

Outsourcing's offshore myth

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Critics have condemned offshore development as everything from shortsighted to un-American--but it may well wind up rescuing the U.S. software industry.

To remain competitive in the global market, U.S. software companies must continue to drive innovation. However, innovation today is being strangled through insufficient R&D budgets on the company side and an overspending hangover on the customer side. Offshore development can help on both fronts.

Recent changes in the way U.S. companies are using offshore labor have sparked heated controversy, which is understandable considering that jobs are at stake in an already tight economy. But while it may be human nature to cling to the status quo, the software industry will be better off adapting to these changes and allowing innovation to flourish. Here's why.

For a mature software company, spending on true product innovation is a lot less than what you might think. It usually accounts for less than 30 percent of the R&D budget. This small piece of the pie is being further squeezed from two directions. First, overall R&D spending by public U.S. software companies is shrinking. In fact, in 2002 it fell by 2 percent, after having consistently grown at 15 percent annually since 1998.

Most of these cuts are taking a bite out of new product development. Second, R&D budgets are being consumed by ever-increasing maintenance-related activities, such as bug-fixing, upgrades and minor enhancements. Maintenance agreements with a large customer base accumulated over the years mandate this support.

With such limited resources available, software companies can't successfully generate real innovation. Instead, many of our best and brightest are mired down in what amounts to software housekeeping tasks. The irony is that many of these developers would be happier with--and better suited for--truly innovative work. But companies have painted themselves into a corner. This is where offshore development can help.

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In most cases, a well-executed offshore development program can help release an additional 20 percent of the R&D budget for new innovation while continuing to meet the maintenance obligations of mature companies. While many point to cheap labor as the main incentive for this approach, this is only a short-term fix. For example, salaries in India are growing at 15 percent to 30 percent per year, and the gap with U.S. salaries will be negligible by about 2020.

So what happens after salaries even out? The real reason offshore labor can help resuscitate software innovation in the U.S. is cultural, not economic.

As a company matures, innovation tapers off and grunt work multiplies. The fact is that U.S. development shops do not find grunt work appealing. And why would they? American developers have a passion for innovation. They are more interested in pushing the state of the art in design and functionality. Because these housekeeping activities are less creative and have more-defined

processes, they lend themselves better to a standardized development process methodology--something that offshore companies have invested in perfecting.

In addition, using offshore labor can help control the overgrowth of grunt work by improving the quality of the code itself. U.S. companies are forced to compromise on quality to meet deadlines and to focus on more creative tasks. The result is a surge of post-release bugs discovered by customers. Offshore companies, who have grown up testing other people's code, have invested in more advanced testing methodologies than most U.S. companies. That improved, offshore-led quality can not only free up R&D resources for new development, it can make it easier for customers to absorb innovation by lowering the cost of operating companies' software.

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This brings us to the other half of the equation--customers. Over the past few months, we have interviewed nearly 40 CIOs of large enterprises. They all say the same thing: IT operating costs are consuming too many of their resources. In the late 1990s, U.S. companies overspent on technology by \$250 billion, according to McKinsey Global Institute. Companies are now bogged down with operating these systems. In fact, the cost of managing the IT infrastructure built during the boom consumes 70 percent to 80 percent of the IT budget in large enterprises. About half of that figure represents labor costs.

If customers don't have the resources to experiment with new technology, demand withers and therefore so does innovation. Through the availability of software that is cheaper to operate, along with outsourcing some IT labor, companies can free up resources to invest in new technology again.

Offshore development and maintenance shops are also ideal platforms for offering services that reduce the cost of "caring and feeding" for systems running in the customer's back office. Vendors can remotely help customers with many of their current labor-intensive systems management and help desk tasks. Reducing the cost of operating existing applications can free up more dollars for investment in new products in the United States.

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As the offshore trend evolves, many jobs will stay in the United States, especially jobs that are tied to customer needs and linked to product innovation. Some new jobs may be also created. But some jobs will almost certainly disappear, and those changes will be hard to swallow. One thing that won't change is that the United States will always be a nation of inventors and innovators.

While offshore development is still embryonic, it has already fundamentally changed the way software is being developed, maintained and consumed. Allowing this process to evolve could rejuvenate software innovation in the United States. We shouldn't let our fears stand in the way.

Biography

George Gilbert and Rahul Sood are principals at Tech Strategy Partners, a consulting firm that advises software companies on developing and running offshore outsourcing programs.