

STUDY ON OUTSOURCING HUMAN RESOURCE ACTIVITIES: MEASURING THE COSTS AND BENEFITS

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ABSTRACT

“Outsourcing involves the sourcing of goods and services previously produced internally within the sourcing organization from external suppliers.” The key point worth noting is that this definition excludes processes never performed internally. Linder writes that outsourcing is “purchasing ongoing services from an outside company that a company currently provides, or most organizations normally provide, for themselves.” This view limits McIvor’s definition by adding the qualification that most organizations normally provide some services for themselves. Lee and Hitt (1995, p. 836) provide a much broader definition for outsourcing, as “the reliance on external sources for the manufacturing of components and other value-adding activities.” This definition could include nearly any activity so long as it is value-adding. This paper adopts the broader definition, though it excludes activities such as advertising and independent auditing as these are nearly universally outsourced by companies, that are not directly selling these services to other companies.

Keywords: *Outsourcing, Measurement, Costs, Human Resource, Economy.*

INTRODUCTION

An exploratory study of this type benefits from looking at the broader picture of the wider phenomenon. This chapter begins by comparing definitions of outsourcing followed by a brief review of the literature on the reasons for outsourcing. Next a recap of both the history and the geographic scope of outsourcing are presented. Finally, human resource outsourcing is described with an analysis of the major types of HR activities commonly outsourced. There is little disagreement in the academic community that outsourcing is an important management practice and that the level of outsourcing has increased dramatically in the last decade. Business Week noted that HRO has been the fastest growing area of business process outsourcing (Engardio, et al., 2006). There is somewhat less agreement about the definition of the term “outsourcing”. Business process outsourcing can include transferring an entire business function (e.g., payroll), a production process (e.g., ready-to-install windshield manufacture) or a portion of the related processes (e.g., mailing pay checks, windshield glass delivery).

The decision to outsource may be purely financial, but may also have strategic implications. As recently as 2002, the Shorter Oxford English Dictionary did not define outsourcing. The definition of outsourcing found on Wikipedia on December 17, 2007, read “Outsourcing is

subcontracting a process, such as product design or manufacturing, to a third-party company.” There are dozens of definitions of the term in the academic literature. Brown and Wilson (2005, p. 24) define outsourcing as “the act of obtaining services from an external source.”

Describing information technology (IT) outsourcing Kern, Willcocks and Heck (2002) state that “outsourcing is the practice of contracting out or selling the organization's IT assets, people and/or activities to a third-party supplier for monetary payments over an agreed time period.” This framework fits the experience of HRO in that the definition includes the practice of “badge flipping” which is the term used when an HRO provider assumes the employment responsibility for a share of the new client’s former human resource professionals.

REVIEW OF LITERATURE

A search of the Business Premier database on articles with the term “outsourcing” in their titles, keyword and abstracts yields more than 2,700 peer- reviewed articles and more than 20,000 non- peer reviewed articles appear. At the end of 2008, the Library of Congress had more than 300 books with outsourcing as a keyword. The topic of outsourcing is by no means new and the number of research studies published in this area is still growing, so carving out original research will not become easier. This study focuses on the rapidly growing segment of HRO. Advantages and disadvantages of the current literature will be reviewed and the current state of knowledge with respect to performance and context will be discussed. Key theories applicable to HRO suitability are explored in a later chapter with an attempt to move beyond the current focus on the micro-economic perspective of outsourcing. The use of contingent workers to perform business processes is similar to outsourcing in some respects as they provide flexibility with respect to work levels and offer the promise of lower costs due to the lack of benefits provided.

Davis-Blake and Uzzi (1993) provide statistically significant evidence linking five firm traits to the use of contingent and temporary workers: firm specific training, government oversight, job complexity, the presence of bureaucratized employment practices and size. Each of these traits was associated with lower usage of independent contractors. With respect to the determinants of a firm’s use of contract workers, employee benefit costs had no statistically significant relationship. However, variable employment levels, bureaucratized employment practices, establishment size, and the presence of multiple establishments within the organization were statistically associated with increased use of independent contractors. Industry was an important determinant of contract work with larger usage of the practice by organizations in construction, manufacturing and services.

Through the end of 2008 the academic journal Human Resource Management had only three articles dealing primarily with HRO and one with professional employer organizations (PEO). Klass, McClendon and Gainey (2001) authored the first study examining the relationship between organizational characteristics and the decision to outsource HR. This study split HRO into four categories: HR generalist activities, transactional activities such as payroll, human

capital activities such as training and recruiting and selection activities. They sent surveys to 2,000 randomly selected members of the Society for Human Resource Management (SHRM) who had the job title Vice President or Director of Human Resources.

They received data from HR executives in 432 organizations and found that the impact of organizational characteristics varied among the different types of HR activities outsourced. The primary measure was a rating of the degree of outsourcing using a 7-point scale for twenty different areas of HR in the design of programs and policies and the administration of programs and policies. Their factor analysis suggested four factors. One factor is HR generalist activities such as HR planning, employee relations, performance appraisal and safety. A second factor is transaction activities such as benefits, HRIS and payroll. A third factor is human capital building and maintaining activities such as training and employee assistance. The final factor is recruiting and staffing.

The organizations were measured on the following dimensions. Idiosyncratic HR practices or the extent to which the organization's HR practices were seen as unique were measured using four items. HR strategic involvement was measured using a two-item scale. Positive HR outcomes measured the extent to which the firm was performing well in employee motivation, cooperation and performance and this was measured using four items. Promotional opportunities were measured using a four-point scale and included items on the availability of opportunities and existence of preferential treatment for internal candidates. Demand uncertainty measured the predictability of firm performance, product demand as well as environmental and overall uncertainty using a five-item scale. Pay level was measured using a dummy variable based on a single item asking whether the firm was leading the market in terms of pay for its HR staff.

Firm size was measured in terms of full-time equivalent employees. Primary industry was measured using 14 categories. Outsourcing by competitors was measured using a two-item scale. Idiosyncratic practices were negative related to outsourcing HR generalist and human capital activities, which would be expected for firms with unique approaches to HR. Firms with strong HR strategy linkages outsource more specialist activities such as human capital and selection activities. A negative relationship was found between the outsourcing of human capital selection activities and two other dependent variables: positive HR outcomes and promotional opportunities. The pay level of HR staff was positively related to outsourcing these same two specialist activities. Demand uncertainty was positively related to outsourcing transactional activities and generalist activities.

No relationship was found with firm size or HR outsourcing by competitors. Cooke, Shen and McBride (2005) reviewed the literature on outsourcing HR as a competitive strategy. This review states that the empirical evidence on the reasons for outsourcing HR and results of HRO are "both fragmented and inconclusive" (Cooke, Shen and McBride, 2005, p. 414). Their review also contrasts the dearth of empirical work with the large amount of prescriptive literature on the financial and strategic reasons for outsourcing.

Their article argues for applying the resource-based view of the firm (Barney, 1991) and institutional theory in the outsourcing decision making process. They examine the implications of HRO for the function and groups of people affected by the decision. For example, HRO liberates remaining HR professionals to perform more strategic and consultative work in line with Ulrich's (1998) advocacy for the HR becoming a strategic partner.

SCOPE FOR FURTHER RESEARCH

Most of the data used in this study was collected through a series of survey questionnaires. In a small number of cases in-person or telephone interviews were conducted to better understand the reasons for outsourcing levels. These conversations were also used to encourage HR professionals to complete the questionnaires on behalf of their organization. Data collection involved both paper and online versions of the questionnaire. Nearly one hundred organizations were invited personally by the researcher to complete a paper version of the questionnaire. (See Appendix A for the paper version and three online versions of the questionnaire.) Nearly one thousand organizations were invited to participate by one of two market research firms, Greenfield Online and Market Tools.

The data collected provides a cross-sectional study of organizations of various sizes in several industries for the year 2009. It should be noted that although the final online deployment was in 2010 respondents were directed to provide figures for 2009. Prior to data collection, attention was given to the size of the sample needed to make inferences about HRO. Three issues were considered. The number of participants was considered to ensure adequate power for hypothesis testing. The incidence of HRO was a factor in framing the targeted organizations. As a result, very small (less than 50 employees) organizations were not targeted because such organizations are less likely to engage in many of the HRM activities being studied and, therefore, would not be able to outsource them. Organizations with less than ten employees were screened from the data collection process where ever possible. This work will be extended into a longitudinal study so some attention was given to the possibility of attrition, as well. Concerns about the effect size led to a power analysis prior to data collection.

A power analysis utilizing G*Power version 3 software for the overall equation which assumed an R^2 in the range of 0.15 and $\alpha = 0.05$, to ensure adequate power ($\beta = 0.80$), showed that at least 178 organizations would need to complete the questionnaire (Buchner, Erdfelder and Faul, 2001; Erdfelder, 1996). This calculation assumes seven predictors and 20 controls (including industry and region which require 14 and four dummy variables, respectively). An R^2 of 0.20 is relatively conservative, with studies using similar numbers of predictors finding an R^2 above this level (Aryee et al., 1999; Fagenson-Eland, Marks & Amendola, 1997; Whitely et al., 1992). Changing the R^2 to 0.10 increases the target sample size to 257.

This sample size may not be sufficient for adequate power for each predictor as this estimate only assures adequate power for the overall equation. This analysis has been provided starting

point in planning the approach to collecting data. Data collection continued with three online deployments until this threshold was reached.

OBJECTIVE OF STUDY

The main objectives of Study are-

- To provide the sourcing of goods and services previously produced internally within the sourcing organization from external suppliers.
- To adopt the broader definition, though it excludes activities such as advertising and independent auditing as these are nearly universally outsourced by companies that are not directly selling these services to other companies.
- To define the state of outsourcing as “the procurement of goods and services from external suppliers.

SIGNIFICANCE OF STUDY

Though the two words are frequently used interchangeably, “outsourcing” differs from “offshoring” in that outsourcing relates to the restructuring of the firm’s production process while offshoring is relative to the location of production. It is curious that the term offshoring is used to describe foreign or global sourcing and is actually inaccurate as a term for trade between U.S. and Indian firms or German and Polish firms as there is no “shore” across which trade is conducted. As the two terms outsourcing and offshoring are not mutually exclusive, it is useful for clarity to refer to domestic outsourcing and non-domestic outsourcing.

Reductions in tariff and non-tariff barriers to trade, investment and the flow of labor across national borders combined with developments in information and communication technologies permit collaboration between people and across distances that were previously impossible or impractical. Public sector shifts towards privatization have encouraged outsourcing. These forces are causing organization structures to evolve. India-based BPO providers-- such as Infosys, TCS and Wipro have seen their market share increase to 7 percent of the worldwide market in 2006, from less than 0.5 percent in 2002 according to a study by outsourcing advisory firm TPI (Financial Express, 2007).

This increase of more than 14 times compares to the falling share by the “Big Six” global outsourcing majors -- Accenture, IBM, HP, ACS, CSC and EDS whose market share fell from 71 percent in 2002 to 46 percent in 2006 (Financial Express, 2007)

HYPOTHESIS

The seven sets of hypotheses are reviewed with the evidence supporting or refuting each. Note that the results driven by attributes on the HRM activities are review by attribute. So, when reviewing the association of each of the six attributes on the outcome variables, the discussion begins with overall outsourcing levels (hypotheses 1A - 6A) and then moves to voluntary

employee turnover, one of the potential hidden costs or benefits, (hypothesis 1B-6B). The first set of hypotheses (labelled with an “A”) all use the level of HRO as the dependent variable. The second set of hypotheses (labelled with a “B”) all use the 2007 level of voluntary employee turnover as the dependent variable. Note that the predicted direction need not be the same as the prediction of TCE for observed levels in the market are expected to have a stronger affect than the predictions of a potential hidden cost of outsourcing an activity.

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