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Human resource outsourcing: Market and operating performance effects of administrative HR functions

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ABSTRACT

Using event study methodology and two-stage regression analysis on a sample of firms announcing human resource outsourcing (HRO) contracts, this study tests the association between administrative HRO and firm-level capital market and long run operating performance, with archival financial data controlling for endogeneity and outsourcing decision optimality. The results demonstrate that the equity capital market responds positively to client firms announcing administrative HRO, particularly service firms and those outsourcing transactional HR tasks. Additional statistical analysis shows that suboptimal outsourcing is negatively associated with long run operating performance measured as return on assets and operating return on assets. This study contributes to outsourcing literature by more precisely quantifying outsourcing performance through archival financial data and employing capital market empirical tests. Further, it controls for outsourcing decision optimality in examining long run operating performance effects. This research focuses on HR, a critical function within the firm and value enhancing to the firm.

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1. Introduction

Firms outsource human resource (HR) services for cost savings, efficiency, service improvements, access to HR expertise and increased flexibility (Bendorf, Barge, & Graziano, 2005; Lee, 2007; Marquez, 2007; Oshima, Kao, & Tower, 2005). Transaction cost economics (TCE) along with capital market and resource based theories suggests an association between outsourcing HR services and overall firm performance (e.g., Lai & Chang, 2010). Yet the existing outsourcing literature has not established an empirical link between human resource outsourcing (HRO) and firm performance, nor has a link been established to the equity capital markets. Prior HRO research primarily addresses the client's decision to outsource (e.g., Adler, 2003; Delmotte & Sels, 2008; Klaas, McClendon, & Gainey, 2001; Kosnik, Wong-Mingji, & Hoover, 2006), characteristics of outsourcing clients (Klaas et al., 2001), the outsourcing relationship (Lievens & Corte, 2008), and the effect of outsourcing on employees (Fisher, Wasserman, Wolf, & Wears, 2008; Kessler, Coyle-Shapiro, & Purcell, 1999). Given the far-reaching effect of the HR function within the firm, understanding the outsourcing decision impact is critical for managers desiring to improve profitability and equity market impact.

Managing a firm's workforce effectively and strategically can increase shareholder value by 10 to 20% (Becker & Huselid, 2003). This underscores the economic importance of the HR system. Outsourcing HR services can potentially improve organizational efficiency and HR service

performance, as well as provide significant cost savings. In fact, some estimate that transforming human resources to optimize efficiency can result in labor cost savings of \$9.8 billion for a typical Fortune 500 company (Hansen, 2008) and should lead to improved firm performance.

Understanding the market and operating performance effects of outsourcing is important to stakeholders and investors, and closes a gap in the HRO literature (Shen, 2005). This study extends the HR literature in several ways. First, prior studies have lacked proprietary HRO data, and have constructed proxies for outsourcing costs or relied on surveyed managers' perceptions of performance following outsourcing (e.g., De Vita, Tekaya, & Wang, 2010; Dickmann & Tyson, 2005; Gainey, Klaas, & Moore, 2002; Gilley, Greer, & Rasheed, 2004; Klaas, McClendon, & Gainey, 1999; Lilly, Gray, & Virick, 2005). Heretofore, with few exceptions, researchers have not conducted empirical archival studies seeking to link HR management to corporate performance or market value (Abowd, Milkovich, & Hannon, 1990; Jiang & Qureshi, 2006). Second, in addition to operating performance, this study investigates the capital market reaction to firms announcing administrative HRO contracts. Third, the reported results statistically control for the boundary condition, optimality of the outsourcing decision. Finally, the study addresses outsourcing HR services which can directly and indirectly affect firm performance through the services provided to and treatment of employees.

Whereas human resource outsourcing encompasses a broad range of functions, Klaas et al. (1999, 2001) distinguish the particular types of HR functions examined in this study, namely, HR generalist, transactional, human capital and recruiting. HR generalist activities include for example, performance appraisal, planning and EEO/diversity. Transactional

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activities are payroll, benefits and HRIS. Human capital activities include training and development and employee assistance, while recruiting involves staffing functions. The focus of this paper is on administrative HR services including payroll processing, benefits administration, employment verification, staffing, training, and workforce management.

In summary, within the HRO performance literature, this study is distinct in investigating overall stock market and operating performance of client firms to pinpoint empirically and systematically, the impact of outsourcing critical administrative HR functions on financial performance using archival financial data as an alternative to perceived financial operating performance.

2. Theory and hypotheses

Transaction cost economics (TCE), capital market theory, and resource based theory are the theoretical constructs underpinning this study. First, TCE provides a basis for the outsourcing decision and its expected impact on firm value and profitability. Internal production minimizes the number of contracts with managers thus lowering transaction costs (Coase, 1937). In contrast, market allocation of resources through outsourcing poses risks of incomplete contracts and opportunistic behavior inducing higher transaction costs.

Based on these assumptions, Williamson's (1979) TCE identifies functional characteristics of individual activities (asset specificity, uncertainty and frequency) allowing managers to minimize total processing costs. Asset specificity indicates difficulty transferring to a different use or user or being of little value outside of a particular relationship (Lohtia, Brooks, & Krapfel, 1994). Uncertainty is the expected variation in the demand for activities or the inability to monitor activities leading to control issues and limitations on future planning (Pilling, Crosby, & Jackson, 1994). While higher uncertainty is a probable precursor to increased monitoring costs, establishing trust between partners can mitigate additional costs (Bharadwaj & Matsuno, 2006). Frequency is the volume or rate of activity performance. These attributes as well as finding a suitable partner, enforcing incomplete contracts and providing incentives to minimize opportunistic behavior cause firms to incur transaction costs (Grossman & Helpman, 2005; Klaas, 2008; Pilling et al., 1994). Theoretically and empirically documented, managers seeking to maximize profits consider production and transaction costs in the HR outsourcing decision (Ang & Straub, 1998; Grossman & Helpman, 2002), selecting the option with lower total costs. Following the HRO decision, capital market theory and resource based theory offer explanations for the resulting performance effects. By publicly announcing HRO contracts, managers provide new information to the capital market concerning their operating strategies that the market should quickly incorporate into the stock price, linking HRO to financial market performance. Resource based theory views the firm as a collection of productive resources and capabilities that become the primary source of profit for a firm (Grant, 1991; Penrose, 1995). Engaging in HRO allows managers to focus resources on strategic HR functions that support the firm's core competencies and overall performance rather than administrative or transactional functions that an external provider can perform at possibly a lower cost.

2.1. Market response

Capital market theory suggests that changes in stock returns around the announcement of new information result from reduced information asymmetry and signaling the market regarding expected future cash flows of the firm. While investors might interpret HRO as weakness in HR operations, an HRO client voluntarily releasing HRO contract information likely means they expect investors to interpret the action positively due to potential increased profits and cash flows to the firm in the long term due to cost savings and efficiency.

While no research exists, to our knowledge, examining the investor wealth effect of HRO specifically, Hayes, Hunton, and Reck (2000)

use event study methodology to examine the impact of information systems (IS) outsourcing announcements on the market value of contract-granting firms (outsourcing client firms) and find positive abnormal stock returns of smaller firms and service industry firms one day following the outsourcing announcement. Based upon the theoretical framework and consistent with Hayes et al. (2000), the first hypothesis is stated in the alternative form:

H1. The capital market reaction to client firms announcing HRO contracts is positive.

In determining internal or external performance of a function, TCE uses the attributes of asset specificity, uncertainty and frequency (Williamson, 1979, 1991). Frequent activities and those requiring specific assets should be performed internally because of the higher transaction costs of external coordination (Widener & Selto, 1999), whereas activities not requiring specific assets regardless of frequency or that are low in knowledge intensity, are optimal candidates for outsourcing (Varadarajan, 2009). De Vita et al. (2010) find support for this theoretical expectation and document that buyers' asset specificity has a negative impact on outsourcing relationship performance. Further, Lui, Wong, and Liu (2009) find that generating cooperative behavior rather than reducing opportunistic behavior influences the relation between asset specificity and partnership performance.

Although some HR services are unlikely candidates for outsourcing because of potentially higher transaction costs, economies of scale allow external providers to perform services at lower costs than client firms, resulting in improved profitability. Increased cash flows may follow outsourcing routine services or those not requiring specific assets (e.g., payroll and employment or income verification) over non-routine activities. Therefore, the second hypothesis states:

H2. The capital market response to client firms announcing outsourcing contracts for HR services that are routine and do not require specific assets is positive.

2.2. Operating performance

Outsourcing strategy effects should be observed in long term operating performance for two reasons. First, assuming management bases its outsourcing decision on the tenets of TCE with the goal of minimizing costs, overall performance should improve. Second, the market response to an outsourcing announcement is the result of investors' revised expectations about future cash flows based on newly available information. A positive market response to an announcement suggests investors expect improved future operating performance. Likewise, resource based theory suggests that even an outsourcing decision resulting in a negative net wealth effect enables the firm to focus resources on strategic activities indirectly leading to improved operating performance.

Although theory suggests expected improved operating performance following HRO, empirical survey research to date reports mixed results on the relation between outsourcing and firm performance. Gilley et al. (2004) employ survey methodology in firms outsourcing training and payroll functions, and find no relation between managers' perceived firm operating performance and HRO. Empirical studies investigating profitability effects of other types of outsourcing are inconclusive. Namely, no direct effect of outsourcing peripheral and core activities on firms' financial and non-financial performance (Gilley & Rasheed, 2000), a negative short term and positive long term impact of outsourcing business services on firm performance (Gorzig & Stephan, 2002), no effect of outsourcing business services on profits (Görg & Hanley, 2004) and a decline in profitability in the year of the announcement, but improvement in subsequent years (Juma'h & Wood, 2000). These contradictions show that notwithstanding the prevalence of outsourcing, there is no clear empirical evidence that firm operating performance improves following HRO strategy implementation.

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