

HR Outsourcing: Not a Panacea*

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As a market becomes more competitive, organizations face dilemmas in not only obtaining competitive advantages but also in becoming more efficient. The role of human resources (HR) functions is becoming more important; hence, HR outsourcing (HRO) is considered a way to be strategically effective and efficient. Thus, HRO continues to grow in market share and the needs it addresses, and its importance have been reviewed. Although most studies focus on the potential advantages of HRO or how to maximize its benefits, they often underreport the potential pitfalls. Thus, the aim of this paper is to organize both (encouraging and discouraging) perspectives of HRO and recommend an additional perspective to review before deciding on HRO by providing propositions. Rather than make an argument, this paper suggests that HRO decisions should be made based on a sound understanding of organizational status by comparing the pros and cons of HRO.

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I. Introduction

In order for organizations to survive a rapidly changing market environment, they must incorporate various mechanisms to sustain their competitive advantages. Considering that human resources (HR) are valuable assets for organizations, it is vital for organizations to maximize their ability to manage HR effectively.

Ulrich (1996) emphasized the importance of HR functions by suggesting four roles of HR: as (a) business partners, (b) change agents, (c) administrative experts, and (d) employee advocates. Various issues regarding those HR roles have been examined, and subsequently, HR outsourcing (HRO) has been considered one mechanism of achieving those objectives.

The importance and the acknowledgement of HR functions have increased (Glaister, 2014). HR functions began to be outsourced in the mid-1990s, although HR functions are traditionally handled internally. Cooke, Shen, and McBride (2005) explained that 97% of organizations have already adopted or partially adopted HRO. Other researchers have predicted that HRO will be expanded (Cooke et al., 2005; Cook & Gildner, 2006; Klaas et al., 1999). Delmotte and Sels (2007) explained that HRO is one domain that is greatly affected by outsourcing. Chiang, Chow, and Birtch (2010) also explain the popularity of HRO in Europe and North America, where over 90% of firms are either partially or fully outsourcing HR functions.

Early studies regarding HRO, such as Greer, Youngblood, and Gary (1999), have indicated increasing need for and necessity of HRO. This prediction seems to have been correct, since Shelgren (2004) indicated that HRO is one of world's fastest-growing industries. Many empirical studies have been published regarding trends in HRO (Gainey & Klaas, 2003) that discuss HRO and its related issues. Yet, despite extensive research regarding HRO issues to explore different functions, firm sizes, and industries as well as the benefits and their consequences, there has been a lack of discussion of some potential setbacks. In fact, a majority

of studies merely mention those issues but focus on the organizational benefits of HRO (Cooke et al., 2005; Stroh & Treehuboff, 2003).

Numerous studies have extensively analyzed this issue based on the five Ws and one H by reviewing wide spectrums of topics regarding HRO, from different functions to different nations, and recommended solutions for maximizing the effectiveness of HRO. Existing studies have explained that despite the cons of HRO, it generally improves organizational performance and thus should be considered as a valuable practice. However, although it can be argued that HRO may bring positive aspects to organizations, it neglects a fundamental question: Is HRO really a good thing to do?

Thus, in this paper, I aim to both review the existing major perspectives on HRO and present opposing perspectives about how HRO might result in inimical outcomes by organizing the pros and cons of HRO and explaining the possible consequent fallouts, as HRO is not a panacea for organizations.

II. Literature Review

Due to the different research focuses among studies, the term HRO has had different forms, such as professional employer organization (PEO) and recruitment process outsourcing (RPO). However, it has often been used with strategic outsourcing at organizational level, such as business process outsourcing and offshoring. Interestingly, there are fewer studies solely focusing on HRO than expected. Nevertheless, HRO has a relatively homogenous definition throughout the literature regarding how human resource functions are contracted out to external providers, instead of remaining in-house functions (Shih & Chiang, 2011). That is, organizations decide to contract out either part of or all their HR functions to outside contractors, as opposed to internally processing the functions using internal employees.

Cooke et al. (2005) and Klaas, McClendon, and Gainey (2001) have explained the need for HRO from two major perspectives: transaction cost economics (TCE) and the resource-based view (RBV). A reduction in transaction costs is one reason to support HRO, and both supporters and opponents of HRO agree on this benefit. Organizational decisions regarding HRO and its expected perceived benefits can be understood using the concept of TCE. As TCE emphasizes that decisions are made under market conditions and following opportunistic behavior, organizational decisions regarding HRO are based on calculations of the total transaction costs associated with obtaining inputs of expected output quality (Klaas et al., 1999). Thus, organizations choose the most efficient methods when they analyze production and coordination costs, which will lead them to opt for HRO. As previous studies have explained, one of the most popular reasons for organizations to outsource HR functions is demand for reducing HR costs. Whether due to low economic growth or a desire to maintain a competitive advantage in the market, issues of reducing costs are considered essential for obtaining better quality at lower costs, resulting in organizations opting for HRO (Adler, 2003; Delmotte & Sels, 2007).

The RBV is also one of the most considered aspects in organizational HRO decisions. While the TCE perspective focuses on economic reasons, the RBV approach differs by emphasizing issues of competitiveness (Ordanini & Silvestri, 2008). Based on the RBV, HRO can reorganize an organization's resources so that it can focus on its core competencies and thus become more strategic. According to the RBV, organizations that can focus on their core competencies will gain a competitive advantage in the market, which can increase their internal ability (Cooke et al., 2005).

Along with discussing these two major perspectives, studies also discuss Lepak and Snell's (1998) model of virtual HR, which involves functions that can be outsourced based on TCE and RBV. This model distinguishes among idiosyncratic, peripheral, traditional, and core activities based on the value

and uniqueness of HR functions and suggests that administrative work, which is relatively standardized, can be contracted out to external providers, whereas firm-specific and/or unique tasks needs to be completed in-house.

As part of discussion on which tasks should be externally processed or internally governed, researchers have examined different aspects of HRO. Seth and Sethi (2011) indicated that HRO is popular in the areas of employee assistance, pension and retirement plans, employee benefits, training, and payroll. In addition to these five aspects, other studies have also emphasized the benefits of HRO in the recruitment process (Cooke et al., 2005; Johnson, Wilding, & Robson, 2013).

Although the degree to which they recommend HRO varies, studies have indicated which functions should be outsourced to maximize effectiveness and increase organizational performance and which functions should remain internal and traditional (Cooke et al., 2005; Seth & Sethi, 2011).

As Cooke et al. (2005) explained, organizations are outsourcing training and development, recruitment and selection, pay and benefits, and workforce outplacement functions. Because the existing literature has argued that non-core activities should be outsourced, the functions that should be considered non-core activities should be discussed further.

III. Arguments For HRO

As presented above, there are two major perspectives for understanding HRO: TCE and RBV. Since HRO considers aspects of both efficiency and value, recommending HRO based on these two perspectives seems plausible. Proponents of HRO argue that HRO can be beneficial for organizations because it can save costs, increase efficiency, reallocate focus for core skills and activities, and provide external links for obtaining knowledge and information (Cooke et al.,

2005; Wehner, Giardini, & Kabast, 2014).

The first and most popular argument for recommending HRO is to reduce transaction costs. Klaas et al. (1999) explained that the difference between internal and external processes is in how transaction costs are generated. Because returns from efficiency are not diluted by need to share such returns across diversified organizations (internally), an external, market-based provider has relatively higher incentives for better performance. Also, with market competition factors playing a role, efficient completion of contractual obligations as well as greater economies of scale can be expected when multiple clients require similar services, allowing for efficient access to expertise. According to this perspective, due to the organizational hierarchy, HR being carried out internally offers smaller incentives, since it is less sensitive to market competition (such as supply and demand shifts), and can require higher levels of monitoring, as people might pursue subunit goals at the expense of ultimate organizational goals. Thus, from this perspective, organizations should use HRO to reduce transaction costs and liabilities. Another reason to outsource HR is because HRO can reallocate human capital in a more strategic and effective manner for organizations to obtain better competitive advantages.

While TCE heavily emphasizes efficiency issues, the RBV asserts that an organization's competitive advantage and better performance require distinctiveness in the organization's capabilities. Proponents of the RBV contend that organizational performance will be greater in the hands of internal employees, rather than external providers. Based on the RBV, internal resources should be focused on increasing the organization's competitiveness by focusing on its core and strategic functions and contracting out non-core functions, so that employees in the organization do not need to be bothered with non-core functions (Ordanini & Silvestri, 2008). As Cooke et al. (2005) argued, organizations can obtain a competitive advantage with HRO because external providers can introduce new perspectives that exploit internal strengths by reacting to external opportunities,

and HRO can neutralize external threats and minimize internal weaknesses.

Both perspectives suggest that in terms of both efficiency and competitiveness, HRO can encourage organizations to reduce costs, focus on more strategic functions, specialize in economies of scale, increase their flexibility, and learn from external providers. Despite concerns that HRO might hinder organizations' performances, existing studies present positive relationships (although varying in degree) between HRO and performances.

IV. Arguments Against HRO

Shih and Chiang (2011) explain that extant theories on HRO cannot fully explain how organizations can benefit from HRO in certain functions. Even though their hypothesis was partially supported, their entire framework was not validated. Thus, despite the fact that a majority of the existing studies show a positive relationship between HRO and performance, they also mention potential pitfalls of HRO, which are considered significant issues that should not be bypassed. These issues include a loss of in-house ability and knowledge, a loss of uniqueness, difficulty in controlling the quality of services and results, a decrease in employee morale, the loss of long-term competitiveness, and higher total costs (Greer et al., 1999).

There is a strategic danger that organizations can lose their capabilities permanently if they outsource HR functions. Although HRO continues to have an expanding presence in the market, issues regarding the retention of in-house expertise and knowledge require attention. As mentioned earlier, one of the foremost reasons why organizations decide on HRO is to reduce transaction costs, which means that organizations assume that those HR tasks are fully delivered the same way as when using in-house processes. However, is it safe to believe that assumption? It is hard to expect external providers to deliver

in-house expertise to new employees in the same way as in-house processes will because the external provider is not an insider (Hauser, 2011; Stroh & Treehuboff, 2003).

Similarly, HRO can cause an organization to lose its unique culture and long-term competitiveness. Perhaps by saving costs, HRO can be beneficial by allowing an organization to focus on its strategic functions in the short term; however, from a long-term perspective, it can hinder an organization from gaining the uniqueness that can differentiate it from its rivals. Because external providers can only provide information to new employees through external delegation, they are limited from fully knowing the internal culture, which can mislead new employees and may result in wrong person-organization fit. Also, considering that every HR function actually matters to each employee in the organization, it is better for employees to have internal bonding and monitoring HR functions to back up their need for improvement (Stroh & Treehuboff, 2003).

Furthermore, HRO tends to involve standardized processes, and outsiders lack firm-specific knowledge and can engage in opportunistic behavior. HRO can fail to incorporate each organization's distinctive characteristics and strategies. For instance, if HRO fails to differentiate among different strategies and mechanisms, it might not align with the organization's goal, and if that happens, even if transaction costs are reduced, the quality of service will decrease and the level of dissatisfaction will increase. Due to organizations delegating control through HRO, it becomes harder for organizations to control the expected quality of the outcomes (Cooke et al., 2005; Hauser, 2011).

Additionally, HRO can also affect employees' morale— how employees perceive HRO can affect employees' attitudes (Seth & Sethi, 2011; Stroh & Treehuboff, 2003). This can happen when employees see HRO as a threat, such as a downsizing of the organization: perceive that their role can be outsourced as well (since the organizational decision on HRO was due to the need to reduce costs,

in-house HR functions can be restructured, leading to issues of job security); or perceive that the HRO provider may fail to meet expectations. Considering that retaining employees and their abilities and talents is essential, organizations should carefully review this perspective.

V. Discussion

Interestingly, the relationships between HRO and performance show positive results. Although I do not disagree with results, at the same time, they evoke another question about whether the measure captured the appropriate factors. For instance, cost-cutting mechanisms showed a positive relationship with performance, but because the measure only captured prior transaction costs and did not capture costs after implementation, it does not consider how well contracted output intermingles with organizational processes. Hence, it seems necessary to establish what to measure and how to organize those measurement processes.

Furthermore, the literature lacks explanations on the decision processes on HRO. When choosing whether to support HRO, the decision should be made strategically by reviewing the core and non-core functions of HRO; however, existing studies focus on organizational-level decisions and pressures to lower the budget, which means that there is a possibility that the HRO decision is being made to reduce costs and not from a competency perspective.

One famous Asian saying emphasizes the importance of allocating HR, saying that management is getting things done through people—which means that it is people who make things happen and continue. Although there is competition among rivals in the market and a need for change and improvement, organizations must decide what will allow them to become most efficient and effective, and HRO can serve this purpose. Yet, this paper suggests another

perspective: the importance of a long-term vision. Since employees are ones who develop core competencies and continue to develop them to pass them on to the next generation, is it not worthwhile to invest in in-house functions? As we emphasize the importance of organizational culture, can HRO enhance the organizational culture or lead organizations to have a healthier organizational culture?

As Klaas et al. (2001) explained, HR processes cannot always be codified and calculated as transaction costs, but these processes and knowledge can reflect the organization's culture, since those processes and knowledge are accumulations of years of experience. It is hard to believe that outsourcing and discontinuing tradition can enhance organizational performance in the long term.

The recent review article on outsourcing by Lahiri (2016) explains that empirical studies on outsourcing yield five types of outcomes: positive, negative, mixed, moderated, and no significant outcomes. Although outsourcing yielded positive effects 31.6% of the time, they were negative 7% of the time, mixed 38.6% of the time, and had no significant effects 12.3% of the time, which is almost double the possibility of having a positive effect. This shows that although outsourcing in general may generate a positive effect, at the same time, it has much higher chances of creating non-positive effects. In this review article, unfortunately, no positive effects of outsourcing of HR functions were included, although a sample of negative effects of HRO was included.

Butler and Callahan (2014) examined the relationship between administrative HRO announcements and both short-term capital market response and long-term operating performance. HR outsourcing announcements between 1984 and 2005 were measured as the outsourcing measure, and cumulative abnormal returns, ROA, and operating ROA were used as performance measures. The results indicated that although there was a positive association between administrative HRO announcements and response by the equity capital market,

there was a negative relationship between suboptimal outsourcing and long-run operating performance.

As for mixed effects, Klaas et al. (1999) used the degree of outpouring in different areas of HR for designing and administering programs and policies as the outsourcing measure and the subjective benefits of HR outsourcing on an organization as the performance measure; they indicated that the relationship between the level of HRO and the perceived benefits of outsourcing was moderated by organizational variables such as idiosyncratic HR practices, the uncertainty facing the firm, firm size, and cost pressure. The results indicated that there is no support for moderating influences of pay level, overall outsourcing emphasis, or strategic HR decisions. As Lahiri's (2016) review on outsourcing indicates, outsourcing itself is not guaranteed to resolve issues, which goes back to the argument of this paper that decisions on HRO should be extensively reviewed before deciding on it.

VI. Propositions

As existing studies focus and indicate when to and when not to adopt HRO, the aim of this paper is to provide more steps and a wider spectrum of topics to consider before deciding on HRO. The importance of HR functions and the need to obtain a competitive advantage in the market are a strong argument in support of HRO. Competitive advantage means an ability in the market with which organizations outperform their counterparts. Thus, in order for an organization to have a competitive advantage, it should be superior to its rivals. However, if all organizations decide outsource HR and do not care about being different or their company spirit, then HRO may be beneficial in saving costs yet fail to maintain organizational cultures.

Based on explanations from existing studies, one potential issue is the

possibility of losing unique organizational characteristics. Further considerations should still be reviewed when an organization decides on HRO. Thus, I argue that organizations should consider short-term benefits and long-term costs simultaneously. The organization's culture and uniqueness should be reviewed carefully before contracting out functions. Although saving costs is important, if there is no organizational strength to be left, there is no point to saving costs in the first place.

Proposition 1: HRO can be beneficial in the short term for reducing costs; however, it can be harmful in the long term because it may cause the organization to lose some of its organizational culture and distinctive characteristics.

I want to raise the issue of measuring transaction costs. Evidence and empirical studies show that one strength of HRO is definably eliminating or at least minimizing transaction costs. Transaction costs occur when individuals/organizations participate in market dynamics. By definition, this shows that certain levels of labor and expenses are required to bring goods/services. Therefore, HRO can minimize transaction costs. However, I believe that an issue may occur afterward. Since initial phase processes (before actually implementing process within the organization) are being done by external providers, although organizations want to believe that external provider is diligently carrying out what they have contracted, the initial phase processes may not fully incorporate what the organizations initially expected. This means that when the outputs are returned to the organizations, the organizations may have to redo certain steps to ensure that the steps can be internalized, so that the organizations can actually use them.

While existing studies strongly emphasize HRO and transaction costs, it lacks reviews on when to measure transaction costs. Hence, I argue that

transaction costs should also be measured after implementing HRO outputs to an organization to see if the organization requires additional modification. If the organization does not require additional modification, it can be argued that HRO truly saves on transaction costs.

Proposition 2: HRO may reduce transaction costs for processes; however, when it is applied to internal processes, it may cause higher costs from for adjusting the process, which leads to higher total costs.

Another issue that needs attention before HRO is internal ability. Because technology and the market environment are rapidly changing, it is strategically correct to receive professional help from an external provider. However, an organization should thoroughly review whether that assistance from external experts is needed, whether it is needed in the short term (episodic), or whether those skills/abilities should be encouraged and trained within the organization so that help can be provided in-house and not by an external party. The aim of this argument is not to argue that external help is non-essential, but to explain that having a new additional perspective is different from rely on only that perspective. For example, while receiving consulting/recommending opinions and contracting out routine and non-core functions to an external provider can be beneficial, being fully dependent on a third-party expert means that in-house employees have no control over that function, which may cause issues in the long term, in that the function may be fully done by those experts and there will be no in-house knowledge of it (Seth & Sethi, 2011). If that pattern continues, in-house ability will keep decreasing, which means that the organization will lose its in-house ability and have more liability issues due to the external provider (Greer et al., 1999).

Proposition 3: HRO can allow organizations to access experts to receive assistance, which increases effectiveness and offers higher possibilities of better performance; however, it may increase an organization's dependency on external providers. Internal abilities may decrease, which can weaken an organization's capabilities and increase its liabilities.

As Klaas et al. (2005) explain, although all organizations aim to have effective HR functions, small and medium organizations face difficulties because they lack the economies of scale needed to build effective HR systems. For small and medium organizations with 500 or fewer employees, Klaas et al. (2005) argue that HRO can be helpful in providing effective HR mechanisms. In their study, PEO was suggested for dealing with HR issues because it not only provides transactional aspects but also human capital - enhancing services. For organizations with few employees and less infrastructure than large-scale organizations, it becomes even more vital to strategically decide what to focus and develop. In this case, for small and medium organizations that aim to have effective HR functions yet do not have the ability to fully provide or implement such functions, then it is probably better to outsource HR and strategically decide to focus on developing the organization's core functions to maximize their competitive advantage in the market.

Proposition 4: HRO can be suggested to small- and medium-sized organizations, since unlike large organizations, organizations of that size cannot afford to have the necessary HR functions and strategic processes.

With the assumptions from existing studies and the above propositions, the goal of this paper is for organizations to review simple questions that can be

applied when considering HRO.

Questions:

Question 1: Is this function or job only available from an external expert?

If the answer is yes, then the organization may decide to outsource HR.

If the answer is no, then move to Question 2.

Question 2: Does this function or job remain unique (i.e., with company spirit) even after outsourcing?

If the answer is yes, then move to Question 3.

If the answer is no, then the organization may decide not to outsource HR

Question 3: When this function or job is outsourced, will it require huge efforts to internalize?

If the answer is yes, then move to Question 4.

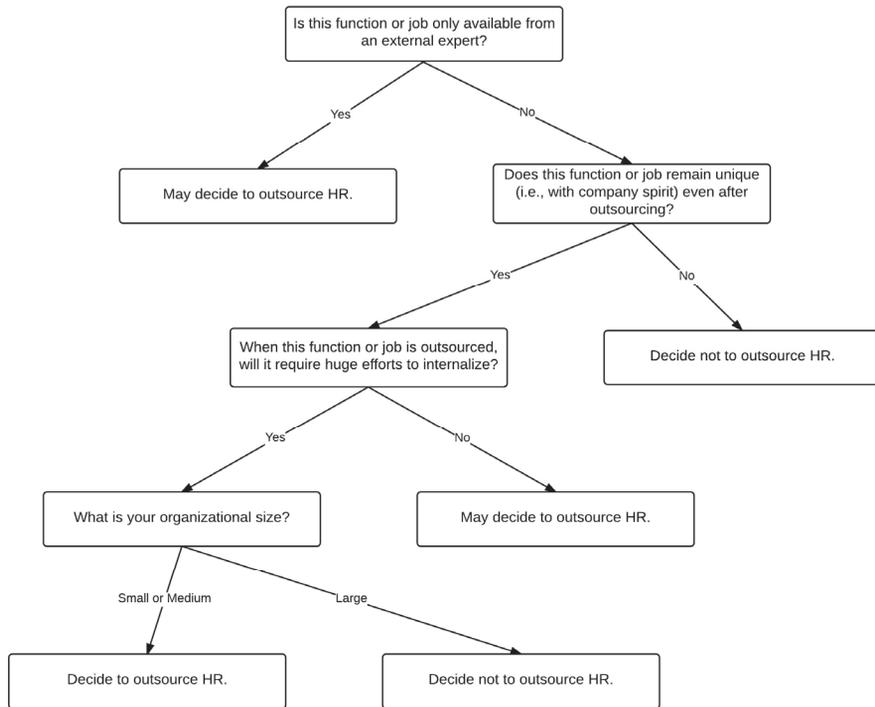
If the answer is no, then the organization may decide to outsource HR.

Question 4: What is your organizational size?

If the answer is small or medium, then decide to outsource HR.

If the answer is Large, then the organization may decide not to outsource HR.

The following is a decision tree based on above questions for organizations to review before deciding HRO.



<Figure 1> Decision Tree for HRO

VII. Conclusion

The aim of this paper was to present both points of view regarding HRO, rather than to argue for suspending HRO. Organizations can make their decision by understanding both sides equally. In reviewing the literature regarding HRO, I have seen that although practitioners continue to expand HRO, the volume of academic research on HRO has not caught up to the speed of HRO's spread (Shih & Chiang, 2011). Existing studies have mentioned how cost reduction is critical to survive and how vital it is to gain a competitive advantage in the market. As the economy is not doing well, costs have become a critical issue, and as competition continues to increase, the necessity of competitiveness

has become predominant. HR outsourcing can be suggested to small and medium size organizations, since unlike large organizations, organizations of that size cannot afford to have needed HR functions and strategic processes.

As emphasized throughout the paper, decisions on HR outsourcing should be reviewed exhaustively and made strategically. Abdul-Halim et al. (2016) show that while traditional and transaction HR functions show strong positive results after adopting HRO, non-core and routinized work may be even better to outsource. However, this paper explains the perspective that when large and well-established organizations outsource HR for cost-saving purposes, it may be helpful in the short term for saving money, but it may cost even more over the long term due to the organizations losing their characteristics and organizational culture, internalizing processes, and issues of dependency and liabilities, although it can be beneficial for small and medium organizations that cannot afford to create and manage HR processes without HRO.

An organization's decision on HRO affects various aspects of organization and its employees as well as its market competition. It not only shapes the cost structure but also affects the work process and employees' morale. Thus, when HRO is successful, it can be beneficial to the organization, but when the decision is poorly made, it can result in harmful outcomes for the organization. Thus, organizations should consider not only the general pros and cons of HRO but also whether it fits with each organization's unique background and situation.

Existing studies have explained the pros and cons of implementing or not implementing HRO, but they focus more on how to do so and what contexts or which functions to be outsource. This is why a majority of the HRO literature discusses core and non-core functions. Subsequent studies have expanded upon and also developed from that framework. However, having this type of perspective for organizations to review before deciding on HRO can be helpful for organizations to yield positive outcomes.

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HR 아웃소싱에 관한 연구

정 현 선*

요 약

시장에서의 경쟁이 심화됨에 따라, 기업은 인적자원을 통한 경쟁 우위를 확보하는 동시에 시장방향에 효율적으로 대응해야 하는 상황에 봉착하게 된다. 이런 측면에서 HR 아웃소싱은 전략적으로 기업 이익을 극대화하고 생산성 향상을 도모할 수 있는 수단으로 사용되고 있다. 이에 걸맞게 HR 아웃소싱은 시장에서 꾸준히 영역을 확장하고 있으며 HR 아웃소싱의 필요성과 중요성이 관련 연구 등을 통해 뒷받침되고 있다. 대다수 연구들이 HR 아웃소싱의 잠재적인 효과와 이윤 창출 극대화 방법에 초점을 맞추면서, HR 아웃소싱이 초래할 수 있는 내재적 위험성을 종종 간과하는 경향이 있다. 그런 측면에서 본 연구의 목적은 HR 아웃소싱 도입 결정에 앞서 HR 아웃소싱의 긍정적·부정적 요인을 짚어보면서, HR 아웃소싱이 가장 효과적일 수 있는 상황을 제안하고자 한다. 본 연구는 논쟁을 야기하고자 함이 아니라, HR 아웃소싱 도입은 기업이 처한 여건 및 상황에 근거를 두면서 HR 아웃소싱의 찬반 양면을 철저히 분석한 후 시행되어야함을 강조하고자 한다.

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