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# **Americas Conference on Information Systems AMCIS2009 San Francisco Human Resources Systems Outsourcing as a Source of Sustained Competitive Advantage: Proposal for an Empirical Investigation**

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## **ABSTRACT**

The global outsourcing industry, including the Human Resources (HR) Systems outsourcing industry is growing at a phenomenal rate. The proponents of the resource-based view (RBV) have long argued that a firm gains sustainable competitive advantage from those resources and capabilities it controls and which are valuable, rare, imperfectly imitable, and not substitutable. The RBV also indicates that HR systems can be a source of sustained competitive advantage. What happens when such HR systems are outsourced? Does HR systems outsourcing itself become a source of sustained competitive advantage for a firm? Is there any relation between whether a firm perceives its HR systems to be a source of sustained competitive advantage or not and its decision to outsource its HR systems? These are the questions that this study seeks to address.

## **Keywords**

Human Resources (HR)/ human resources information systems (HRIS)/human resources (HR) systems outsourcing, competitive advantage, resource-based view (RBV), event study.

## **INTRODUCTION**

Barney (1991) states that according to the resource-based view (RBV), a firm derives sustained competitive advantage from the resources and capabilities it controls and which are valuable, rare, imperfectly imitable, and not substitutable. According to Barney (1992), Reed and DeFillippi (1990), and Wright and McMahan (1992), the RBV also indicates that HR systems can be a source of sustained competitive advantage (Lado and Wilson, 1994). What happens when such a resource and capability that is a potential source of sustained competitive advantage for a firm is outsourced? Does HR systems' outsourcing itself become a source of sustained competitive advantage for a firm? Is there any relation between whether a firm perceives its HR systems to be a source of sustained competitive advantage or not and its decision to outsource its HR systems? Based on a review of the existing research on HR outsourcing and competitive advantage, there appears to be a gap in research with regard to these questions. Therefore, it is endeavored to address these questions in this study.

## **THE RESOURCE-BASED VIEW**

The RBV postulates that firms gain and sustain competitive advantages by deploying valuable resources and capabilities that are inelastic in supply (Ray, Barney and Muhanna, 2004). According to Porter (1991, p.108), "resources are not valuable in and of themselves, but they are valuable because they allow firms to perform activities...business processes are the source of competitive advantage" (Ray et al., 2004, p.26). Barney (1991) theorizes that the resource-based logic implies that "business processes that exploit valuable, but common resources can only be a source of competitive parity; business processes that exploit valuable and rare resources can be a source of temporary competitive advantage; and business processes that exploit valuable, rare, and costly-to-imitate resources can be a source of sustained competitive advantage" (Ray et al., 2004, p.26). According to Barney (1991), a firm derives sustained competitive advantage from the resources and capabilities it controls and which are valuable, rare, imperfectly imitable, and not substitutable (Barney, Wright and Ketchen Jr., 2001). Further these resources and capabilities are tangible and intangible assets that include a firm's management skills, its organizational processes and routines, and the information and knowledge that it controls (Barney et al., 2001).

### Organizational Competencies: Resources and Capabilities

According to Amit and Schoemaker (1993), a firm's resources include the tangible and intangible, human and non-human input factors owned or controlled by a firm and entering the production of goods and services in order to satisfy human wants (Lado and Wilson, 1994). Based on the research of Dierickx and Cool (1989), organizational capabilities are "the dynamic, nonfinite mechanisms that enable the firm to acquire, develop, and deploy its resources to achieve superior performance relative to other firms" (Lado and Wilson, 1994, p.701). Organizational competencies have been defined as the "firm-specific resources and capabilities that enable the organization to develop, choose, and implement value-enhancing strategies"; and they "include all firm-specific assets, knowledge, skills, and capabilities embedded in the organization's structure, technology, processes, and interpersonal (and intergroup) relationships" (Lado and Wilson, 1994, p.702).

### HR SYSTEMS: A SOURCE OF SUSTAINED COMPETITIVE ADVANTAGE

According to Barney (1992), Reed and DeFillippi (1990), and Wright and McMahan (1992), the resource-based view indicates that HR systems can be a source of sustained competitive advantage when they facilitate "the development of competencies that are firm specific, produce complex social relationships, are embedded in a firm's history and culture, and generate tacit organizational knowledge" (Lado and Wilson, 1994, p. 699). *A human resources (HR) system has been defined as a "set of distinct but interrelated activities, functions, and processes that are directed at attracting, developing, and maintaining (or disposing of) a firm's human resources" (Lado and Wilson, 1994, p. 701). Throughout this paper the term 'HR systems' will be used to convey the definition given by Lado and Wilson (1994). By this definition 'HR systems' include HR computer information systems, HR paper-based information systems, and any HR activities, functions and processes directed at attracting, developing, and maintaining a firm's human resources. Moreover, in this paper, HR systems outsourcing and HR outsourcing will be used interchangeably and will fit the given definition of HR systems.*

It is to be noted that such an all encompassing definition of HR systems might lead to some critiques that demand a separation between HR activities and HR information systems. But the given catch-all definition of HR systems will be used in this paper as it is considered to be more apt for the research goals of this study.

Brockbank (1999) argues that current business conditions require HR agendas and processes to provide greater competitive advantage. In fact, Pfeffer (1994) even went on to reject alternative sources of competitive advantage and championed the case for 'managing people right' (Bacon, 2001). Based on these research postulates, if it is assumed that HR systems can be a source of sustained competitive advantage when they facilitate the development of organizational competencies, then what happens when such HR systems are outsourced? What is the impact of HR outsourcing on a firm's competitive advantage? Is there any relation between whether a firm perceives its HR systems to be a source of sustained competitive advantage or not and its decision to outsource its HR systems? Why are HR systems being outsourced (the drivers)? What types of HR systems are being outsourced (HR outsourcing categories and vendor-based industry segments)? An effort is made to address some of these questions through this study.

### OUTSOURCING

Outsourcing can be defined as a relationship in which a company enters into a contract with a vendor who is willing to provide skills, knowledge, technology, service and manpower for an agreed-upon price and period to perform functions the client no longer wants to do (Adler, 2003). Organizations dissatisfied with their back-office processes and functions in areas such as human resources, information technology, indirect procurement, finance and accounting are turning to outsourcing some or all of these functions to business process outsourcing providers (BPOs) (Feeny, Lacity and Willcocks, 2005). Senior executives are usually dissatisfied with some of the processes and functions because they are perceived to be "too costly to operate, limited in their capabilities, and frustratingly slow" (Feeny et al., 2005, p.41). According to Feeny et al. (2005) some BPO providers are capable of providing upfront capital to convert cumbersome, decentralized human resources and administrative systems into shared utilities that can then be delivered through new offices, new business processes and web-enabled technology.

### HR SYSTEMS OUTSOURCING

According to a survey of HR Outsourcing Trends, a research report by The Conference Board and sponsored by Accenture HR Services, two-thirds of the surveyed companies currently outsource a major HR function (Pollitt, Gelman and Dell, 2004). An interesting finding of this study was that rarely did a company stop outsourcing after having once started it and additionally it was found that only less than one percent of outsourced HR functions have been in sourced or brought back in-house (Pollitt et al., 2004).

According to Mark Hodges (formerly associated with Exult, one of the largest HR outsourcing firms and now a consultant), more than 20 HR processes are being outsourced in five major “towers” of related HR work: compensation and benefits, organization and people development, employee data management, workforce planning and deployment, and human capital services (Stopper, 2003). If Hodges provides summary categories of outsourced HR processes, Tomback (2003) provides a list of HR processes that can be outsourced. These HR services include: employee data and records management, payroll, health and welfare plans, COBRA, flexible spending and transportation reimbursement accounts, defined benefits plans, defined contribution plans, executive benefits, work/life programs, leaves of absence, tuition reimbursement, family medical leave act, severance/separation, performance management, recruiting/staffing, candidate assessment and selection, candidate pool management, new employee orientations, performance management, and vendor management (Tomback, 2003). Beginning with payroll processing; now the field has evolved to a stage where it is possible to outsource virtually any HR activity (Adler, 2003). If the world economy has reached such a stage where it is possible to outsource any HR activity, then it definitely begets the question as to why companies are outsourcing their HR activities.

### **The Drivers of HR Systems Outsourcing**

According to Adler (2003), the changing business environment has an impact on the pros and cons for HR outsourcing. Adler (2003) has identified the following factors shaping the field of HR outsourcing: conflicting pressures in the labor market, to provide more value at lower cost, changing complexity of the legal environment, challenge of merging heterogeneous HR systems owing to mergers and acquisitions and globalization, and the development of technology.

### **HR Systems Outsourcing Types and Vendor-Based Industry Segments**

Klaas McClendon and Gainey (2001) classified HR outsourcing into the following four types: HR generalist activities (e.g., HR planning, performance appraisal), transactional activities (e.g., payroll), human capital activities (e.g., training), and recruiting and selection.

The HR outsourcing providers/vendors can be classified into three industry segments as observed by Adler (2003). These three segments are consultants, administrative-service providers and technology enablers (Adler, 2003). The HR consultants according to Adler (2003) specialize in providing expertise on compensation, stock-option plan design, employee benefits and workplace diversity. The providers in this industry segment include “large organizations such as Hewitt Associates, Towers Perrin, Mercer Human Resource Consulting and Watson Wyatt Worldwide, as well as a number of smaller, more specialized firms” (Adler, 2003, p.54).

Administrative-service providers manage activities such as payroll and benefits processing and can sometimes in turn outsource certain niche activities such as the management of workers’ compensation and COBRA (Adler, 2003). The dominant players in this segment are back-end processing-centric vendors such as Automatic Data Processing Inc. (ADP) and front-end Web-centric firms such as eBenefits Inc. (Adler, 2003).

Technology enablers help companies to continue managing their back-office HR processes in-house by usually providing customized or packaged HR software (Adler, 2003). The technology enablers usually provide implementation, software maintenance, data management, network access and round-the-clock support while the client provides the functional HR professionals needed to use the system (Adler, 2003). This segment also includes “traditional IT consultants that have formed partnerships to gain access to HR capabilities (for example, Unisys Corp. with Exult and IBM with Synhrgr HR technologies)” (Adler, 2003, p.55).

## **HR SYSTEMS OUTSOURCING: THEORETICAL FOUNDATION**

### **Role of Transaction Costs and Impact of Organizational Characteristics**

Klaas, McClendon and Gainey (1999) used the perspective of Transaction Costs Economics (TCE) to examine whether organizational-level factors acted as a moderator in the relationship between the degree of reliance on HR outsourcing and the perceived benefits of outsourcing. While on the one hand according to Csoko (1995) HR outsourcing can provide economies of scale, increase incentives and accountability, increase access to specialized expertise, and thus, reduce costs; on the other hand according to Ulrich (1996), there are instances when outsourcing has limited the development of distinctive competencies and created inefficiencies because of lack of firm-specific knowledge on the part of contractors and their opportunistic behavior (Klaas, Mc Clendon and Gainey, 1999). Why is there such variation in the effects of HR outsourcing? Klaas et al. (1999) argue that not much is known about the source of this variation, but believe that transaction costs economics provides a framework that would help understand the conditions in which HR outsourcing leads to benefits. According to the transaction costs economics, in the process of obtaining inputs, firms choose between alternative

governance structures (e.g., market contracting when outside suppliers are chosen and as stated by Milgram and Roberts (1990), organizational hierarchy when internal employees are relied upon) (Klaas et al, 1999). It is further stated by Klaas et al. (1999) that firms strive to choose governance structures that minimize the total transaction costs pertaining to the acquisition of inputs of a desired level of quality. Seeming to flow from this, Klaas et al (1999) studied whether organizational factors moderated the relationship between the degree of reliance on HR outsourcing and the perceived benefits of outsourcing. It was found that “idiosyncratic HR practices, uncertainty, firm size, and cost pressures all moderated the relationship between the amount of outsourcing and the perceived benefits” (Klaas et al, 1999, p.129).

Klaas et al. (1999) clarify that even though cost considerations are important, there are other motivations and benefits for outsourcing such as access to specialized expertise, increased quality of services, and time savings.

### Other Theoretical Considerations

Klaas, Gainey, McClendon and Yang (2005) used social network theory, transaction cost economics, and social exchange theory and examined how professional employer organizations (PEOs) and client characteristics moderate the impact associated with outsourcing human capital-enhancing services in small and medium enterprises. PEOs refer to those organizations that specialize in HR management and offer a wide array of services such as payroll management, employee benefits design and administration, tax filing and administration and compliance with state and federal workplace legislation (Katz, 1999). According to Granovetter (1982) and Hansen (1999), the social network theory indicates that the role of communication patterns is highlighted in knowledge transfer (Klaas et al., 2005). Thus, the different theoretical patterns seem to suggest that “PEO-client communication patterns are likely to moderate the impact associated with using human capital-enhancing services” (Klaas et al., 2005, p.240).

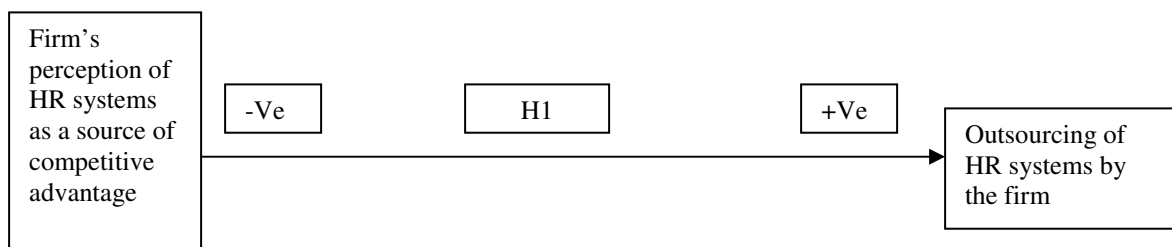
### HR SYSTEMS OUTSOURCING AND RBV THEORY

In the previous section, the different theoretical perspectives that have been used in existing research to explain human resources outsourcing were briefly discussed. In this section however, an attempt will be made to examine HR systems outsourcing through the lens of the RBV theory and thereby, address some of the questions raised in the earlier sections of the paper.

### Perceptions of Competitive Advantage and Decision to Outsource HR Systems

According to Barney (1992), Reed and DeFillippi (1990), and Wright and McMahan (1992), the RBV indicates that human resources systems can be a source of sustained competitive advantage (Lado and Wilson, 1994). But do firms view their HR systems as a source of sustained competitive advantage? Is a firm that views its HR systems as a source of sustained competitive advantage, less likely to outsource its HR systems? This leads to the first hypothesis.

*Hypothesis 1: The outsourcing of HR systems by a firm is associated with a perception in the firm that those HR systems are not a source of competitive advantage.*



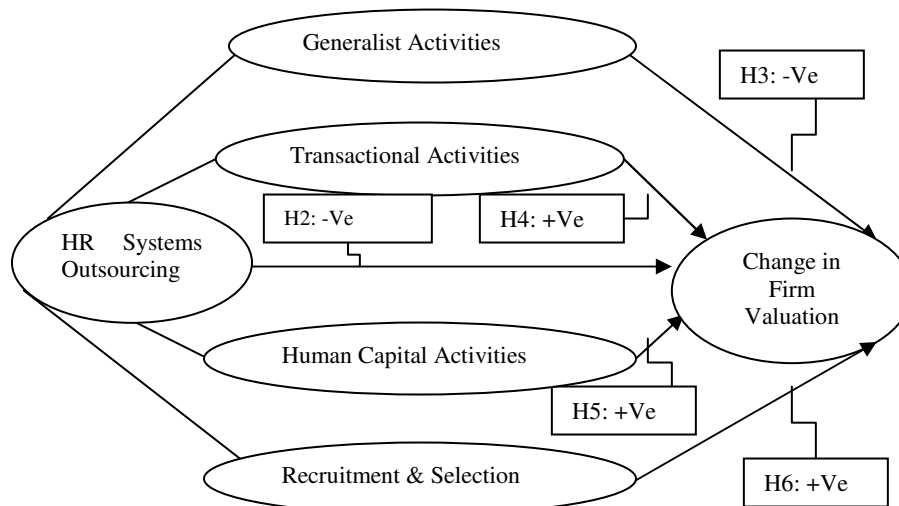
**Figure 1. Relationship Between a Firm's Perception of its HR Systems as a Source of Competitive Advantage and its Decision to Outsource the HR Systems**

### HR Systems Outsourcing as a Source of Sustained Competitive Advantage

As stated earlier, the RBV indicates that human resources systems can be a source of sustained competitive advantage (Lado and Wilson, 1994). What happens when such a resource and capability like HR systems that is a potential source of sustained competitive advantage for a firm is outsourced? Does HR outsourcing itself become a source of sustained competitive advantage for a firm? According to Quinn (1994), when a company's internal HR is not best-in-world and the company has no inclination to invest and make it the best, spending resources on internal HR will make it lose competitive advantage against companies that strategically outsource their HR (Jeffay, Bohannon and Laspisa, 1997). It is further argued that through outsourcing HR, "the competitor has access to the best-in-world HR services to do it better, faster and cheaper" (Jeffay et al., 1997, p.42). Switser (1997) reports that KPMG's second annual survey, titled "Companies Increasingly Look to Outsourcing for Competitive Advantage", found that corporate executives consider business process outsourcing as a strategic tool that will help their businesses to stay competitive and reap the benefits of efficiency and cost effectiveness. This is very valuable information as it shows the perspective of executives. But, does this translate into market reality? Does HR outsourcing really prove to be a source of sustainable competitive advantage? In order to find out the answer to this question, it is proposed to use the event study methodology and examine market reactions to HR outsourcing announcements. This will help to determine whether the RBV perspective that HR is a source of sustained competitive advantage holds much relevance in the present day scenario where HR outsourcing is viewed as a means to gain the comparative cost advantage. This leads to the following hypothesis, which is also depicted in Figure 2:

*Hypothesis 2: Announcements of HR systems outsourcing will lead to a negative change in firm valuation.*

As seen earlier, according to Klaas et al. (2001), HR outsourcing can be categorized into the following four types: HR generalist activities (e.g., HR planning, performance appraisal), transactional activities (e.g., payroll), human capital activities (e.g., training), and recruiting and selection. Moreover, according to Klaas et al. (2001), different organizational characteristics may influence the viability of outsourcing some forms of HR activities more than the others, and thus result in different determinants for various forms of HR outsourcing. Extending this thought, it can be proposed that announcements of different forms of HR outsourcing will lead to a different impact on firm valuation. This leads to the following hypotheses, which are depicted in Figure 2.



**Figure 2. Impact of HR Outsourcing on Firm Valuation**

Outside agencies are usually not familiar with an organization's culture and work related norms, and therefore, would not be qualified enough to handle some of the generalist activities like performance appraisal. Klaas et al. (2001) found that there is a negative relationship between a firm's idiosyncratic HR practices and the level of outsourcing of HR generalist activities.

Therefore, it can be assumed that since generalist activities like performance appraisal are so rooted in a firm's unique idiosyncratic approaches, the levels of outsourcing such generalist activities would be lower. Thus, any outsourcing announcement of such generalist activities should have a negative impact on firm valuation.

*Hypothesis 3: Outsourcing announcements of HR generalist activities (e.g., performance appraisal) will lead to a negative change in firm valuation.*

According to Stroh and Treehuboff (2003), one of the most widely outsourced functions in HR is benefits administration. Stroh and Treehuboff (2003) state that according to a survey conducted by Buck Consultants in 2000, for more than 10 years many firms have been outsourcing benefits plans, health and welfare programs, and retiree benefits administration. The possible reason for this has been attributed to the fact that payroll and benefits administration are not profit-producing or core business missions (Stroh and Treehuboff, 2003). According to Laabs (1993), outsourcing functions such as payroll and benefits administration helps the HR professionals to focus more attention on creating business strategies that have a positive impact on the bottom line (Stroh and Treehuboff, 2003). Based on a survey of 25 organizations, Greer, Youngblood, and Gray (1999) found that HR outsourcing could enhance the HR value chain and support the development of HR as a business partner and thus, a strategic contributor to the goals of the organization. According to Lawler III, Ulrich, Fitz-enz, and Madden (2004), outsourcing transactional activities can reduce cost, provide higher service quality, access to state-of-the art processes, and can redirect the HR department's focus towards making strategic contributions to the company (Chait, 2005). This implies that outsourcing transactional activities such as payroll are of benefit to the firm and therefore, their announcements should lead to a positive change in firm valuation.

*Hypothesis 4: Outsourcing announcements of HR transactional activities (e.g., payroll) will lead to a positive change in firm valuation.*

Stroh and Treehuboff (2003), say that training is one of the first functions to suffer when a company faces budgetary constraints and is looking at cost cutting measures. They argue that outsourcing training offers cost savings (Stroh and Treehuboff, 2003). The five main reasons for which companies outsource training and development are given by Lever (1997) as follows: "(1) there are a wide variety of vendors to choose from; (2) training practices and procedures are changing frequently; (3) the company's training needs are unpredictable; (4) the training required is specific to the hiring organization; and (5) employee training is necessary for the organizations to reach its goals" (Stroh and Treehuboff, 2003, p.22).

It was found that "outsourcing resulted in increased performance in the training area and improvements in the design and delivery of training" (Gainey, Klaas and Moore, 2002, p.16). Klaas et al (2005) found that in small and medium enterprises, outsourcing human-capital enhancing services (e.g., organizational development, training, employee relations, staffing, performance management, and rewards) to professional employer organizations (PEOs) was positively related to HR outcomes (e.g., attraction and retention, employee performance and skill level, and employee motivation and morale). All these reasons indicate the positive benefits associated with outsourcing training, and imply that outsourcing training and other human capital activities should be of benefit to the organization and therefore, their outsourcing announcements should lead to a positive change in a firm's valuation.

*Hypothesis 5: Outsourcing announcements of human capital activities (e.g., training) will lead to a positive change in firm valuation.*

According to Stroh and Treehuboff (2003), the best of training cannot make up for poor hiring decisions. For companies that do not recruit on a routine basis, outsourcing this aspect of HR is an attractive option as it provides them with the expertise that they might lack and reduces the time taken for the recruitment process (Stroh and Treehuboff, 2003). According to Spee (1995), Byham and Riddle (1999), and Hays (1999), for organizations that do not have HR staff with advanced computerized skills, the benefits gained through outside agents who provide technological sophistication and global capabilities are attractive (Stroh and Treehuboff, 2003). Because of these reasons, we believe that outsourcing recruitment and selection could be of advantage to the firm and therefore, any such outsourcing announcement should result in a positive change in a firm's valuation.

*Hypothesis 6: Outsourcing announcements of recruitment and selection will lead to a positive change in firm valuation.*

## METHODOLOGY

In order to test the first hypothesis, announcements of HR outsourcing will be collected. Then the firms that are outsourcing their HR systems will then be contacted to find out whether they viewed their HR systems as a source of sustained competitive advantage or not. Then it will be determined whether there is a positive relationship between a company's decision to outsource and its perception of whether HR is a source of sustained competitive advantage or not.

In order to test the remaining four hypotheses, the event study methodology will be used. The objective here will be to study the stock price behavior of firms making a HR outsourcing announcement. In order to do this, an event study on the lines of the study done by Chatterjee, Richardson, and Zmud (2001) on the impact of announcements of newly created CIO positions on the firm's stock price behavior will be done. The extent of HR outsourcing will be classified according to the categories proposed by Klaas et al. (2001), which are as follows: HR generalist activities (e.g., HR planning, performance appraisal), transactional activities (e.g., payroll), human capital activities (e.g., training), and recruiting and selection. It will be ensured that the firms used in the study would be public companies that are listed on NYSE or NASDAQ and are also included in the Center for Research for Security Prices (CRSP) daily stock returns file. It will also be ensured that the stock price behavior of the firms under study is attributable solely to the outsourcing announcements and not due to any other events. To ensure this, it will be determined if news such as earnings, dividends, or any other major announcements on the day before, the day of, or the day after the outsourcing announcement might contaminate the price data. Moreover, since the current economic downturn has impacted the stock market as a whole, care will be taken to ensure that the HR systems outsourcing announcements will be collected from an earlier time period which was not marked by extreme volatile economic/market fluctuations. Following the event methodology approach, the stock prices of the firms would be reported for the day before the announcement, the day of the announcement, and the day after the announcement. Thus, by using the event methodology the hypotheses will be tested to determine whether HR outsourcing is a source of sustained competitive advantage or not.

## CONCLUSION

Based on a review of research on HR outsourcing, it has been found that the empirical articles on HR outsourcing have focused on the role of transaction costs (Klaas et al., 1999), impact of organizational characteristics (Klaas et al., 2001), moderator effects of PEO and client characteristics on outsourcing human capital-enhancing HR services (Klaas et al., 2005), the rationale and consequences of HR outsourcing (Greet et al., 1999), outsourcing the training function (Gainey et al., 2002), and managerial motivations behind outsourcing practices (Lever, 1997). According to Barney (1992), Reed and DeFillippi (1990), and Wright and McMahan (1992), the resource-based view can be a source of sustained competitive advantage (Lado and Wilson, 1994). Brockbank (1999) and Bacon (2001) have also written about HR as a source of competitive advantage. The questions raised in this study are: "What happens when such a resource and capability that is a potential source of sustained competitive advantage for a firm is outsourced? Does HR outsourcing itself become a source of sustained competitive advantage for a firm?" It is believed that the proposed research study will address these questions and thus, make a value-added contribution to research on HR systems outsourcing.

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