
iii. Net total costs exclude insurance/assurance claims and payouts.

Analysis

i. Non-offshoring companies had the lowest cost-income ratio (Standard Life), highest profit-income ratio (CIS) and lowest proportion of employee-related costs (Standard Life).
ii. All three non-offshoring companies out-performed the offshoring companies on all three measures.

Supermarket / Retail Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit	Profit/ Income %	Employee costs/ Net total costs %
The Co-Op	5.4	4.4	82.2	0.96	17.7%	31%
Morrisons	4.9	3.7	75.0	1.2	24.4%	30%
Sainsbury's	18.2	16.8	92.3	1.4	7.7%	36%
Somerfield / Kwik Save	2.6	2.3	88.4	0.3	11.5%	38%
Tesco	24.7	23.2	94.0	1.5	6.1%	33%

Growth in Profitabilility (%)

Company	2001	2002	2003	2004	%Increase 2001-2004
Morrisons	21	22	23	24	14
Tesco	5.6	5.6	5.7	5.9	5

Explanatory Notes

i. Retail only comparison – other activities such as insurance and finance have been excluded.
ii. Net costs do not include purchases.
iii. Other than Tesco and Morrisons, the supermarkets are incomparable in terms of profitability increase over time because of takeovers and acquisitions.
iv. Morrisons does not offshore; its costs have risen in 2005 as a result of the takeover and efforts to incorporate Safeway's offshore activities, although these costs would be discounted as one-offs for the purposes of any future comparison between retailers during 2005.
v. Somerfield / Kwik Save are now owned by Sainsbury's, but do not offshore.
vi. Tesco embarked upon major outsourcing in 1998.

Analysis

i. A non-offshoring company had the lowest cost-income ratio (Morrisons) and highest profit-income ratio (Morrisons).
ii. All three non-offshoring companies out-performed the offshoring companies on both cost-income and profit-income measures.
iii. The proportion of employee-related costs exhibited no clear pattern: the highest figure belonged to a non-offshore company (Somerfield), but so too did the two lowest (The Co-Op and Morrisons).
iv. Morrisons' increase in profitability (14%) was considerably greater than Tesco's (5%)

Water Utility Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Employee costs/ Net total costs %
Severn Trent Water	2.01	1.57	78	0.44	21	61
South West Water	0.292	0.173	59	0.119	41	73
Thames Water	1.17	0.778	66	0.39	33	71
Welsh Water	0.245	0.139	56	0.106	43	59

Growth in Profitability(%)

Company	2001	2002	2003	2004	%Increase 2001-2004
Severn Trent Water	22	22	21	21	-4.5
South West Water	36	38	40	41	13.8
Thames	31	32	32	33	6.4
Welsh Water	39	41	41	43	10.2

Explanatory Notes

i. This sector offers a statistically good comparison: same overheads, very similar business, same controls.
ii. Thames Water embarked upon major outsourcing in 1999.
iii. Severn Trent Water outsources work to STS but does not offshore.
iv. Welsh Water outsources to Logica but does not offshore.
v. Severn Trent Water has over the past three years invested more in infrastructure than any other water company and this is reflected in its cost-income ratio.

Analysis

i. Setting aside Severn Trent Water, both remaining non-offshoring companies had the lowest cost-income ratios and highest profit-income ratios.
ii. As with retail, the proportion of employee-related costs exhibited no clear pattern.

PROFESSIONAL CONTRACTORS GROUP

Gas / Electricity Utilities Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Employee costs/ Net total costs %
Centrica	18.3	14.7	80%	3.59	19	51
Scottish Power	5.7	4.7	82%	1.0	17	49
United Utilities	2.1	1.52	72%	0.58	27	42

Growth in Profitability (%)

Company	2001	2002	2003	2004	%Increase 2001-2004
Centrica	19	18	19	19	0
Scottish Power	15	16	17	17	13
United Utilities	26	26	27	27	3.8

Explanatory Notes

i. Centrica includes British Gas, Onetel, and Dyno and uses offshoring extensively.

Analysis

i. No clear trends are visible in the cost-income and profit-income ratios.
ii. Centrica, the only offshoring company in this group, has the highest proportion of employee-related costs.
iii. Centrica's 0% profit increase compares badly with the profit increases of the non-offshoring companies, which average 8.4%.

Telecommunications Comparison

Company	Gross Income £x10^9	Cost £x10^9	Cost/ Income %	Profit £x10^9	Profit/ Income %	Employee costs/ Net total costs %
3	0.63 (dollars)	0.41	65	0.22	34	29
Orange	47.1	28.9	61	18.2	38.6	28
T-mobile	57.8 (euros)	31.4	54	26.4	45.6	23

Explanatory Notes

i. T-mobile is owned by Deutsche Telekom Group. Results here are for the UK subsidiary only.
ii. 3 is owned by 3com - results here are for 3com, the US based company.
iii. Orange is owned by French Telecom.

Analysis

i. Non-offshoring companies had the lowest cost-income ratio (T-mobile), highest profit-income ratio (Orange) and lowest proportion of employee-related costs (T-mobile).
ii. Both non-offshoring companies out-performed 3, the only offshoring company in this group, on all three measures.

Analysis of results overall

These results do not show any clear advantage to be had from offshoring. Moreover, they suggest that, more often than not, companies that do not offshore achieve more impressive results.

In all 6 categories, from a list of randomly chosen companies across several key business sectors, the companies that do not offshore had the lowest cost-income ratio.

In four out of six categories, companies that offshore had the highest cost-income ratio. Water Utilities and Gas / Electricity utilities were the exceptions.

The increase in average profitability of companies in the years 2001 to 2004 was higher for companies that did not offshore in every sector for which figures could be compiled.

Conclusions

The results of this study show that the case for offshoring has absolutely not been proved. It does not seem to enhance companies' profitability to an extent sufficient to offset the short-term losses to the UK's economy. Savings resulting from offshoring work, even if significant compared to the total cost of offshored work, are small in comparison to most companies' bottom line profit.

There is therefore a strong suggestion that offshoring does not significantly enhance companies' profitability. This study must be taken as indicative rather than definitive, however, as the sample of data taken, although random, is too small to be statistically significant. It seems likely from this work, however, that offshoring is not particularly useful. Perhaps most significantly, there are no trends whatsoever in the data which suggest that it is of any substantial benefit.

Currently, the majority of IT work permits are issued to foreign based companies whose UK subsidiaries specialise in moving work offshore. In the absence of evidence showing any economic benefit from offshoring IT work, there must be controls on the issue of these permits.

It is clear, on the basis of this study, that more work is needed to investigate this apparent failure of economic theory to deliver policy that works in practice. PCG urges the government to commission a thorough empirical study of the effects of offshoring as a matter of urgency.

Bibliography

Publications

Prof. J. Bhagwati - *Trade and Poverty In The Poor Countries,* May (2002)
http://www.columbia.edu/~jb38/paper2001/AEA%20Trade%20and%20Poverty%20in%20the%20Poor%20Countries.pdf

DiamondCluster International's 2005 Global IT Outsourcing Study
http://today.reuters.com/Stocks/QuoteCompanyNewsArticle.aspx?view=CN&symbol=ACN.N&storyID=73678+07-Jun-2005+RTRS

McKinsey&Company – *Offshoring is it a Win-Win Game?* August 2003
http://www.mckinsey.com/knowledge/mgi/reports/pdfs/offshore/Offshoring_MGI_Perspective.pdf

Gurdial Rai – *Economic Impacts of Offshoring* - www.pcg.org.uk

Dani Rodrick - Feasible Globalizations (Harvard University), July 2002
http://ksghome.harvard.edu/~.drodrik.academic.ksg/Feasible.pdf

Published Company Accounts and Financial Statements

Banking / Financial

HSBC 2004 Results
http://www.hsbc.com/hsbc/investor_centre/financial-results/historic-results

Lloyds TSB 2004 Results
http://www.investorrelations.lloydstsb.com/media/PDF_IR/R&A2004LTSBGroup.pdf

Barclays 2004 Results
http://www.investorrelations.barclays.co.uk/BRC1/jsp/brccontrol?task=articlegroup&value=946&target=_self&site=inv

RBS 2004 Results
http://www.investors.rbs.com/investor_relations/financial_info/results.cfm

Assurance/Insurance Financial Results

Norwich union (aviva website)
http://www.aviva.com/ar04/index.asp?pageid=110

Legal and General
http://investor.legalandgeneral.com/annuals.cfm

AXA
http://www.axa.com/lib/axa/uploads/ra/2004/AXA_Management_Report_2004.pdf

Standard Life
http://ukgroup.standardlife.com/content/corporate/board/accounts_index.html

CIS
http://www.cis.co.uk/financial2003/financialstatements/

Supermarket/Retail

Sainsburys
http://www.j-sainsbury.co.uk/index.asp?pageid=20

Somerfield
http://www.somerfield.plc.uk/download/reports/report04.pdf

Co-op
http://www.co-op.co.uk/annualreport/

Tesco
http://84.40.10.21/presentResults/results2003_04/Prelims/site/u/u2.html

Morrisons
http://www.morrisons.co.uk/2004AnnualReport.pdf

Water Utilities

Thames water
http://www.thameswateruk.co.uk/en_gb/Downloads/PDFs/AboutUs_financialresults_dec04.pdf

Severn Trent Water
http://www.severntrent.com/ss_pdf/downloads/pdfs/financialreports/reportandaccounts_2004.pdf

Welsh Water
http://www.dwrcymru.com/English/publications/main.asp

South West Water
http://www.swwater.co.uk/index.cfm?articleid=670

Gas/Electricity Utilities

Centrica
http://www.centrica.co.uk/index.asp?pageid=43
http://www.centrica.co.uk/files/reports/2004arep/index.asp

United Utilities
http://www.unitedutilities.com/?OBH=136

Scottish power
http://www.scottishpower.com/pages/forinvestors_library_search_results?informationcategory=InvestorsCategory&nav=informationcategoryInvestorsCategory

Telecoms

Orange
http://www.francetelecom.com/en/financials/investors/data/statements/att00002170/Financial_statement_2004_Fi_Report.pdf

T-mobile
http://www.annualreport2004.telekom.de/en/ka/konzerngewinn_und_verlustrechnung/index.php

3com
http://www.3com.com/corpinfo/en_US/pressbox/press_release.jsp?INFO_ID=212284