

Outsourcing an answer to UK economic woes and the pension's crisis?

Offshoring (outsourcing to overseas countries) may be the saving grace for the UK economy and in particular the UK pensions crisis, but needs to be aligned to larger public policy and in particular skills training.

Outsourcing and offshoring must also be embraced by the SME market if the national story is to work, which means helping such companies understand and manage risks that may be involved, with specific customised solutions being available to the market.

In 1950 the average retirement age was 67 and life expectancy was 78. Now, the figures are 63 and 83 respectively. The Turner report calculated that if present trends continue a male aged 65 could expect to survive into his early nineties – women may live for even longer. Combine this with war time baby boomers approaching retirement in 2020s and you have a demographic bulge hitting retirement age – all wanting a decent pension – the problem only gets worse over time.

British pensions are already poorer than EU equivalents – it is debatable whether the UK can afford to be more generous in terms of pensions. A fundamental cause for this demographic time bomb is the low fertility rates in many industrialized nations - it is likely this trend will continue.

The “aged dependency ratio,” which is the number of elderly people receiving state benefits relative to the number of working-aged adults supporting them, offers a depressing insight to the future of the UK. In 1950, this ratio stood at just 19% in 1950, 27% today and expected to be 47% in 2050. This demographic shift is transforming the context for UK pension policy. Add to this the expenditure that will need to be spent on long term care for the disabled elderly, and you have a problem on a massive scale.

The low dependency ratio not only affects the ability for the country to pay pensions to its growing number of senior citizens, but also means the economy will not be able to get enough domestic skilled work-force for its manufacturing and services sectors. Under such a scenario, it will be difficult for workers to produce enough goods and services needed by the old. At the same time, with growth in incomes, (which may or may not include pensioners) the demand for goods and services may be higher. Some of the gap will, undoubtedly need to be met by productivity increases. Unless the UK can find a supply of labour to fill this gap, the domestic market will shrink, production will fall, as will the Government's revenue, forcing it to manage higher medical and pension expenses with a lower income.

In many respects these problems have been in place for a number of years now. However mass immigration and cheaper manufactured goods from China has sheltered the UK from the adverse affects its societal trend is having upon the domestic economy.

Among the options for the future is a policy choice of continuing to have higher immigration of a young work force from developing countries and/or to have much greater trade.

The rapidly growing economies of countries such as China and India not only present immense competition for UK business but also provide a potentially huge market for its goods and services. One of the key issues for the UK Government and businesses is how best to respond to this challenge to ensure that the UK economy benefits from this international economic activity in the global market place.

The continued trend for mass immigration of a young work force from developing countries to the UK has the potential to change the culture of the UK for good, and something which clearly all politicians are keen to avoid.

The China affect although still relatively strong will slowly diminish as wage inflation within China, feeds into their exports and results in higher prices for goods within the UK market.

One option that should be seriously considered is to replicate the model of outsourcing manufacturing

to China to the service sector. This has the potential to address some of the longer term issues that the UK is likely to face. To the extent that goods can be traded, trade is far more politically and socially acceptable to most nations than immigration.

A study by the Centre for Economic and Business Research (CEBR) stated *"Overall, the benefits of outsourcing for individual companies and their shareholders have been well documented, but I think a lot of people will be surprised to see how the benefits could extend across, and strengthen, the entire economy over the longer term"*.

Clearly offshoring potentially has implications for UK jobs. The underlying problem it would seem lies with lower skilled jobs which would be first to be sent offshore. Offshoring would help in reducing the labour supply shortages at a national level and create employment opportunities for more highly skilled and better paid jobs as a whole, but at an individual level, clearly there may be those who would lose their jobs and not be able to find alternatives. For the national story to work at an individual level, it would have to be assumed that people had the skills and motivation to exploit these new opportunities – offshoring and skills training may need to go hand in hand.

A report by The Work Foundation claimed that job losses from offshoring have been overstated, with very limited real impact on UK white collar jobs - it went on to suggest that offshoring was becoming a surrogate for wider issues about economic insecurity. Another report by Said Business School suggested that the net flow of trade for the UK in business services has been in the opposite direction. Foreign-based firms source business services from the UK to a greater extent than UK firms' source abroad.

Another answer to attempt to deal with this time bomb and as it happens goes hand in hand with the outsourcing option, is the potential outsourcing has in improving productivity improvement for UK businesses. UK productivity is already lagging behind many of its competitors (see report by O'Mahony and De Boer, 2002)

The differences in productivity can arise from either a) Inputs: capital, labour, raw materials in terms of quantity and quality and b) efficiency with which they are used. Offshoring potentially not only lowers the input costs, but also may be more efficient in using these inputs.

- A paper by Alexander Hijzen, Tomohiko Inui and Yasuyuki Todo, exploring the impact of offshoring, or contracting out of business activities to foreign providers, on firm productivity, using Japanese firm-level data for the period 1994-2000 found that offshoring has generally a positive effect on productivity growth. They suggest that a 1% increase in offshoring intensity raises productivity growth by 0.17%. For the average offshoring firm this implies a 1.8% increase in annual productivity growth.
- Mann (2005) suggests that offshoring in the IT industry led to an annual increase in productivity of 0.3% for the period from 1995 to 2002.
- Using the effects of offshoring on productivity in US manufacturing industries from 1992 to 2000, Amiti and Wei (2006) find that service offshoring has a positive effect on productivity, accounting for around 11% of productivity growth.

The current benefits from outsourcing and offshoring have been reaped by the larger businesses in the UK, but the vast majority of businesses in the UK are classified as SMEs. Outsourcing as a means to fill the labour gap, avoid the requirement for mass immigration, fund better state pensions and bring further productivity improvements at the national level, requires it to penetrate further into businesses.

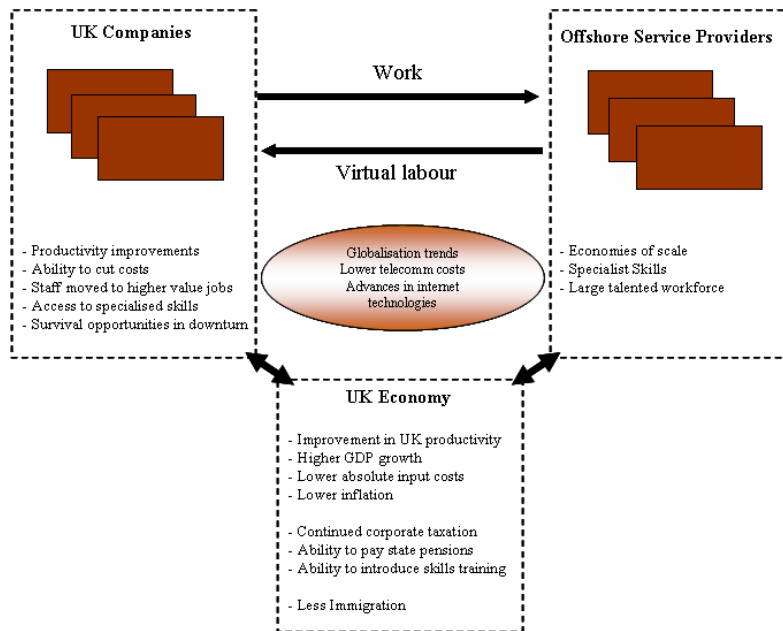
As with most things in life, there is the usual risk-reward trade-off – outsourcing and in particular offshoring has the potential for sizeable rewards, but is accompanied by significant risks (which the large businesses with sufficient deep pockets can manage – in some cases). These risks emanate principally from the lack of experience of outsourcing and in particular offshoring by the vast majority of the market. To successfully use offshoring as a business tool requires organisations to undertake significant business process analysis, select and manage outsourcing service providers, transition their

services seamlessly, draft and execute commercial contracts and manage the different culture, norms, business practices and legal systems of the countries of the offshoring service provider.

Another factor which has held back the penetration of offshoring has been the reluctance of service providers to actively target the SME market – principally because the current service providers are making sufficient returns from only targeting the large enterprise market. Deregulation and the introduction of competition within the telecommunications market and the advancement of the internet and remote management technologies are also now at a stage where the value proposition from offshoring is substantial.

The negative sentiments towards offshoring in the general press and by some politicians and public institutions in the UK and beyond increased the resistance by many companies to explore the outsourcing option and has disincentivised service providers from aggressively targeting the market.

What has become a taboo subject within the UK, may well be an economic saviour over time.



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