CHAPTER 3: THEORETICAL FRAMEWORK AND HYPOTHESES
FORMULATION

This chapter has four sections namely – gaps in literature, objectives of the study, theoretical framework, and formulation of hypotheses.

1.1 Gaps in Literature

Based on the extensive literature review, the following gaps emerged, which are not only intuitively appealing but also well rooted in the literature.

• Not many studies have been empirically conducted using both TCE and RBV theoretical perspectives. Hence, studying these two important theories will give a better picture about the outsourcing of core (strategic) and non-core (transactional) HR activities.

• Most of the studies on HRO have focussed only on taking the HR activity as a whole without considering differences at the top, Middle and lower management levels. We are arguing that the basis for outsourcing decisions of HR activities at different levels like top management, Middle management and lower management will vary across and within organizations. Therefore, in this study, we will be focussing on Amount of HRO, i.e., outsourcing of HR activities at the top, Middle and lower management levels.

• There are very few studies that empirically investigated the effect of organization characteristics and market variables on HRO. This will be explored in detail in the present study.
Although there have been very few studies conducted on HRO in India (Mohapatra, 2012), we did not come across any study that has explored the Amount of HRO and firm performance in India.

1.2 Objectives of the Study

The present investigation focused on how some important HRO activities like training, payroll, recruitment and selection, benefit administration and employee communication impacted the firm performance. In other words, which HR activities were outsourced more and why? More specifically, the present study had the following objectives that are derived from the identified research gaps:

- To empirically study the HR outsourcing of core and transactional activities using TCE and RBV theories.
- To study the influence of organizational characteristics and market variables on HRO.
- To study the effect of Amount of HRO on performance of firms.
- To investigate the overall effect of organizational characteristics, market variables and HRO activities on firm performance in India.

We also explored which HR activities were outsourced more at different levels of management – top management level, middle management level and lower management level. We could not locate any studies on HRO at various management levels in India. But we consider this as an important area of research. Therefore, we had explored HRO at various management levels, but without proposing any hypotheses.
1.3 Theoretical Framework and Formulation of Hypotheses

The conceptual model for research has been developed based on an extensive review of literature primarily aimed at capturing Amount of HRO and its impact on the firm performance. The present study had taken into account the seven organizational characteristics or organization related variables suggested by Klaas (1999; 2001), which have been reviewed in the previous section. Similarly, one market related variable is included based on Klaas (2001) study. Following these, a conceptual model is developed using three sets of variables (see Figures 3.1 and 3.2).

Review of literature (Klaas et al., 1999; 2001) suggests that the Amount of HRO had 33 items covering different aspects of HRO in terms of design of programs and policies and administration of programs and policies. They conducted a study on amount of HRO. The data were collected from 2000 randomly selected members of the Society of Human Resource Management (SHRM) in United States who were working as Vice President or Director of Human Resources. The respondents rated each item on a 7-point scale with percentages as anchors. The responses to the 33 items were factor analyzed using principal component analysis with promax rotation. The following four factors were identified:

a) **HR generalist activities** consisted of items related to tasks typically performed by HR generalists and it had 12 items (e.g., performance appraisal, HR planning, equal employment opportunity/diversity, employee relations, and safety and health).

b) **Transactional activities** consisted of items relating largely to more routine, transactional activities and it had 7 items (e.g., payroll, benefits, and human resource information system).
c) **Human capital activities** consisted largely of items relating to the building and maintenance of human capital and it had 6 items (e.g., training, organizational development, and employee assistance).

d) **Recruiting & selection** consisted of 8 items relating to staffing activities – recruiting, selection, and induction.

A closer examination of the 33 items loaded in four factories revealed that many of them are not relevant for Indian organizations. Some items were repeated. Therefore, extensive discussions were held with the HR experts and professionals in the field. Based on these discussions, 14 activities of HR from the list 33 were identified as (a) most relevant in the Indian context, and (b) capturing almost all the HR activities in Indian organizations. These 14 activates included: HR Planning, Employee Relations, EEO/Diversity, Organizational Development, Safety and Health, Performance Appraisal, HRIS, Payroll, Benefits, Training, Employee Assistance Programs, Recruiting, Selection, and Induction.

In this connection, a preliminary study was conducted to verify the validity of these 14 HR activities in the Indian context. For this purpose we had developed a questionnaire based on the above 14 HR activities. The data were collected from 96 senior managers attending training programmes at IBS, Hyderabad, and Centre for Organization Development, Hyderabad. Factor Analysis technique was used to analyze the data. Initially we obtained four factors from these 14 HR activities, but they suffered from overlapping and cross loadings across the four factors. The activities that were loaded on more than one factor included Employee Relations, EEO/Diversity, Organization Development, Safety and Health, and Benefits Management (see Appendix C for
preliminary study results analysis). Elimination of these activities with cross loadings reduced the list to 9 activities. These 9 activities were again subjected to factor analysis. The results of the analysis showed that 9 HR activities can be grouped into just two factors instead of four – Transactional, and Core activities. The KMO score of 0.61 indicated just acceptable sample adequacy. The total variance explained by the two single factors 60.65 %. Factor loading for each the nine items exceeded the normative value of 0.70. Therefore, for this study, Amount of HRO had these two dimensions with 9 HR activities.

Firm performance is measured on three dimensions - financial, innovation and stakeholders’ performance. Literature suggests that Organizational Characteristics and Market Variables are antecedents to the Amount of HRO and firm performance relationship (Klaas, 1998; Klass et al., 1999 and 2001; and Gilley, Greer and Rasheed, 2004).

![Figure 3.1 - Schematic Diagram of Theorized Relationships](image)

Transactional Cost Economics (TCE) is concerned with two forms of governance systems – market governance and organizational governance. Whenever any firm takes a HRO decision, it is opting for market form of governance as opposed to organizational form of governance
(Williamson, 1991). Many of the make and buy decisions in HRO are addressed in TCE. Many organizational characteristics are likely to affect the costs and benefits related with the market governance mechanism.

Similarly, the Resource Based View (RBV) 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 sustainable competitive advantage (Barney, 1991). Therefore, such activities ought to require organizational governance mechanism rather than market contracting governance. Hence 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.

This study used the TCE and RBV perspectives to formulate hypotheses that predicted the association among the organizational characteristics, market variable, Amount of HRO and the firm performance.

1.3.1 **Idiosyncratic HR Practices and Amount of HRO**

Firms supplying HR services make huge investments to create their HR service resources that can be provided to several clients. This helps them to gain economies of scale so that they can provide these services at a very competitive price. However, the HR service providers will not get advantage of economies of scale if a client firm has idiosyncratic HR service requirements, or it has practices that are not easy to be codified because of their tacit nature of knowledge (Conner and Prahalad, 1996; Barney, 1991). The impact of idiosyncratic practices may depend upon the type of HR activity outsourced for which any dependence on the unique practices may change the advantages related with outsourcing. For example, training, selection and
performance appraisal may require a thorough understanding of an organization’s unique culture. To the extent organizations have idiosyncratic HR practices, tacit knowledge is required in developing appropriate HR service activities. There will be a decline in the economies of scale when idiosyncratic practices need specific investment to provide services to a single firm. HR service provider has to then price its services to recover the entire cost from the single firm. The price charged for these specialized services by the service provider will be higher as a result of the increased cost (Williamson 1996). As a result, the firm outsourcing HR activities loses the advantage of HRO. In such situations, these firms would create capacities to meet all the core HR services requirements in-house rather than outsourcing (Klaas et. al, 2001). As opposed to this, mundane day to day routine activities like payroll and benefit administration may depend less on organization specific knowledge (Conner & Prahalad, 1996; Barney, 1991). Therefore, we predict that firms that have idiosyncratic practices would rely less on HRO for core activities whereas they will rely more on HRO for the transactional activities.

**H1A: Firms having lesser idiosyncratic HR practices will rely more on the Amount of HRO-Transactional activities.**

**H1B: Firms having greater idiosyncratic HR practices will rely less on the Amount of HRO-Core activities.**

### 1.3.2 HR Strategic Involvement and Amount of HRO

Of late, there has been a momentum for HR function to become a partner in strategic business decisions and directly contribute to the overall performance of the firm (Wright, Gerhart, Snell, and McMahan, 1997). To the extent to which this should happen, HR practitioners become strategic, knowledgeable about the overall functioning of the business, and become
comprehensive about the business orientation (Ulrich, 1996). In such firms, HR practitioners are likely to take greater interest in the strategic matters, which are central to the firm’s performance more than the general routine activities such as payroll administration. Again, the impact of strategic involvement is likely to vary with the type of HR outsourcing. Core level of activities will likely need a higher level of understanding of the firm’s strategies, and risks and costs associated with the vendors. On the other hand, the transactional activities are less likely to do with the organization strategy and hence these activities require little or no involvement of strategic HR. (Klaas et al., 1999; Klaas et al., 2001). These transactional activities will have a bearing on the cost savings to the firm as they are associated with the economies of scale.

As a result, the focus on the routine and mundane kind of activities will be outsourced to allow HR practitioners to concentrate on the core activities. Therefore, we predict that in firms where HR department is involved in strategic issues of the firm, the reliance on outsourcing transactional HR activities will be more compared to the core HR activities. Hence, the following hypotheses.

**H2A:** Reliance on HRO-Transactional activities will be higher in firms where HR department is seen as strategic partner.

**H2B:** Reliance on HRO-Core activities will be lower in firms where HR department is seen as strategic partner.

1.3.3 Promotional Opportunities and Amount of HRO

Organizations that are rapidly growing require increasing HR resources. This necessitates increasing the size of HR department in an organization, resulting higher employee costs. These
costs are also likely to depend, however, on the control mechanisms existing within the organizations (Dow, 1987). One such control mechanism is the internal labor market (Lazeor & Rosen, 1981) related to promotional opportunities. Organizations that provide superior promotional opportunities and career advancements to its employees compared to other firms in their industry segment, may achieve superior levels of employee performance and productivity. Such firms may not outsource HR activities due to the greater emphasis placed on internal promotion for their HR staff. Therefore, we propose the following hypothesis.

**H3**: Firms that provide superior promotional opportunities to their HR staff compared to other firms in their industry segment, their reliance on both HRO-Transactional and HRO-Core activities will be lower.

### 1.3.4 Demand Uncertainties and Amount of HRO

Labor requirements vary across firms that produce goods and services having seasonal demands. This trend is also true even in many other firms that do not face seasonal demand problem. Hence firms have to manage the demand for varying labor force size across seasons. Demand Uncertainties for labor has its own effect on the costs associated with HRO (Williamson, 1996). Demand shifts for goods and services are difficult to manage with the existing employees and their activities when tasks are performed in-house. As such, shift in demand calls for cost adjustments. In either case, any upside or downside shift in demand for goods and services will have cost implications if the tasks are performed inside. Increase in staff requires hiring and training costs whereas decreasing (retrenching) staff will result in losing the human capital investments on the employees. On the other hand, contractors (HR service providers) can easily manage shifts in demand because of their large and diverse client base (Abraham and Taylor,
They adjust the staffing levels without significant costs and hence offer HR services at competitive prices (Lepak and Snell, 1998). Hence, firms facing labor Demand Uncertainties will rely heavily on the Amount of HRO activities.

**H4: In firms facing substantial labor Demand Uncertainties across seasons, reliance on Amount of HR outsourcing will be higher.**

### 1.3.5 Cost Pressures and Amount of HRO

One of the important reasons for HR outsourcing, as argued earlier, is cost savings because of the market competition and economies of scales (Goldfarb & Naasz, 1995). But firms face different cost pressures, which vary based on the extent such cost savings are valued by the managers in the firm (Williamson, 1996). In organizations where the cost pressures are severe, the value assigned to reduce short term costs may be sufficient to balance the concerns about the risk of opportunistic behavior of the HR service providers. So cost pressures are likely to affect the strength of the relationship between reliance on HRO and perceived benefits from outsourcing because of their likely effect on how organizations value cost savings. Therefore, increased reliance on HRO is likely to be seen as generating more perceived benefits for firms that face severe cost pressures than for those that are facing a more liberal environment. However, core HR activities will not be outsourced even when cost pressures are high as external service providers will not be adequately competitive. Hence we propose the following hypotheses.

**H5A: Firms having severe cost pressures are likely to rely more on HRO-Transactional activities.**

**H5B: Firms having severe cost pressures are likely to rely less on HRO-Core activities.**
1.3.6 Pay Level and Amount of HRO

There is a great variation in pay policies across organizations (Gerhart and Milkovich, 1990). Due to this variation, the cost incurred in providing HR services in-house is likely to vary across organizations. For those organizations which follow pay-lead strategy, the in-house HR costs will be more. Hence the chances of HRO will increase. On the other hand, by following pay-lead strategy, organizations might attract and retain talented employees (Rynes and Barber, 1990). Firms may like to leverage their talented human capital for core activities rather than for routine transactional activities. Hence, the routine activities like payroll and training are likely to be outsourced. In addition to these, the availability of quality vendors for specialist functions like training and selection may reduce costs compared to if they are performed in-house. Therefore, while cost associated with pay leadership will provide incentives to outsource transactional activities, core/strategic activities are likely to be more difficult to outsource to outside vendors. Hence we postulate the following hypotheses.

**H6A: Firms following pay leadership will rely more on HRO-Transactional activities.**

**H6B: Firms following pay leadership will rely less on HRO-Core activities.**

1.3.7 Firm size and Amount of HRO

Firm size does affect the cost associated with outsourcing due to its impact on economies of scale (Abraham and Taylor, 1996). Firms need specialized HR services like recruitment and selection and hence require HR specialists to provide such services (Ulrich, 1996). Many a times, smaller firms may not require these specialized services frequently. The unit cost for such infrequent services will be relatively higher if performed internally employing specialists.
Whereas in large firms, the per unit cost for such specialized services will be substantially lower due to greater economies of scale. Because of the differences in economies of scale, costs associated with in-house delivery of HR services are more likely to be higher for smaller firms (Abraham and Taylor 1996; Williamson, 1996), making them rely heavily on HR outsourcing.

**H7: There exists an inverse relationship between firm size and reliance on Amount of HRO.**

On the basis of the above arguments, we also postulate that the organizational characteristics are related to the amount of human resource outsourcing in some way or the other.

**Hypothesis 8: Organizational characteristics are related to the Amount of HRO.**

### 1.3.8 Outsourcing by Competitors and Amount of HRO

Coase (1938), Teece (1982), and Klaas et al. (1998) have argued that according to TCE, firms make choices about governance structures in their efforts to economize on the total transaction costs associated with a given quality and quantity of service. However, according to TCE, such choices occur within the context of bounded rationality (Simon, 1991; Williamson, 1975). As such, TCE allows for choices about governance structure to be biased by patterns of behavior within the existing institutional environment (Chandler, 1962; Mansfield, 1977). It is argued that if the competitors in a firm’s environment are outsourcing their HR activities, it will be treated as signals as to the efficiencies associated with HRO. In such situations, in order to sustain its competitive advantage, a firm may also resort to outsourcing its HR activities and benefit from the assumed efficiencies in costs.
H9: Reliance on HRO will be positively related to the degree to which a firm’s major competitors are seen as relying on HRO.

1.3.9 Relationship between Amount of HRO and Firm Performance

Many HR departments use outsourcing to enhance the value of the firm (Gilley et al., 2004). One of the key principles of strategy has been to allocate resources in the most judicious fashion so that it provides competitive advantage to the firm. Therefore, to gain competitive advantage, the firms focus on key areas by allocating larger amount of resources to them (Hamel and Prahald, 1994).

Several theorists like Goldstein (1986) argued for the effect of training on performance of firms. Later on, other studies have found positive effects of training on firm performance with respect to cost savings, productivity and sales revenue (Rayne and Geringer, 2000), return on investment (Morrow et al., 1997), and perceptual measures of performance (Huselid, 1996). But they have not included the entire gamut of HRO activities.

Gilley and Rasheed (2000) attempted to address the general theme of outsourcing across a variety of business activities. While they did not find any direct relationship between outsourcing and firm performance, they did find that certain kinds of outsourcing activities had a positive effect on firm performance in cost leadership and innovation differentiation strategies, especially those operating in a stable industry environment. Hence we postulate the below hypothesis on the basis of the above arguments.
Hypothesis 10: There exists a positive relationship between Amount of HRO and Firm Performance.

Based on these hypotheses, the following model is proposed (see Figure 3.2), which is tested in the present study. The research method used for testing this model will be presented and discussed in Chapter 4.
Figure 3.2 - Proposed Research Model