

CHAPTER 2 : LITERATURE REVIEW

This chapter on literature review has nine sections. The first section is about the different definitions of outsourcing. Section two is about various types of outsourcing. Section three focuses on the Information Technology Outsourcing (ITO). Section four presents a brief idea about the Business Process Outsourcing (BPO). Section five deals with the advantages and disadvantages of outsourcing, in general. Section six gives an account of Human Resource Outsourcing (HRO), its growth, advantages and disadvantages, types and the reasons for HRO. Section seven presents the relationship between HRO, organizational characteristics and market variables. Section eight gives information about the HRO and Firm performance relationship. Finally, section nine is about the theoretical perspective which presents Transactional Cost Economics (TCE) and Resource Based View (RBV) of the firm.

1.1 Defining Outsourcing

Outsourcing is a key business practice. The visibility of outsourcing has gone up vividly in the few decades, especially in Information Technology and Business Process Outsourcing. However, there is little agreement among the academic scholars about the definition of ‘outsourcing.’ There are dozens of definitions of outsourcing in the literature, but we have used only the most pertinent of them in this study.

According to Brown and Wilson (2005, p. 24) outsourcing is “the act of obtaining services from an external source.” Kern, Willcocks and Heck (2002) have defined the Information Technology Outsourcing (ITO) as “the practice of contracting out or selling the organization’s IT assets,

people and/or activities to a third party supplier for monetary payments over an agreed time period.” Kern, Willcocks and Heck (2002) definition can be linked with Human Resource Outsourcing as it also takes people into consideration for outsourcing through a third party vendor.

In the book titled “The Outsourcing Process: Strategies for Evaluation and Management,” McIvor (2005, p.7) defined outsourcing as “... sourcing of goods and services previously produced internally within the sourcing organization from external suppliers.” The important aspect of this definition is that it does not take into account that some HR processes are still performed internally. Linder (2004, p. 27) points out that “outsourcing is purchasing ongoing services from an outside company that a company currently provides, or most organizations normally provide for themselves.” This definition expands the gamut of outsourcing, unlike McIvor (2005), to the fact that organizations do provide some services for themselves. Going beyond the narrow definition of outsourcing, Lee and Hitt (1995, p. 836) provided a broader definition for outsourcing as “the reliance on external sources for the manufacturing of components and other value adding activities.” This definition encompasses almost every activity so long as it is adding value to that activity.

Mol (2007, p.3-4) defined outsourcing in three broad ways:

- a) “Outsourcing refers to those activities that are undertaken by outside suppliers.”
- b) “Outsourcing refers to the transfer of activities and possibly assets from a firm to an outside supplier.”
- c) “Outsourcing refers to those activities that are undertaken by outside suppliers but could also be undertaken by the firm.”

This study adopts the broader definition of outsourcing in line with Mol (2007) and Kern, Willcocks and Heck (2002). This study also does not include advertisement and independent auditing as these activities are universally outsourced by companies.

1.2 Types of Outsourcing

There are many similar terms in meaning to outsourcing. Some of them are discussed below.

a) Outsourcing: Outsourcing is the activities undertaken by an outside supplier to take care of transfer of activities and possibly assets from a firm that had been in in-house previously (Domberger, 1998).

b) Out tasking: Out tasking, sometimes also called subcontracting, refers to hiring an external service provider temporarily for supplementing resources e.g., design and delivery of a training activity (Friedman, 2006).

c) Consulting: According to Friedman (2006) consulting helps organizations in giving information about 'how to do' something, whereas outsourcing 'does it.' In the literature of Business Process Outsourcing (BPO) the distinction between the two is blurry. This is because of the fact that several HRO service providers are part of the larger management consulting and BPO firms.

d) Off shoring: Off shoring is outsourcing across national boundaries (Adler, 2003).

e) **Contingent workers:** Leasing people to a company/service seeker by a HR services supply firm (Domberger, 1998).

These different types of definitions were used by various researchers to suit their particular context. However, there is some overlap of activities in each of these definitions. These definitions of outsourcing, implying procurement of resources from an external agency to run the internal operations, do not capture the true strategic nature of the issue. It is way beyond the sourcing decisions of the firms. All firms do purchase and procure things to run their operations. On the other hand, outsourcing is a fundamental decision to negate the vertical integration of an activity within an organization. This way, outsourcing is strategic in nature and has a long lasting effect on the overall functioning of the organization (Gilley and Rasheed, 2000). According to the Outsourcing Institute (2001) “Outsourcing is a management strategy by which an organization outsources major, non-core functions to specialized efficient service providers.” To reflect its strategic significance, outsourcing is defined by Cooke et al., (2005, p.415) as “Sourcing of goods and services previously produced internally within the sourcing organization from an external supplier.”

1.3 Information Technology Outsourcing (ITO)

Information Technology Outsourcing or Information System Outsourcing has become an alternative delivery mechanism for the IT/ITes products and services which have traditionally been delivered by an organization’s internal IT department. Loh and Venkatraman (1992) defined ITO as “the significant contribution by external vendors in the physical and/or human resources associated with the entire or specific components of the IT infrastructure in the user organization.” ITO is considered to be growing globally at the annual rate of 14% and the current

market is said to be lucrative (McDougall, 2006). Loh and Venkatraman (1992) opined that ITO activities can range between total outsourcing to total insourcing. They have treated outsourcing as a continuous variable and it varies to the degree of outsourcing activity.

1.4 Business Process Outsourcing (BPO)

Business Process Outsourcing has become one of the greatest means to build competitive advantage for all companies of different sizes and volumes (Click and Duening, 2004, p. 2). ITO is undoubtedly one of the most critical aspects of organizations whereas BPO is an advanced type of ITO which has completely changed the way outsourcing of products, processes and services is managed now (Yang, Kim, Nam, Min, 2007). Its phenomenal growth is attributed to the advancement in Information Technology and Communications. Internationalization of projects and services also contributed to the development of this field. Mehta et al., (2006) opined that BPO industry is heterogeneous in nature and differentiated by horizontal process areas like HR, Operations, Finance, and vertical specialization such as medical transcription in health sector and processing and imaging in banking sector.

1.5 Advantages and Disadvantages of Outsourcing

There have been a lot of arguments for and against outsourcing. Several authors have offered justifications for the advantages and drawbacks of outsourcing done by the firms. Domberger (1998) had identified five advantages to outsourcing: low production cost, tax avoidance, flexibility, relational rents and focus on strategy. As for disadvantages of outsourcing, Domberger (1998) and Hendry (1995) have identified hollowing out, opportunistic behavior, transaction costs, reduced learning and innovation as the major ones. Hollowing out is nothing but losing the knowledge of the function about the workforce which is solely owned and controlled by the

organization. This would result in non-attracting of the talent to the organization. By the time the vendor acquires the knowledge-process of the serving clients, the switching costs to return back to the in-house activity will make it very difficult. This can lead to opportunistically inclined behavior by the vendor toward its clients with respect to reducing service levels and pricing a contract renewal. Transaction costs such as monitoring the agreement, establishing and renewing the contract, etc., would affect the overall business of the firms if delays or litigation happen. Lastly, whatever the learning and innovation happens will be captured by the external service provider.

1.6 Human Resource Outsourcing (HRO)

Human Resource Outsourcing (HRO) can be defined as the process of subcontracting human resource functions to a third-party supplier, which were earlier performed internally or they could be currently being performed internally (Ordanini and Silvestri, 2008, pg. 372). The main reasons for HRO include allowing a firm to invest time, effort, and money into core activities and developing strategies to make it more competitive. There is a continuing momentum for HRO in the recent past because of its value proposition to the businesses (Tremblay, Patry, and Lanoie, 2008, pg. 685). In this study, we define HRO as the process of contracting out the HRM activities in part or full to an external service provider to take responsibility and risk for the business as against the HRM activities being performed internally by the employees of the firm. Our definition remains intact within a make-or-buy structure. This also means that our definition encompasses outsourcing of the traditional business activities, from routine repetitive tasks to the overall HRM activities to an outside supplier.

A company outsourcing HR activities generally experiences improvement in the service it provides to its employees and customers. But at the same time it is also crucial to identify what functions can and should be outsourced as outsourcing all functions may not help the organization gain competitive advantage. Adler (2003) observed that changes in business environment are affecting how companies manage their human resources, maintaining the balance of pros and cons for outsourcing HR business processes. He identified four major forces affecting HRO: first, conflicting pressures in the labor market; second, HR departments' self tightening efforts; third, complexity of legal environment of HR and the fourth, mergers and acquisitions have become increasingly frequent, creating greater challenges for the HR.

1.6.1 Growth of HRO

Of all the outsourcing activities, HRO is one of the fastest growing sectors with over 18.2 % of the overall outsourcing market (Brown and Hale, 2007). According to Yankee Group (2005), the projections for 2009 expenditure on HRO was forecasted to be \$14 billion. This is a steep increase compared to 2006 and it is growing unprecedentedly in the last few years. Equaterra (2006) presented a summary of the deals of Human Resource Outsourcing by various firms from 2004 to 2006. It includes Accenture and Best Buy agreements of 7 year contract covering 90,000 employees; Hewitt's 5-year contract covering 30,000; Sun Microsystems's 10 year agreement with Capgemini; and Convergys and State of Florida's contract for \$ 350 million covering 89,000 employees.

1.6.2 Advantages and Disadvantages of HRO

Human Resource Outsourcing has costs and benefits to the organization. Some direct costs include: personnel costs of time spent to identify what HR activities need to be outsourced, and selection and maintenance of contract with the vendors. Other costs would include supply costs, training, travelling, and purchase of new equipment/software. When it comes to benefits one can think of personnel time saved, operating efficiencies, rely on expertise, and access to latest technology.

1.6.3 Types of HR Activities Outsourced

Human Resource Outsourcing activities vary from a single process like payroll or benefit administration to several processes. Brown and Wilson (2005, p. 22) had given a list of 12 HR activities that can be outsourced. The HRM activities that can be outsourced are:

- a) Recruitment and selection***
- b) Training and development***
- c) Performance management***
- d) Compensation , payroll and salary surveys***
- e) Benefits design and administration***
- f) Mentoring and coaching***
- g) Employee relations***
- h) Employee assistance program***
- i) Corporate relocation***
- j) Employee communication***
- k) Organizational design and development***

l) HRIS/HRIT

Notable omissions from the above list are performance management and employee relations.

1.6.4 Reasons for Human Resource Outsourcing

Organizations are well aware about the decisions of what they make and what they buy. A number of empirical studies supported that HRO trend is beneficial to the organizations (Gainey and Klaas, 2003; Warrensburg et al., 2006). Some other studies point out that HR outsourcing is not just restricted to mere transactional HR activities such as payroll administration, records management, benefits management (Greer et al., 1999). Many transformational and strategic HR activities are also outsourced, for example, training programs, recruitment and selection of professionals, manpower planning.

Some of the advantages of HRO are better focus on the HRM issues which are directly related to the overall success of the organization, and improved customer service quality (Greer et al., 1999). Some others pointed out that HRO is going to enhance strategic capabilities and improve the company's performance, create competitive advantage and strengthen the internal capabilities (Lever, 1997).

One of the popular beliefs is that firms use HRO to cut costs in the HR department. However, some scholars caution that cost reduction should not be the only factor considered in the decision to outsource (Shelgren, 2004). Hence care should be taken while outsourcing HR activities. For example, Greer, Youngblood and Gray (1999) pointed out that employee relations and performance management should not be outsourced at all unlike the other day to day functions of the HRM. Organizations should focus on its core activities that would enable them to gain

competitive advantage by outsourcing the non-core or peripheral activities with low added value to the external agencies (Prahalad and Hamel, 1990). With the changing business environment, it is becoming inevitable for the organizations to opt for outsourcing. In order to respond to the market demand, organizations need to have flexible staffing plan that would enable them to grab the contracts and projects (Greer, Youngblood and Gray, 1999). Companies look for financial incentive to save on wages/salaries without compromising on the quality of the work. Outsourcing operations can lower the wages/salaries paid by the companies to its employees. Employee's compensation in the US comprises of not just salary but includes incentives and benefits (Adler, 2003). In some of the developed countries the government imposed costs are very high because of the strict regulation of the employment laws. So the companies in these nations would like to hire people offshore rather than the local people to save on these high regulatory costs (Shaw and Fairhurst, 1997). Host countries offer a lot of tax benefits to the home country corporate to set up its business and outsource processes there (Kakabadse and Kakabadse, 2000).

In addition to the reasons stated above, there are other reasons to outsource, like freeing internal resources for other purposes (e.g., if a function is time consuming it can be given to the outsider), insufficient internal resources, risk management, tax benefits, etc.

There are very few studies which empirically tested the reasons why firms outsource HR activities (Klaas et al., 1999; Lever, 1997). However, the interest in HRO has increased substantially over the last two decades and many academicians are showing interest in conducting research in this area.

Table 2.1 - Summary of Key Literature on Human Resource Outsourcing (Theme Wise)

Authors(Year)	Theme	Methodology
HRO Decision Making		
1. Greer, Youngblood, and Gray (1999)	HRO Make and Buy decisions. Identifies outsourcing rationales and consequences.	Conceptual
2. Adler (2003)	HRO Decisions	Conceptual
3. Ordanini and Silvestri (2008)	HRO decision of Recruitment and Selection services	Empirical/ Regression Analysis
4. Alewell, Hauff, Thommes and Weiland (2009)	Triggers of HRO decisions – German firms	Empirical/ Logistic Regressions Analysis
HRO Functions		
5. Lilly, Gray and Virick (2005)	HRO Function, Environmental & Organizational Characteristics that affect HR Performance	Conceptual Model
6. Lievens and DeCorte (2008)	Development and test of a model of external organizational commitment in HRO	Conceptual Model
7. Cicek and Ozer (2011)	Effect of HRO on Organizational Performance and the role of Organizational Culture	Conceptual

Authors(Year)	Theme	Methodology
HRO – Service Provider Perspective		
8. Fisher, Wasserman, Wolf, and Wears (2004)	Outsourcing challenges faced by HR professionals in both service provider and client organizations	Conceptual Model
9. Butler, Challahan, and Smith (2010)	HRO firm performance from service provider’s perspective	Empirical/ Regression Analysis
HRO in Asian Context		
10. Chiang, Chow and Birtch (2010)	HRO in Asian Context – Hongkong	Empirical/ Regression Analysis/ Qualitative – Interview
11. Kuruvilla, and Ranganathan (2010)	HR challenges in India’s BPO industry	Conceptual
12. Mahmud et al., (2012)	Current state of HRO in Telecommunication Industry in Bangladesh	Empirical
HRO and Different Theories		
13. Klaas, McClendon, and Gainey (1999)	HRO and the role of Transaction Cost Economics	Empirical/Principle Component Analysis/ Regression Analysis
14. Klaas, McClendon, and Gainey (2001)	HRO and Organizational Characteristics	Empirical/ Regression Analysis
15. Tremblay, Patry, and Lanoie (2008)	Determinants or Drivers of HRO. Organizational Characteristics, Transaction costs and Risks	Empirical/ Ordered Probit Statistical Analysis
16. Klaas (2008)	TCE/RBV/HR Architecture/ Institutional theory to examine trends in HRO	Conceptual
17. Karthikeyan et al., (2012)	HRO Decision using RBV framework	Conceptual/Model
HRO & Firm Performance		

18. Gilley & Rasheed (2000)	Analysis of HR activities and its effect on Firm Performance	Empirical/ EFA/CFA/Regression Analysis
19. Gilley, Greer, and Rasheed (2004)	HRO and Organizational performance in manufacturing firms	Empirical/ EFA/CFA/Regression Analysis

As has been pointed out earlier, the extant literature on HRO is still in the nascent stage although the industry may be catching up with a lot of developmental activities, but these changes are not really reflected in the academic literature (Ordanini and Silvestri, 2008). There is a dearth of good academic as well as empirical literature on HRO (Karthikeyan, Bhagat, and Kannan, 2012). One of the motivations of this study is to fill the void and contribute to the knowledge base of the existing literature through empirical work and propose some theoretical and managerial implications for the emerging industry of HRO.

1.7 HRO, Organizational Characteristics, and Market Variables

Macroeconomic factors and environmental forces have compelled organizations to relook and re-examine management process of accommodating HRO in the recent past. One of the early studies that reviewed the extant literature on HRO identified outsourcing rationales and consequences by conducting interviews with 26 senior HR executives and professionals in 25 organizations (Greer, Youngblood and Gray, 1999). In that study the authors obtained data from large and small companies comprising of many industries and they have also included a few small HR service providers with a small number of employees. Of 26 HR executives, 19 were men and 7 were women. Template method which is similar to Content Analysis was used to analyze the data in the semi-structured interview format. Operational and strategic rationales for outsourcing were identified. Based on their findings, the authors provided guidelines for HRO, for managing the outsourcing transition and vendor relationships and evaluating vendor performance. The specific

findings from this study included that (a) HRO can enhance the relative value of HR, and (b) HR department can become a strategic partner in achieving the organizational goals.

Over the last two decades, there has been a spurge of many organizations shifting dramatically toward the use of outsourced resources contracting of non-core functions to reduce costs, and enhance flexibility (Adler, 2003). Attempts were made by many HR practitioners to understand these phenomena and bridge the gap between research and practice (Fisher et al., 2008). As a result of these developments, vast literature has evolved to understand the relationship between outsourcing and human resource performance challenges faced by individuals and organizations. Fisher et al. (2008) proposed a series of research questions in this direction to help researchers and practitioners in various organizations better understand the nature of outsourced work. One of the key challenges that they identified is finding a way to align the processes and tactics to achieve shared goals.

More recently, the literature on HRO has concentrated on the drivers of HRO. Shelgren (2004) observed that there are four primary drivers of HRO: customer satisfaction – cost savings, lower technology investment costs, efficient HR processes and headcount reductions. Customers look for credible providers for all their HR needs and the HRO providers successfully excelled in fulfilling these issues efficiently and continue to achieve heights of performance. However, the debate between what is a core and non-core activity in HR continues to hover in the academia. Karthikeyan, Bhagat, and Kannan (2012) came out with a conceptual framework and propositions using RBV. They argued that with the help of RBV firms can make HR outsourcing decisions. The authors reiterate the fact that what is core and non-core differs from organization

to organization. Some organizations consider recruitment as the core activity. While others believe it is the training which grooms the employees and hence contributes more to the value addition. The right outsourcing decision can be taken by keenly looking at the firm's strengths and weaknesses. This study was an attempt to formalize the decision process of HRO. Its main finding was that HRO remains a strategic decision and not merely a transactional activity.

There is some literature on the non-transactional nature of HRO (Ordanini and Silvestri 2008; Chaing et al., 2010). The immense increase in HRO also corresponds with increase in outsourcing of non-transactional activities such as recruitment, selection and training. Ordanini and Silvestri (2008) investigated the outsourcing decisions of recruitment and selection (administrative and strategic) by developing a predictive model based on efficiency drivers, deeply rooted in the literature of TCE and RBV. Their findings showed that the decisions on how to structure the recruitment and selection activities in an organization are multifaceted and complex. The efficiency drivers were consistent with TCE assumptions. They concluded that resource adequacy and HRO inclination are the two main factors that influence the make-or-buy decisions. However, this study did not find any positive and significant relationship between strategic involvement of HR staff and the decision to outsource recruitment and selection practices, unlike Klaas et al. (2001).

The HR function and the delivery of HR services have been modified toward outsourcing in the last decade or so. The reasons for this trend are brought out by the writings of the HR practitioners to a large extent. Klaas (2008) studied this trend within North American firms in greater detail and posited a two-fold contention. First, to draw on relevant theory to understand

why some of the most crucial current trends in HRO have come into existence, and second to draw on relevant theory to examine what trends in HRO are likely to emerge using TCE and RBV models. He suggested that potential exists for continued growth in outsourcing among North American firms. Tremblay et al. (2008) studied HRO in Canadian organizations empirically analyzing the role of organizational characteristics, transaction costs and risks. The objective of this study was to evaluate the influence of three classes of determinants: strategic and organizational characteristics, transactional variables and risk factors on HRO using a cross sectional sample of 271 Canadian organizations. The study used Ordered Probit statistical analysis technique to analyze the data. Results showed that strategic implications on part of HR department, support from top managers, previous experience with outsourcing and benchmarking in HRM are positively related to the intensity of HRO. They also found support for transaction related variables. The point that emerges from this study is that the human and business risks are important drivers of a firm's decision to outsource. However, it is not clear that the drivers are the cause of HRO.

Taking cue from Klaas et al. (2008; 2001; and 1999), and Chiang, Chow, and Birtch (2010) explored the state of HRO in the Asian context particularly in Hongkong about what is the current extent of HRO and what are the various activities outsourced the most in Hongkong? What are the perceived costs, benefits and obstacles related with HRO? They have drawn the arguments based on TCE and RBV. The findings of the study conformed to the anticipated results like HRO in Hong Kong is at a nascent stage and despite the cost reduction strategy by most of the firms, the decisions to outsource are based on economic and non-economic matters. After this, similar attempts were also made to study HRO at various locations in Asia. Mahmud,

Billah, and Chowdhury (2012) studied the current state of HRO in the telecommunication sector in Bangladesh. They tried to study the issues of when and under what conditions HRO contributes value to the companies by identifying the relationship between environmental and organizational characteristics that affect HR department's performance and how HRO mediates the relationship in that sector. The results of this study showed partial significance of HRO. Cooke, Shen, and McBride (2005) reviewed existing literature on HRO practices and discussed the implications for the HR groups and other stakeholders who may be affected by the outsourcing decision. They have concluded that the existing literature should be able to give advice on the most appropriate HR activities that need to be outsourced and how outsourced and in-house HR function can be managed. These questions provide considerable agenda for research and help practitioners in evaluating the implications of HRO better.

Klaas, McClendon and Gainey (2001) studied the relationship between organizational characteristics and the HRO decision. The eight organizational characteristics included: Idiosyncratic HR practices, HR strategic involvement, Positive HR Outcomes, Promotional Opportunities, Demand Uncertainties, Pay level, Firm size and Outsourcing by competitors. They split the Amount of HRO reliance into four factors using Principal Component Analysis: HR generalist activities, transactional activities such as payroll, human capital activities such as training, and recruitment & selection. Data were collected from 2000 members of the Society of Human Resource Management (SHRM) who were working as Vice President or Director of Human Resources in a random manner. Regression Analysis was performed to examine the relationship between Organizational characteristics and Amount of HRO reliance. Support was found for six of the eight hypotheses. No support was seen in Firm Size and HRO by

competitors. Analysis showed that transactional activities were more likely to be outsourced by firms in a more uncertain environment. The findings of this research provide implications for how organizations should move forward to HR outsourcing. Overall, this study points the influence of organizational variables on different types of HR activities and services outsourced was highly contingent in nature. Apart from organizational characteristics, there are many other aspects should be considered when deciding HR outsourcing. It would be interesting to add all these variables together to make a comprehensible conceptual framework and get a fair idea about HRO.

1.8 HRO and Firm Performance

Gilley, Greer and Rasheed (2004) conducted a study on the organization's use of outsourcing and its influence on performance of the firm. They attempted to shed light on the relationship between HRO and firm performance. The effects of outsourcing of two types of HR activities, namely Training and Payroll were studied by them. The reason behind selecting these activities was that many HR departments were using outsourcing training activity to enhance the value received from training expenditures. Similarly payroll functions often require specialized attention especially in the smaller organization because they may not have enough personnel to monitor the payroll functions after their completion. Hence these two HR activities amounted to 70% of the outsourcing in the industry. They have also tried to check the moderating effect of firm size on HRO and organizational performance measures like financial performance, innovation performance, and stakeholder performance. They collected data from 94 firms. Findings of this study provided modest evidence that HRO training and payroll was associated with organizational performance. However the moderating effect of firm size on HRO and organizational performance was not found. This research has opened several avenues for the academicians to

explore the other HR activities that were not considered in this study. In the theoretical framework we have added the Amount of HRO comprising of two HR activities (Klaas et al., 1999; Klaas et al., 2001) to check its influence on firm performance.

1.9 Theoretical Perspectives

There are many theories that have contributed to the study of this emerging field of HRO. The most popular theoretical approaches to studying HRO are Transaction Cost Economics (Coase, 1937; Klein et al., 1978; Williamson, 1975, 1985, 1991, 1996), Agency Theory (Grossman and Hart, 1983; Choudhury and Sabherwal 2003; Koh et al., 2004; Aron et al., 2005) and Resource-Based View of the firm (Penrose 1959; Rumelt, 1984; Wernerfelt, 1984; Barney, 1991). These theories provide logical basis for the decisions of HRO and predict the likely effect of HRO on employee satisfaction and employee retention and firm performance (Gilley, Greer, and Rasheed, 2004). Most of the studies in the field of HRO have directly or indirectly used either one of them or all the three as these theories address why firms outsource their HR activities. (Klaas et al., 1999; 2001 and 2008). However, this study concentrates and restricts itself to the Transaction Cost Economics (TCE) and Resource Based View (RBV) approaches only. The reason for not choosing Agency theory in our study is the fact that we are not analyzing the principal and agent relationship in our theoretical framework.

1.9.1 Transaction Cost Economics (TCE)

Transaction Cost Economics was first introduced by Coase (1937) explaining that resources are allocated according to price mechanism and this allocation is dependent on conditions outside the firm and direct production and price movements which are routed via a series of exchange transactions with the market. The central question of TCE is whether a transaction is more

efficiently performed within a firm or outside it. The choice of producing in-house or buying from outside should be made on the basis of costs involved in both the operations. While producing in-house may incur higher production costs, buying from the market incurs higher transaction costs.

The TCE framework was later extended by Williamson ¹(1975, 1985, 1988, 1991 and 1996) who argued that incomplete contracts and asymmetric information and bounded rationality lead to integration rather than market purchases. Two forms of governance systems prevail in TCE – market governance and organizational governance. Whenever any firm makes a decision to HRO, it is opting for market form of governance as opposed to organizational form of governance. Experts on TCE highlighted the fact that while outsourcing organizations will consider not only the immediate cost of service but also the costs related to monitoring performance and managing relationship of the contracts (Walker and Weber, 1984; Masten and Crocker, 1985).

TCE highlights the relative merits of market governance versus organizational governance for a particular transaction to be chosen to maximize net value of both production and governance costs. Therefore, in the process of making outsourcing decisions, it is not only important to consider the internal and external costs of providing the good/service but also the cost of managing the transaction in-house and outside (Klaas, McClendon and Gainey, 1999). The implication for TCE is that the HRM services that are highly transactional in nature, often

¹ Williamson (1975 through 1996) made many contributions to the theory approach of Transactional Cost economics. Based on his observations and analysis, there are several characteristics of a transaction (i.e., asset specificity, uncertainty, and frequency) that determine appropriate two governance structures for the transaction. If the appropriate decision is made regarding governance structure i.e., make versus buy decision then the transaction will be conducted in a cost-efficient manner

repeatedly occurring, are more likely to get outsourced and hence the outsourcing of such activities may lower the cost burden on the organizations.

1.9.2 Resource Based View of the Firm (RBV)

The RBV is a pioneering theory that dominated the literature on outsourcing (Priem and Butler, 2001). The RBV view of the firm tries to explain how firms gain sustainable competitive advantage through acquisition and nurturing of resources. Resources which are valuable, rare, inimitable and non-substitutable help a firm get the sustainable competitive advantage (Barney, 1991). In other words, resources that are considered useful for the firm to create an edge over the others can typically be viewed as core elements of the firm. Therefore, such activities ought to require organizational governance mechanism rather than market contracting governance. And whenever the resource relates to the mundane and routine tasks and operations, the firm needs to opt for market contracting governance.

Extending this reasoning, many scholars (Stalk et al., 1992; Ray et al., 2004) argued that resources can be used as competitive advantage if and only if they are exploited through business processes. Hence, those activities and business processes that use valuable, rare, inimitable and non-substitutable resources can act as sources of competitive advantage of the firm. Therefore, RBV demands attention to the processes, resource leverage and intangibles. Thus the relevance of RBV to HRO is to understand the core and the non-core activities that can be outsourced or kept inside the firm.

The vast literature on outsourcing has drawn mainly from these two theories, whether conceptual or empirical. TCE and RBV help in explaining the reasons for HRO outsourcing and what are

core and non-core activities of HR that are generally outsourced. In this study, we have used TCE and RBV in the model development of the theoretical framework and hypothesized the