

2005

Outsourcing the Human Resource Function: Environmental and Organizational Characteristics that Affect HR Performance

J. D. Lilly, *Sam Houston State University*

D. A. Gray, *University of Texas at Arlington*

Meghna Virick, *San Jose State University*

OUTSOURCING THE HUMAN RESOURCE FUNCTION: ENVIRONMENTAL AND ORGANIZATIONAL CHARACTERISTICS THAT AFFECT HR PERFORMANCE

Juliana D. Lilly
Sam Houston State University
Huntsville, TX

David A. Gray
Meghna Virick
The University of Texas at Arlington
Arlington, TX

Abstract

A theoretical model is presented that identifies environmental and organizational characteristics that affect human resource (HR) performance in an organization. Specifically, we address the issue of when and under what circumstances does HR outsourcing contribute value to the firm by attempting to identify environmental and organizational characteristics that affect HR department performance and how HR outsourcing mediates that relationship. We propose that supplier competition in the HR provider market has a direct effect on the amount of HR outsourcing which in turn has a direct effect on HR performance. Environmental uncertainty (primary, competitive, and supplier) is proposed to moderate the relationship between amount of HR outsourcing and HR performance while asset specificity is proposed to moderate the relationship between supplier competition and amount of HR outsourcing. An earlier version of this paper was presented at the Southwest Academy of Management meeting in Houston, Texas, March, 2003, and received the 2003 Irwin/McGraw-Hill Distinguished Paper Award.

Introduction

Human resource outsourcing has become a major part of human resource (HR) operations for the last few years. A 2004 joint study conducted by the Society for Human Resource Management (SHRM) and the Bureau of National Affairs (BNA) found that two-thirds of HR executives surveyed say their HR departments outsource at least one HR activity (Bureau of National Affairs, 2004), with this activity expected to increase. Proctor & Gamble (P&G), for instance, signed an agreement with IBM that took effect in January 2004 and led to the outsourcing of P&G's worldwide HR services, valued at \$400 million to IBM. Despite the increased activity, however, there is recognition that careful planning should be employed before making the decision to outsource. In fact, a separate

2004 SHRM human resource outsourcing survey found that in some cases HR outsourcing led to a decrease in customer service (25% of respondents), a less personal relationship with employees (37% of respondents), and a decrease in employee morale (6% of respondents). The information contained in these two recent surveys seems to indicate that a good understanding of the factors that drive HR outsourcing and a good understanding of the expected outcomes is necessary to ensure that organizations fulfill their HR functions in a manner that allows them to remain competitive in their respective industries.

Literature Review

In many studies that discuss outsourcing, cost benefits appear to be a compelling argument for contracting out services previously performed internally (e.g., Anderson & Weitz, 1986; Belous, 1989; Greer, Youngblood, & Gray, 1999; Gupta & Gupta, 1992; Kakabadse & Kakabadse, 2002; Lever, 1997), and Vining & Globerman (1999) note that empirical data from government agencies outsourcing to private suppliers generated savings in the range of 20-30% in production costs. However, some of these same studies caution that cost should not be the only factor considered in the decision to outsource. Other factors to consider include vendor expertise, customer and employee satisfaction (Barthelemy, 2003; Greer, Youngblood & Gray, 1999; Gupta & Gupta, 1992), and loss of strategic advantage (Anderson & Weitz, 1986; Greer, Youngblood & Gray, 1999, Gupta & Gupta, 1992; Lever, 1997). In a more recent study, Adler (2003) notes that a review by the Gartner group listed six factors that are important in outsourcing decisions: dependency risk, spillover risk, trust, relative proficiency, strategic capabilities, and flexibility. The first four of these are classified as short-term factors, whereas the last two can be considered more long-term or strategic. However, no clear formula exists that identifies when outsourcing is most efficient and effective. There are also very few empirical studies that examine the performance implications of make or buy decisions (e.g. Leiblein, Reuer, & Dalsace, 2002). Rather, studies seem to concentrate on the reasons organizations outsource, how to outsource, or the impact of outsourcing on the organization and its employees.

Notably absent from the literature is the question of when outsourcing is most appropriate or under what circumstances an organization should outsource to increase human resources (HR) performance. In other words, are there internal and external forces that are conducive to HR outsourcing? If these forces can be identified, they may provide some clues concerning the appropriate action to take when outsourcing is being considered. This is especially important since 67% of HR departments outsourced one or more functions in 2004 (Bureau of National Affairs, 2004). We specifically address the issue of when and under what circumstances does HR outsourcing contribute value to the firm by attempting to identify environmental and organizational characteristics that affect HR performance and how HR outsourcing mediates that relationship.

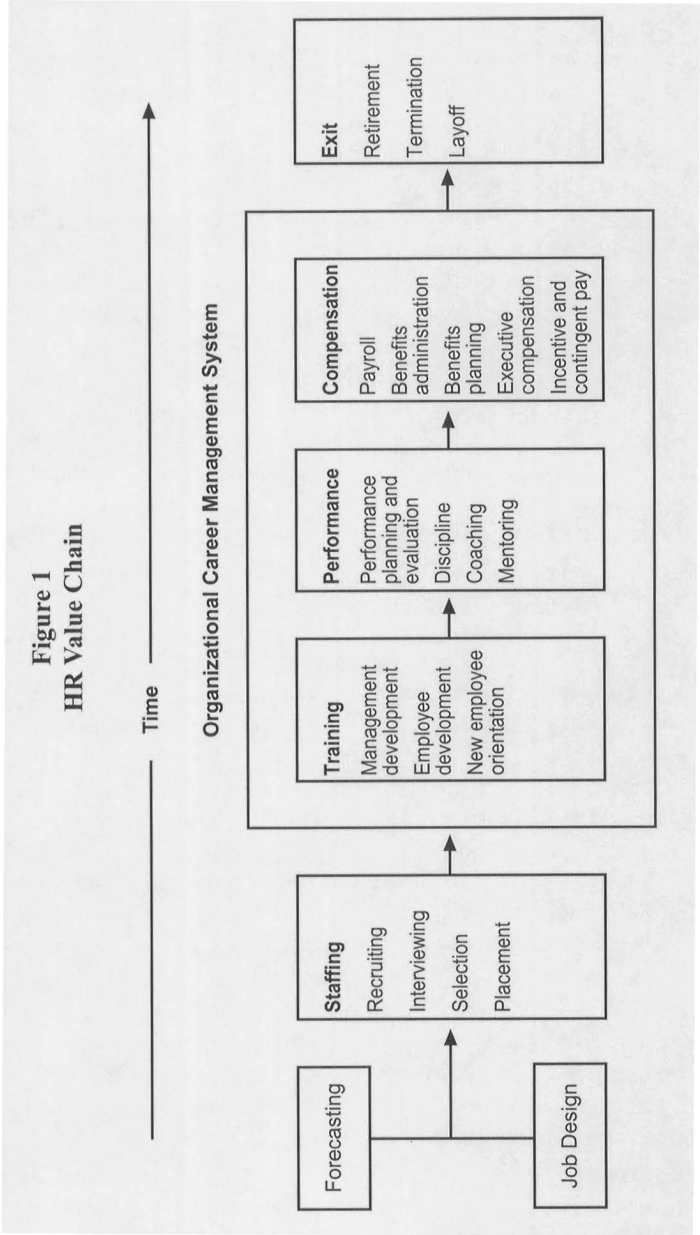
A separate issue concerning the current outsourcing research is the absence of studies looking at the HR function in organizations. Although there are numerous theoretical and empirical articles on outsourcing organizational functions such as information systems and accounting, the academic literature on outsourcing the HR function is almost non-existent. Although Klaas (2003) developed a framework that helps analyze HR outsourcing factors in small and medium-sized enterprises (SMEs) by explicating on the relationship between SMEs and the professional employer organizations and Gainey and Klaas (2003) analyze HR outsourcing specifically in the context of training and development, these studies are the exception rather than the rule. This fact is surprising given that many HR functions such as payroll, benefits, training, and recruiting are often outsourced by organizations (Gilley, Greer & Rasheed, 2004; Lever, 1997).

The SHRM Human Resource Outsourcing Survey Report, released in June 2004, found that HR functions that are entirely outsourced are generally background checking, employee assistance/counseling, and Flexible Spending Account (FSA) administration. The functions that are partially outsourced include administration of health care benefits, pension benefits administration, and payroll. Despite this increase in HR outsourcing activity, to date, the empirical articles on outsourcing HR functions focus on the impact of organizational characteristics (Klaas, McClendon & Gainey, 2001), the role of transaction costs (Gainey & Klaas, 2003; Klaas, 2003; Klaas, McClendon & Gainey, 1999), the relationship between HR department size and outsourcing activity (Pommerenke & Stout, 1996), and the rationale and consequences of HR outsourcing (Greer, Youngblood & Gray, 1999; Lever, 1997). The question concerning when to outsource HR practices based on the internal and external forces driving the firm to consider outsourcing, however, is not directly addressed, although Klaas, McClendon & Gainey (1999) come close in their analysis of moderator variables in the relationship between amount of HR outsourcing and perceived benefits from outsourcing. A separate article by Klaas, McClendon and Gainey (2001) also touches on certain organizational characteristics that lead firms to outsource HR activities, but does not consider HR performance as a dependent variable. As such, it is necessary to address the question of when to outsource the HR function by looking into the theoretical issues of outsourcing in the literature representing disciplines other than HR to form a basis for HR outsourcing. However, a brief discussion of definitions and HR activities is presented first.

In this paper, the term outsourcing will refer to the action of allowing external vendors to perform an entire HR activity (such as training, payroll, etc.) for an organization. The term insourcing will refer to the action of the organization performing the entire HR activity in-house, and the term co-sourcing will refer to the action of allowing an organization's HR generalist to work with external vendors on some activities, or to the action of allowing HR specialists to work as consultants to line managers who actually perform HR duties.

The HR Value Chain

The HR functions performed in an organization can be thought of as a chain of events or tasks that start with the planning of the organization’s staffing needs and end with an employee’s exit from the organization. Figure 1 illustrates the



chain of events as they occur in an organization. These events form the basis of the HR function and serve as a guide for determining which specific HR functions may be eligible for outsourcing. It is important to distinguish between those functions that are a core element of the organization/employee relationship (those that create value for the organization) and those that are not. Two typologies are used to illustrate this point.

Gilley, Greer, and Rasheed (2004) discuss a strategic typology of HR activities developed by Alan Speaker (Greer, 2001) in which HR activities are classified as having either high or low strategic value and as being either transactional or relationship-oriented in nature. Their resulting typology shows the quadrant containing relationship-oriented activities with high strategic value to the firm to include several HR activities related to training and performance evaluation. In addition, the quadrant containing transactional activities with high strategic value includes activities related to staffing, benefits planning, and compliance. Their article suggests that high strategic value activities and relationship-oriented activities might not be good candidates for outsourcing activity. Rather, they suggest that low strategic value activities that are transactional in nature such as payroll, benefits administration, employee records, and relocation administration are the best candidates for outsourcing.

A separate, but similar, typology is Lepak and Snell's (1998) model of virtual HR in which HR activities are classified as either high or low in uniqueness and high or low in value. A high value activity is one that is directly instrumental for achieving organizational objectives, while a low value activity is one that is primarily administrative or transactional in nature. An activity that is low in uniqueness is one that is routine, while an activity high in uniqueness is considered idiosyncratic. Lepak and Snell (1998) argue that the quadrant representing high value and high uniqueness contains core HR activities that are most likely to be carried out internally to obtain a competitive advantage. Thus, these activities should not typically be outsourced, but other routine administrative activities located in other quadrants might be outsourced to the growing supply of external vendors specializing in these activities.

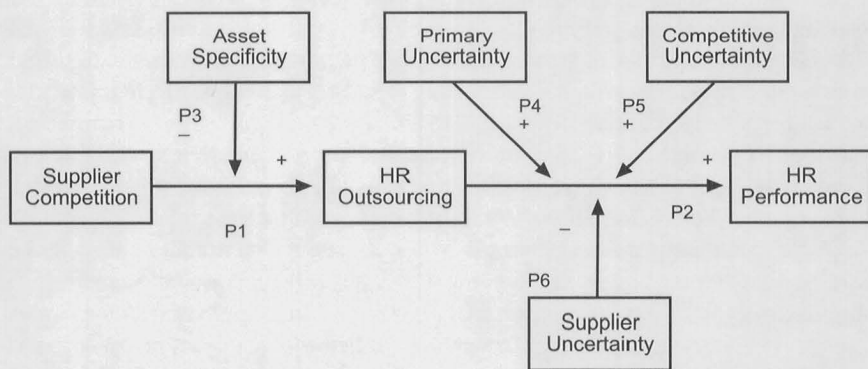
When the HR activities listed by Gilley, et al. (2004) are located in the HR value chain, it becomes obvious that portions of each major HR function are potential candidates for outsourcing. However, three functions in particular, training, performance planning and evaluation, and compensation, deal specifically with an organization's current relationship with its employees. As soon as the employee is hired, he or she receives some type of training, is informed of job performance evaluation processes, and is informed of compensation issues related to pay and benefits. If an employee stays with the organization, the cycle of training, performance, and compensation repeats itself many times throughout the course of the employee's tenure with the organization. The professionalism and fairness with which an organization performs these activities is directly related to how employees feel about the organization. Thus, these three functions comprise an organizational career management system and are crucial in developing corporate

strategies concerning employee retention, employee value to the organization, and employee productivity. As such, outsourcing in these three major HR functions should be considered carefully before any final decisions are made.

The Proposed Model

Because HR outsourcing has received such scant attention in the literature, it is necessary to address the question of when and under what circumstances HR outsourcing contributes to firm performance by looking at the literature representing disciplines other than HR. In particular, theory from economics, organizations, and strategy will be used to develop the proposed framework. Figure 2 depicts the proposed model of the relationship between competition, amount of HR outsourcing and HR performance. Moderator variables, asset specificity and three types of environmental uncertainty, are also used to help determine the conditions under which HR outsourcing may affect HR performance.

Figure 2
Model of HR Outsourcing



Supplier Competition and Outsourcing

When people and organizations agree to conduct business together, a process emerges that helps determine demand, supply, and prices for particular goods and services. As the number of people and organizations involved in business transactions increases, the potential for competition between these groups also increases. For instance, when the number of sellers in a particular market increase, buyers have more freedom to pick and choose the organizations with whom they want to conduct business than they do if there are few sellers. Because large numbers of sellers are trying to capture the same market share, the sellers will compete with one another in an attempt to obtain as much market share as possible. The resulting competition may cause the sellers to differentiate their services in terms of price, quality, or customer service.

When competition is limited, a decreased quantity of goods and services is available, and the prices of those goods and services tend to increase. For example, Lynk (1995) found that mergers between hospitals led to significantly higher prices in health care service, indicating an exploitation of market power created by a reduction of competition. In contrast, as competition increases (with more firms entering the market) the quantity of goods and services available to potential buyers should also increase. Because neoclassical economic theory assumes the buyer to be rational and informed, buyers should choose the product that best meets their needs and price concerns, thereby choosing the alternative that is most efficient. Therefore, as competition between external HR provider firms increases, the quantity of goods and services available to corporate buyers should also increase with buyers choosing the most efficient alternative.

In the five forces model of competition (Porter, 1980), five competitive forces determine the state of competition in an industry. Three of these forces, potential new entrants into a market, substitute products, and rivalry among competing sellers in a market, often lead to new technology, improved products, and lower prices. Thus, a firm wishing to outsource HR functions in a strong competitive vendor environment is likely to benefit from a strong bargaining position.

An organization performing a particular HR activity in-house may not be able to compete effectively with firms offering the same service externally, particularly if an external provider has a competitive advantage unavailable to others. In this situation, marginal analysis would help determine if the HR activity is costing more than the worth of the HR activity's contribution to total organization output. Marginal analysis looks at the changes in costs and benefits that occur when changes from the status quo are proposed. These marginal changes in the costs and benefits are the basis for rational economic choice (Ekelund & Tollison, 1991). In a competitive situation concerning employee wages, for example, marginal analysis would determine if an employee is worth keeping. If the employee being analyzed is paid more than the worth of his or her contribution to total output, it is economically unsound to keep the employee on the payroll. In the same vein, if an insourced human resource activity costs more to operate than it is contributing to total output of the organization, it is economically unsound to continue operating the HR activity internally.

Transaction cost theory (Coase, 1937) helps explain this idea further. Transaction cost refers to the cost of organizing information, protecting the interests of all parties in the transaction, monitoring the transactions, and other similar costs involved in a transaction (Aubert, Rivard & Patry, 1996). In a discussion of transaction costs, Coase (1937) noted that "a firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of exchange on the open market or the costs of organizing in another firm," (Coase, 1937, p. 341). In other words, when internal transaction costs equal the cost of purchasing the same good or service on the open market, the organization will tend to stop producing internally and purchase from the open market.

Williamson (1975) suggests that a buyer who is dependent upon one supplier for goods will be less able to resist or avoid opportunism by the supplier than a buyer who has several suppliers from whom to purchase goods. The lack of alternative suppliers may create a small numbers bargaining problem for the buyer, thus creating an incentive for the buyer to vertically integrate (Levy, 1985). From an outsourcing perspective, when competition for suppliers of a particular good or service increases, the number of choices increase, and the ability of a supplier to engage in opportunistic behavior decreases. The increased level of competition creates an environment that is more favorable to the buyer in terms of choice and the ability to use alternate suppliers if necessary. Without several alternatives, it is doubtful that outsourcing would occur at all since firms would be hesitant to place themselves in a situation that forces them to be dependent upon a single supplier.

This concept of transaction cost falls in line with theories of competition, cost leadership and differentiation strategy (Porter 1980). An organization cannot afford to compete effectively when it pays more for services or goods than its competitors unless it differentiates itself clearly from other market providers. If business competitors use a less expensive but equal method to operate their HR activities, the organization that continues to pay more for the same service may be at a competitive disadvantage by not utilizing a cost strategy. Additionally, as external HR provider firms increase in number, competition among these contract providers will likely lead to new technology, improved products, and economies of scale not available to organizations not specializing in the HR activity. External HR provider firms that exploit either cost advantages or special differentiated services through improved technology and products may entice many organizations to outsource. Indeed, in a study of semiconductor firms, Leiblen, et al. (2002) found that number of suppliers correlated with greater outsourcing activity.

In summary, increased HR vendor competition may create positive benefits for organizations purchasing their services. From a neoclassical economic perspective, increased levels of external supplier competition should lower the costs of externally produced goods causing the rational consumer to purchase the goods externally rather than producing them internally at a higher cost. Therefore:

Proposition 1: There is a positive relationship between supplier competition in the external HR provider market and amount of HR outsourcing.

The Relationship Between Outsourcing and HR Performance

Because firms outsource to increase performance, HR outsourcing should lead to increased HR performance such that HR outsourcing acts as a mediator between supplier competition and HR performance. The decision to make or buy is based on a number of elements in the internal and external environment (White, 2000), and the idea of competing based on the amount of hard assets owned has shifted to competing on the basis of intangible assets and capabilities (Gottfredson,

Puryear & Phillips, 2005). As a result, the amount of outsourcing in areas such as production and information processing has increased tremendously in the last several years in an attempt to compete by using the most attractive opportunities inside and outside the organization. Outsourcing is attractive to upper management because it improves some of the metrics used to judge company performance. For instance, "shedding specific assets allows a company to increase return on assets (ROA) and return on investment (ROI), and decreasing the head count increases revenue per employee," (Rossetti & Choi, 2005, pp. 48-49). Another benefit of outsourcing includes reducing prices of goods provided, which in turn leads to higher price to earning ratios. In summary, firms that outsource any function do so with the idea that the firm's performance will increase. Several sources indicate that this is indeed the case (Ellram & Carr, 1994; Smeltzer, Manship & Rossetti, 2003; Velocci, 2001), and thus we expect that an increase in HR outsourcing will result in an increase in HR performance.

Proposition 2: There is a significant mediating effect of amount of HR outsourcing on the relationship between supplier competition and HR performance.

Asset Specificity

Williamson's (1985, 1986) work on transaction costs expands Coase's (1937) original theory by defining key aspects of a transaction cost framework. One key aspect is that of asset specificity, or the investment in assets that are specific to the requirements of a particular exchange relationship. Research has shown that asset specificity reduces the degree of outsourcing (Jensen & Rothwell, 1998; Monteverde & Teece, 1982). For example, in an HR context, asset specificity is high in a transaction where software is designed to perform a specific HR task for a specific organization. Transaction costs are likely to be high in this instance since the software cannot be used in other organizations. Both purchaser and vendor will desire protections from each other if something goes wrong, thus increasing costs of the transaction. If asset specificity is low, however, market transaction costs are likely to be lower and many suppliers should then effectively compete (Vining & Globerman, 1999). In this scenario, as the number of external HR provider firms offering basic, non-specific service that all organizations need (e.g. payroll administration) increases, external vendor competition should increase and cause internally produced services to be more costly to administer. The key is to determine which activities in the HR value chain have low asset specificity and can be outsourced without damaging the organization/employee relationship.

The specific HR tasks or services being outsourced can have an impact on the relationship proposed in proposition one, particularly if an HR service that creates a competitive advantage for the firm is outsourced. The concept of asset specificity is very similar to Klaas, McClendon and Gainey's (2001) concept of idiosyncratic practices developed by firms to create a strategic HR advantage.

These idiosyncratic practices are often firm-specific, based on tacit firm knowledge, and can limit the ability of an external HR provider firm to provide the same level of service as an internal HR department. As such, asset specificity should be accounted for in the competition/amount of HR outsourcing relationship. Since prior research has shown that asset specificity reduces the amount of outsourcing (Jensen & Rothwell, 1998; Monteverde & Teece, 1982), we propose that asset specificity moderates the relationship between supplier competition and amount of HR outsourcing.

Proposition 3: There is a negative moderating effect of HR task asset specificity on the relationship between supplier competition and amount of HR outsourcing.

Environmental Uncertainty and Outsourcing

Seminal works in the area of environmental uncertainty suggest that the most effective firms tend to use mechanistic or bureaucratic designs in stable, predictable environments while organic designs are used by effective firms in unstable, turbulent environments (Burns & Stalker, 1961; Lawrence & Lorsch, 1967; Thompson, 1967). In other words, the type of organizational design used should match the organization's environment. Although much has been written about the relationship between environmental uncertainty and organizational design, some scholars have looked specifically at the role information processing plays in this relationship (Daft & Lengel, 1986; Galbraith, 1974; Huber, 1991). Arguments have been made suggesting that the level of analysis for information processing should be the subunit or departmental level rather than the organizational level because organizations are composed of subunits which are interdependent (e.g. Tushman & Nadler, 1978). Information processing is important because an organization's ability to process information is tied to environmental uncertainty. The more uncertain the environment, the more difficult information processing becomes, and the more likely it is that an organization developing better methods for processing information will obtain a competitive advantage.

Considering the HR department as a subunit in an organization, it is appropriate to analyze the structure and process of the HR function in the theoretical vein suggested by the studies mentioned previously. Seminal research clearly suggests that in stable, predictable environments, a bureaucratic structure is the most effective design to use. Therefore, when labor demand and supply are stable and predictable, outsourcing the HR function, even a bureaucratic one, seems unnecessary since all market competitors have fairly complete information in an unchanging market. It would be difficult to obtain a competitive advantage for HR under these conditions since the resource in question (labor market information) is not limited to one organization. Indeed, such information is often compiled by government agencies and dispensed publicly to all interested parties.

A more recent view of environmental uncertainty suggests that uncertainty is divided into three distinct components — primary, competitive, and supplier

(Sutcliffe & Zaheer, 1998). The first component, primary uncertainty, refers to "uncertainty arising from exogenous sources, such as natural events, from changes in preferences, as well as from regulatory changes, such as those involving standards or tariffs," (Sutcliffe & Zaheer, 1998, p. 3). Competitive uncertainty is defined as "the uncertainty arising from the actions of potential or actual competitors....," (Sutcliffe & Zaheer, 1998, p. 4). These two forms of uncertainty are somewhat similar in an HR outsourcing context in that a firm must deal with the effects of these types of uncertainty after they occur. For instance, changes in Department of Labor regulations concerning the status of exempt versus nonexempt employees and the calculation of overtime have caused many HR departments to recreate the entire timekeeping process to avoid potential legal problems. When competitors raise or lower the average wage level for a particular area, HR departments must decide if they should or should not match the competitor's wage and the impact that will have on their workforce. Because primary and competitive uncertainty create a situation in which the firm must react after the event has occurred, it is expected that high levels of primary and competitive uncertainty will enhance the ability of firms specializing in HR outsourcing to outperform internal HR departments. The reasoning for this assumption is based on the idea that firms specializing in HR services will have more ability to focus on specific HR issues and will be able to respond more quickly when changes occur.

Proposition 4: There is a positive moderating effect of primary uncertainty on the relationship between amount of HR outsourcing and HR performance.

Proposition 5: There is a positive moderating effect of competitive uncertainty on the relationship between amount of HR outsourcing and HR performance.

The third type of uncertainty proposed by Sutcliff and Zaheer (1998) is supplier uncertainty, defined as the behavioral uncertainty of an exchange partner firm. Supplier uncertainty is related to possible opportunism by the supplier, and is expected to have a negative moderating effect on the relationship between HR outsourcing and HR performance. In an HR outsourcing context, an increase in supplier uncertainty would suggest that the external HR provider firms are in a position to act in self-serving ways at the expense of the contracting organization. Thus, an increase in the ability of external HR provider firms to engage in opportunism could lead to a decrease in HR performance.

Proposition 6: There is a negative moderating effect of supplier uncertainty on the relationship between amount of HR outsourcing and HR performance.

Model Limitations

The propositions presented are intended to give some solid theoretical background for determining when the HR function should or should not be outsourced. It is well and good to discuss competitive advantages and employee reactions concerning outsourcing, but defining the appropriate situation in which to act to increase HR performance has not yet been established. The proposed model is a starting point for connecting outsourcing activities to HR performance.

A potential difficulty with the model, however, is adequately defining and measuring what is meant by HR performance. In firm-level studies of outsourcing, profitability and earnings per share may be appropriate measures of performance, but performance in the HR function is more difficult to quantify in dollar amounts, although some authors have made progress in this regard (Becker, Huselid & Ulrich, 2001). Basic operating cost comparisons can be made easily, but intangible functions such as creating the appropriate organizational culture or ensuring that employees feel valued and supported by the organization are difficult to measure and difficult to translate into dollar amounts. These intangible factors, however, need to be quantified in order to obtain a valid measure of HR performance. If the goal of outsourcing is to improve the function being outsourced, valid measures must be available to determine whether the outsourcing is successful. Perhaps each component in the HR value chain can be analyzed to determine specific measures for each function that can then be compiled into an overall measure of HR performance. The measures might include both operating costs and behavioral components translated into dollar amounts.

In addition, since the dependent variable is HR performance, the knowledge, skills, and abilities (KSAs) of individuals performing the work are most likely part of the HR performance measure. The model, however, does not account for individual contributions to HR performance. Just as HR performance is difficult to measure, individual KSA contributions to an organization are also difficult to measure. For instance, the labor relations manager who convinces the local union to avert a strike certainly has KSAs that contribute value to the firm, but how should the manager's KSAs be measured? Perhaps colleagues, subordinates, and supervisors could give a reasonable measure of the manager's KSAs as some 360-degree performance evaluations require, but obtaining 360-degree feedback for all HR department employees can be impractical, and performance ratings are often inflated and inaccurate. Thus, although HR performance is likely to be a function of employees' skills and abilities, employee KSAs are not included in the model.

Another limitation concerns other functions and departments within the organization. Because HR performance often depends upon the willingness of other departments to follow organizational policy and procedure, individuals outside of the HR function may have an impact on HR performance. For example, assume the HR department adequately conducts sexual harassment workshops and has tried without success to discipline a vice-president who informs his managers to ignore all complaints from female employees. The vice-president is a personal

friend of the CEO, and simply refuses to take sexual harassment seriously. Lawsuits resulting from sexual harassment complaints may count against HR performance even though HR employees have done everything possible to stop sexual harassment.

The factors discussed above and others are likely to contribute to HR performance that are not considered in the proposed model, and any test of the model will most likely yield a small r-square value because of the missing variables. Despite this limitation, the model is adequate as a starting point for determining how outsourcing affects the relationship between external forces of competition and HR performance. If the model is significant, it would indicate that the amount of HR outsourcing does have an impact on HR performance under certain conditions. Since the goal of outsourcing any task is to reduce costs, gain expertise and control over processes, and improve quality of service (Shelgren, 2004), knowing that HR outsourcing may add value to the firm is a positive step in determining ways to capitalize on any potential benefits of outsourcing.

Conclusion

A number of organizations have begun to outsource the HR function, and it would be helpful to understand the impact of outsourcing on firm performance. Electronic Data Systems will combine forces with Towers Perrin to create an HR outsourcing company that is expected to bring in \$600 million in annual revenues (Fuquay, 2005), and consulting firm NelsonHall says the worldwide market for HR outsourcing services is expected to grow 21% annually to \$7 billion by 2008 (McDougall, 2005). The sheer size of the market for HR outsourcing suggests that firms should be aware of the forces that indicate outsourcing to be beneficial or detrimental to the organization. The research to date on HR outsourcing has not yet determined the circumstances under which HR outsourcing would be most beneficial, and part of the problem lies with the inability of researchers and firms to grasp an overall, widely accepted measure of HR performance.

Many HR functions may not lend themselves to outsourcing, and changing the dependent variable from HR performance to HR function performance for specific functions such as payroll or employee development may help determine which functions should or should not be outsourced. The HR value chain illustrates in a timeline fashion how certain HR activities become tied to an employee's value to the organization. Training leads to better performance which leads to higher compensation, and the cycle of training, performance and compensation repeats itself throughout the life of the employee in the organization. Because an organization has invested time and money in training employees, the decision to outsource should not be made lightly. If conditions in the environment and in the organization are conducive to outsourcing, the amount of time and money invested in the HR professional employees who are to be downsized should be considered for the sake of the organization as well as for the sake of the employee.

Unlike an outsourced manufacturing process, where the cost of goods and quality metrics can clearly show if the outsourced process is successful in meeting numeric goals of production, HR practices are typically intertwined together to form a coherent overall strategy that is more difficult to tease apart and measure individually. The literature on HR bundles illustrates this point (see Macduffie, 1995, for a specific manufacturing example). For instance, an overall strategy that claims, "People are our most important asset," would suggest that all HR practices from recruiting to retirement focus on the individual employee to make them feel like a valued part of the organization. If a specific HR function such as benefits administration is outsourced to an external provider, however, the employee may feel more like a number than like a valued employee. At this point, there is a potential breakdown in the overall strategy, and metrics showing the amount of money saved by outsourcing benefits administration may look promising, but employees themselves may feel less committed to the organization. As a result, other HR performance measures that are typically not calculated in benefits administration, such as turnover or absenteeism, may increase. HR management is concerned with the management of people in an organization throughout all phases of the employment process, and improving one part at the expense of another part makes little sense. Thus, the emphasis earlier in this paper on core HR activities with high strategic value is not misplaced, and the authors who caution that cost should not be the only factor in the decision to outsource have good reason for their arguments (Anderson & Weitz, 1986; Greer, Youngblood & Gray, 1999; Lever, 1997).

The field of HR management has transformed over the past few decades from being primarily a record-keeping function to a strategic function that helps develop strategies for fitting HR practices with the overall organization's strategy. The old record-keeping functions tend to be routine, bureaucratic, and have low strategic value; thus, they can probably be outsourced with little effect on the individual employees of the organization. However, some people do not see the value of "new" and strategic HR departments because they see all of the HR function as a bureaucratic, record-keeping function that adds nothing to the firm's bottom line. Thomas Stewart (1996), for example, suggests that most HR departments are 80 percent routine administration with no value-added, so the entire HR department should be abolished; not improved, but completely eliminated. The problem with Stewart's suggestion is that many researchers have decided that the acquisition and management of human capital can become a strong competitive advantage for an organization if handled appropriately (Barney, 1995; Barney & Wright, 1998; Brockbank, 1999). Since most managers are kept busy with typical tasks such as production or sales, few have extra time to devote to the human resource component of the business. This situation means that someone needs to develop the HR practices that are critical to creating and sustaining a competitive advantage with human capital. It also means that decisions to outsource the HR function must be made with the appropriate information, and the research in this area needs more development and clarity.

Future research should focus on other organizational characteristics or environmental characteristics that affect HR performance based on the amount of outsourcing. Other organizational characteristics might include organization structure and design, particularly in the HR department itself, or the size of the organization. Other environmental characteristics might include boundary spanning capabilities of the organization or the level of resource dependence the firm experiences. Learning more about the conditions under which HR outsourcing affects specific HR functions would help HR departments plan accordingly when making decisions to outsource. Although the purpose of this paper is to identify characteristics of the organization or environment that determine when to outsource HR and subsequent performance, another valuable component of determining whether outsourcing is successful concerns the individuals performing the work. A more complete model would include organizational, environmental, and individual employee characteristics that all work in concert to determine the appropriate situation in which to outsource.

References

- Adler, P.S. (2003). Making the HR outsourcing decision. MIT Sloan Management Review, 45, 53-60.
- Anderson, E. & Weitz, B. A. (1986). Make-or-buy decisions: Vertical integration and marketing productivity. Sloan Management Review, 27, 3-20.
- Aubert, B. A., Rivard, S. & Patry, M. (1996). A transaction cost approach to outsourcing behavior: Some empirical evidence. Information and Management, 30, 51-64.
- Barney, J. (1995). Looking inside for competitive advantage. Academy of Management Executive, 9, (4), 49-61.
- Barney, J. & Wright, P. (1998). On becoming a strategic partner: The role of human resources in gaining competitive advantage. Human Resource Management, 37, (1), 31-46.
- Barthelemy, J. (2003). The seven deadly sins of outsourcing. Academy of Management Executive, 17, (2), 87-100.
- Becker, B. E., Huselid, M. A. & Ulrich, D. (2001). The HR scorecard: Linking people, strategy, and performance. Boston: Harvard Business School Press.
- Belous, R. S. (1989). Human resource flexibility and equity: Difficult questions for business, labor, and government. Journal of Labor Research, 10, 67-72.
- Brockbank, W. (1999). If HR were really strategically proactive: Present and future directions in HR's contribution to competitive advantage. Human Resource Management, 38, (4), 337-352.

- Bureau of National Affairs. (2004). Human resource department benchmarks and analysis survey 2004. A BNA/SHRM Collaboration.
- Burns, T. & Stalker, G. M. (1961). The management of innovation. London: Tavistock Publications.
- Coase, R. H. (1937). The nature of the firm. Economica, 4, 386-405. Reprinted in G. J. Stigler & K. E. Baulding (Eds.) Readings in price theory 1952. Chicago: Irwin.
- Daft, R. L. & Lengel, R. H. (1986). Organization information requirements, media richness and structural design. Management Science, 32, 554-571.
- Ekelund, R. B. & Tollison, R.D. (1991). Macroeconomics, third edition. New York: Harper Collins.
- Ellram, L. & Carr, A. (1994). Strategic purchasing: a history and review of the literature. International Journal of Purchasing and Materials Management, 33, 13-20.
- Fuquay, J. (2005). EDS joins outsourcing venture. January 19, 2005, Business section, Fort Worth Star Telegram.
- Gainey T.W., & Klaas, B.S. (2003). The outsourcing of training and development: factors impacting client satisfaction. Journal of Management, 29, (2), 207-229.
- Galbraith, J. R. (1974). Organization design: An information-processing view. Interfaces, 4, 28-36.
- Gilley, K. M., Greer, C. R. & Rasheed, A. A. (2004). Human resource outsourcing and performance in manufacturing firms. Journal of Business Research, 57, 232-240.
- Gottfredson, M, Puryear, R. & Phillips, S. (2005). Strategic sourcing from periphery to the core. Harvard Business Review, 83, (February), 132-139.
- Greer, C. R. (2001). Strategy and human resources: A general managerial approach, 2nd ed. Upper Saddle River (NJ): Prentice-Hall.
- Greer, C. R., Youngblood, S. A., & Gray, D. A. (1999). Human resource management outsourcing: The make or buy decision. Academy of Management Executive, 13, 85-96.
- Gupta, U. & Gupta, A. (1992). Outsourcing the IS function: Is it necessary for your organization? Information Systems Management, (Summer), 44-50.
- Huber, G. P. (1991). Organizational learning: The contributing processes and the literatures. Organization Science, 2, 88-115.
- Jensen, J. & Rothwell, G. (1998). Transaction costs, regulation, and subcontracting at nuclear power plants. Journal of Economic Behavior and Organization, 36, 369-381.

- Kakabadse, A., & Kakabadse, N. (2002). Trends in outsourcing. European Management Journal, 20, 189-198.
- Klaas, B.S. (2003). Professional employer organizations and their role in small and medium enterprises: the impact of HR outsourcing. Entrepreneurship Theory and Practice, 28, 43-61.
- Klaas, B. S., McClendon, J. & Gainey, T. W. (1999). HR outsourcing and its impact: The role of transaction costs. Personnel Psychology, 52, 113-136.
- Klaas, B. S., McClendon, J. A. & Gainey, T. W. (2001). Outsourcing HR: The impact of organizational characteristics. Human Resource Management, 40, 125-138.
- Lawrence, P. R. & Lorsch, J. W. (1967). Differentiation and integration in complex organizations. Administrative Science Quarterly, 12, 1-47.
- Leiblein, M.J., Reuer, J.J., & Dalsace, F. (2002). Do make or buy decisions matter? The influence of organizational governance on technological performance. Strategic Management Journal, 23, 817-833.
- Lepak, D. P. & Snell, S. A. (1998). Virtual HR: Strategic human resource management in the 21st century. Human Resource Management Review, 8, 215-234.
- Lever, S. (1997). An analysis of managerial motivations behind outsourcing practices in human resources. Human Resource Planning, 20, 37-47.
- Levy, D. T. (1985). The transactions cost approach to vertical integration: An empirical examination. The Review of Economics and Statistics, 67, 438-445.
- Lynk, W. J. (1995). Non-profit hospital mergers and the exercise of market power. Journal of Law and Economics, 38, 437-461.
- MacDuffie, J. P. (1995). Human resource bundles and manufacturing performance: Organizational logic and flexible production systems in the world auto industry. Industrial and Labor Relations Review, 48, (2), 197-221.
- McDougall, P. (2005). EDS likely to open HR center in China. Feb 16 InformationWeek. www.informationweek.com/story/showArticle.jhtml?articleID=60401263
- Monteverde, K., & Teece, D. (1982). Supplier switching costs and vertical integration in the automobile industry. Bell Journal of Economics, 13, 206-213.
- Pommerenke, P. L. & Stout, S. K. (1996). Human resource departments and hospital labor strategies. Hospital & Health Services Administration, 41, 77-90.
- Porter, M. (1980). Competitive strategy: Techniques for analyzing industries and competitors. New York: Free Press.

- Rossetti, C. & Choi, T. Y. (2005). On the dark side of strategic sourcing: Experiences from the aerospace industry. Academy of Management Executive, 19, 46-60.
- Shelgren, D. (2004). Why HR outsourcing continues to expand. Employment Relations Today, 31, 47-53.
- Smeltzer, L., Manship, J. & Rossetti, C. (2003). Strategic sourcing and negotiation planning: an integration of processes. Journal of Supply Chain Management, 39, 16-26.
- Society for Human Resource Management. July (2004). Human resource outsourcing survey report. Alexandria, Virginia: SHRM Research.
- Speaker, A. W. Address at Texas Christian University, Forth Worth, TX (1999).
- Stewart, T. A. (1996). Taking on the last bureaucracy. Fortune, January 15, 105-108.
- Sutcliffe, K. M. & Zaheer, A. 1998. Uncertainty in the transaction environment: An empirical test. Strategic Management Journal, 19 (1), 1-23.
- Thompson, J. (1967). Organizations in action. New York: McGraw-Hill.
- Tushman, M. L. & Nadler, D. A. (1978). Information processing as an integrating concept in organizational design. Academy of Management Review, 3, 613-624.
- Velocci, A. (2001). Strategic sourcing mostly a neglected opportunity. Aviation Week & Space Technology, (April), 70.
- Vining, A. & Globerman, S. (1999). A conceptual framework for understanding the outsourcing decision. European Management Journal, 17, (6), 645-654.
- White, S. (2000). Competition, capabilities, and the make, buy, or ally decisions of Chinese state-owned firms. Academy of Management Journal, 43, 324-341.
- Williamson, O. E. (1975). Markets and hierarchies: Analysis and antitrust implications. New York: Free Press.
- Williamson, O. E. (1985). The economic institutions of capitalism. New York: Free Press.
- Williamson, O. E. (1986). Economic organization: Firms, markets and policy control. New York: New York University Press. Organizational Career Management System

Meghna Virick is a visiting assistant professor at the University of Texas at Arlington. She joined the faculty in 2003, after she completed her doctorate in business administration from the University of Texas at Arlington, specializing in Human Resource Management and Organizational Behavior. She earned her

Masters in Industrial Relations and Personnel Management from XLRI, India, and an MBA from Texas Christian University. Since January, 2003, Dr. Virick has been serving as Research Director of the North Texas Technology Council (NTTC), a non-profit organization that promotes North Texas as a leading and varied technology region. Her research interests are in the area of job loss, diversity, and work family conflict. She has published in journals such as Journal of Applied Psychology and Human Resource Management Review. She has made numerous presentations at the Academy of Management and Society of Industrial and Organizational Psychology.

David A. Gray is Associate Dean of the College of Business and Professor of Management. He was awarded the Ph.D. in Business Administration from the School of Management at the University of Massachusetts in 1974. His research interests have focused on aspects of human resource management and the labor relations process. More specifically, he has researched strategic and operational rationales of human resource outsourcing; the linkage of the HR value chain to the employee-employer psychological contract and the performance impact of various HR practices; and union management conflict and cooperation before and after labor-management relations by objectives, or RBO. The results of these and other research efforts have been published in the Academy of Management Review, Academy of Management Executive, California Management Review, OMEGA: The International Journal of Management Science, Journal of Labor Research, Journal of Collective Negotiations in the Public Sector, Journal of Business Research, and national proceedings of the Academy of Management and Industrial Relations Research Association.

Juliana Lilly is an Assistant Professor of Management at Sam Houston State University. She was awarded the Ph.D. in Business Administration from The University of Texas at Arlington in 2001. Dr. Lilly's research interests include organizational justice, psychological contract violations, outsourcing, and layoffs. She has published in journals such as Journal of Business and Public Affairs, Managerial Finance, and Journal of Applied School Psychology, and has made numerous presentations at the Academy of Management and regional affiliates.