

# The perspective of Malaysian Manufacturing Organizations on Strategy, HR Outsourcing and HR Costs

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## ABSTRACT

*The paper discusses the relationship between different types of human resource management (HRM) strategy and the human resource outsourcing, and impact on the size of human resource (HR) department. Three HRM strategies are considered: Facilitation, accumulation and utilization. The data for the study were obtained from survey responses from 232 organizations, of which 113 were engaged in HR outsourcing. The findings suggest that organizations tend to rely on outsourcing of HR functions when they espouse facilitation and utilization HRM strategy. Concurrently, by relying on HR outsourcing, the organizations manage to experience a reduction in the size of HR department. The results show that it is important for the organizations to better understand the implications of an increased reliance on outsourcing within HR. This allows them to focus on how HR functions are delivered within organizations with the interaction of HRM strategy and the size of HR department will tend to be smaller resulting from outsourcing activities.*

**KEYWORDS:** *outsourcing, strategy, HRM*

**JEL Classification:** M550, L100

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## Introduction

HR outsourcing has become a major part of HR operations for the last few years. Smith et al. (2006) indicate that about 61 percent of the organizations outsourced at least one HR function. Out of that percentage, 68 percent of them outsourced recruitment, 61 percent outsourced human resource information system followed by training (56%) and benefit administration (49%). Similarly, a 2004 joint study carried out by the Society for Human Resource Management and the Bureau of National Affairs (BNA) found that two-third of HR executives surveyed also outsourced at least one HR activity. HR outsourcing is only lauded as one of the strategic tool in the hyper competitive environment. In that, it assists organizations to focus on their scarce resources, increase customers' perception towards quality and reduce the cost of outsourcing the HR functions (Marinaccio, 1994).

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This survey specifies that HR outsourcing has received considerable attention by business firms. In spite the dramatic rise in the outsourcing practices, limited empirical investigations have been reported on HR outsourcing (Delmotte & Sels, 2008). To date, most of the related studies investigated its different aspects such as managerial motivation, service providers, advantages, risks and how outsourcing affects organizations. Similarly, there are few empirical studies that examine the empirical performance of outsourcing (Leiblein, Reuer & Dalsace, 2002; Bolat & Yilmaz, 2009). In fact, there is almost next to none study that analyse the outcome of HR outsourcing on the size of HR department. Therefore, this study is to examine whether HR outsourcing contributes to the reduction of HR employees by identifying different type of human resource management (HRM) strategy as the predictor of HR outsourcing.

In doing so, the paper will commence with the literature review on the concept of HRM strategy and HR outsourcing. Next, the relationships among the HRM strategy, HR outsourcing and the reduction of the size of HR department will be discussed. Subsequently, methodology will be presented and finally, the results and discussion of the study will be elaborated.

## **1. Literature Review**

### **Human Resource Management Strategy**

HRM is one of the concepts that has gained considerable acceptance in management. The decade of the 1980s saw the emergence of HRM strategy as one of the newest sub fields of HRM and many studies have provided typologies of HRM systems and strategies (e.g. Arthur, 1992, 1994; Miles & Snow, 1984; Wright & Snell, 1991). HRM strategy can be defined as the process that are typically concerned with devising ways of managing people which will assist in the achievement of the organizational objectives (Fombrun, Tichy & Devanna, 1984). HRM strategy models grounded in the resource perspective rest on the implicit assumption that the set of employee behaviour, attitudes, and relationships underlying an organization's HR systems can be critical to the implementation of business strategy (Bamberger & Meshoulam, 2000).

Many researchers attempt to develop typologies of HRM strategy. Some of these typologies are generated intuitively on the basis of theory, while others derived the typologies empirically. Though it may not be possible to reconcile all typologies differences, a number of common underlying elements across these typologies are identified (Bamberger & Meshoulam, 2000). Miles and Snow (1984) develop three types of HRM strategy namely utilizer, accumulator and facilitator. Dowling and Schuler's (1990) produce three types of HRM strategies i.e. utilization, facilitation and accumulation. This typology is derived from an alignment with Schuler and Jackson's (1987a) business strategy typology that includes the three strategies of cost reduction, innovation and quality enhancement.

Facilitation HRM strategy focuses on exploration into products and markets in which they traditionally have had little or no experience. Thus, they are less aware of the specific behaviour that is necessary to perform well in these areas. These organizations are constantly trying out new products and markets and will likely move on quickly if it appears that there is little opportunity for profit in an area (Dowling & Schuler, 1990; Miles & Snow, 1984; Morley et al., 2006). Therefore, the organization needs employees that

possess creative behaviour, high level of cooperative, interdependent behaviour, moderate concern for quality and quantity, greater degree of risk taking, high tolerance on ambiguity and unpredictability and have a longer focus.

In contrast, accumulation HRM strategy represents policies and practices of attracting many good candidates very carefully and very consistently, often more on the basis of personal fit than technical fit. This type of HRM strategy should acquire repetitive and predictable behaviour, long-term or intermediate focus, a modest amount of cooperative, interdependent behaviour, a high concern for quality and modest concern for quantity of output.

Utilization HRM strategy has narrow and stable product-market domain and seldom makes major adjustments in its technology or structure. It is predicated on minimal commitment, high skill utilization and seeks to deploy the HR of an organization as efficiently as possible (Arthur, 1990; Dowling & Schuler, 1990; Miles & Snow, 1984). Consequently, it involves with 1) relatively stable and explicit job description, 2) narrowly designed jobs and career paths that encourage specialisation, expertise and efficiency, 3) short-term and result-oriented performance appraisal, 4) close monitoring of market pay levels and 5) minimal levels of training and employees.

### **Outsourcing of HR functions**

There are many definitions of outsourcing. It is defined as the purchase from external vendors of a value-creating activity that either was or could have been done in-house (Gilley & Rasheed, 2000; Hansen et al., 2008). Consequently, outsourcing HR functions is the practice of turning overall or part of an organization HR functions to an external providers (Pelham, 2002; Lievens & De Corte, 2008). Outsourcing activities initially encompassed only small segments of HR functions particular non core functions such as payroll and benefits administration (Adler 2003), but has gradually grown to encompass many HR functions including core functions such as HR planning and development (Quinn, 1992; Delmotte & Sels, 2008). Other potential functions consist of training, recruitment, compensation, relocation and HR information systems (Lilly et al., 2005; Gilley et al., 2004).

Naturally, different organizations in different circumstances will expect different benefits. HR outsourcing is mandated by the need of specific expertise, a new developmental stage of organizational HRM that has exceeded the organization's existing capacity, advances in HR information systems, reduce cost (Laabs, 1993; Lever 1997; Delmotte & Sels, 2008) and increased risk exposure (Greer, et al., 1999; Klaas, 2003). However, the potential benefits from outsourcing also entail some challenges such as resistance from HR department, lack of employee preparation, loss of internal expertise and skills, quality of HR services from vendors, and lack of competitive advantage (Adler, 2003).

Below is the discussion of hypothesis relationship between different types of HRM strategy and HR outsourcing as well as HR outsourcing with reduction in the size of HR department.

## 2. Theory and Hypotheses Development

The decision to outsource HR functions to external vendors or performed internally is addressed by Transaction Cost Economics (Williamson, 1998). Transaction Cost Economics (TCE) offers a useful framework for understanding the conditions under which HR outsourcing is likely to benefit organisations. Organisations may seek lower costs by transacting with external vendors rather than building internal resources to execute the HR functions. HR outsourcing, however, ranges from core (HR planning) to non-core activities (routine payroll administration). Given the dissimilarities between HR functions, different types of HRM strategy may influence the possibility of outsourcing some forms of HR functions more than others, resulting in different determinants for various forms of HR outsourcing. Given that the HRM strategic dimensions will likely affect the cost savings associated with market contracting (Williamson, 1998), this study uses TCE to develop hypotheses that predict relationships between strategies, the outsourcing of HR functions and the reduction in HR labor costs.

The concept of the resource-based view (RBV) of the organisation (e.g. Barney, 1991; Ulrich, 1996) suggests that outsourcing could be productive to the development of the core competence of the organisation specifically in relation to HR functions. In this scenario, HR outsourcing supports strategies of selectively building valuable skills through outsourcing non-core functions, which provides existing HR employees more time to focus on core and high skill functions. This study uses both TCE and RBV perspectives to develop the research hypotheses outlined below.

### **The Relationship between Facilitation HRM strategy and HR outsourcing**

Individuals working under this practice become important and precious to the organization, to themselves as well as to the competitors. New knowledge, skills, and abilities are facilitated. Accordingly, organizations provide opportunities for intensive, free flowing interaction with colleagues. Organization with facilitation HRM strategy focuses on the innovation of new products and tends to face with very dynamic and uncertain environment. The workloads become very unpredictable and the organization experience frequent changes in the practices and procedures guiding work in this area (Lever, 1997; Gainey et al., 2002; Stroh & Treehuboff, 2003). Thus, by practicing most of the HR functions in house will incur significant investment such as software, systems, equipment and other facilities. Consequently, an outsourcing contract will shift the organization burden of monitoring and then implementing the changes of these activities to the service provider who is willing and better able to bear risks for a premium (Lever, 1997; Klaas et al., 2001). Therefore, it is hypothesized that:

*H1: Reliance on HR outsourcing will be higher for organizations with facilitation strategy.*

### **The Relationship between accumulation HRM strategy and HR outsourcing**

This strategy represents policies and practices of attracting many good candidates and facilitates the practice of lifetime employment and seniority. The organization focuses on providing promotional opportunities and therefore reduces of the recruitment activities (Ordanini & Silvestri, 2008; Klaas et al., 2001). Hence, it is effective for the organization to manage the HR functions in house since they do not incur significant investment to cope with frequent changes of attracting new employees. This organization tends to have internal training such as job rotation, job enlargement and job sharing in order to ensure that all the

employees are well equipped with the new and current skills and knowledge which are needed across the time. Accordingly, outsourcing of HR functions may incur additional cost and may be relevant for only a few years (Schuler, 1989; Ordanini & Silvestri, 2008). Building on the points mentioned above, it can be hypothesized that:

*H2: Reliance on HR outsourcing will be lower for organizations with accumulation strategy.*

#### **The Relationship between Utilization HRM strategy and HR outsourcing**

Organizations that engage with utilization HRM strategy seeks to reduce the cost of HR functions. The use of part timers, subcontractors and outsourcing of HR functions are encouraged. Candidates with skills, abilities, experience and knowledge are the priority since the organization saves on training and development cost. This practice facilitates the concept of employment at will and those with the relevant skills survive. The primary focus of this strategy is to increase productivity which means a reduction in the number of employees (Schuler & Jackson, 1987; Woodall, et al., 2009). Therefore, organizations can save both time and money by outsourcing HR functions (Ulrich et al., 2008). Hiring an outsourcing agency with expertise in this area reduces the time needed to perform HR functions (Klaas et al., 2001). The workload in payroll and other administrative HR functions are high and unpredictable, therefore outsourcing is an option which relieves the organization of the need to hire extra payroll personnel, shift staff or risk late payroll and hence reduce labour costs. Therefore, this study hypothesized that:

*H3: Reliance on HR outsourcing will be higher for organizations with utilization strategy*

#### **The Relationship between HR outsourcing and the size of HR department**

The assessment of the HR performance is also a complex process because its management, supports and development goals may be inconsistent or in contradiction with one another (Ahmed, 1999). Gilley et al., (2004) find there is a relationship between training activities and higher performance in term of stakeholders, which includes employment growth/stability, employee morale customer relations and supplier relations as well as a strong relationship between outsourced payroll activities and innovation. Past researchers emphasise on the impact of HR outsourcing on organizational performance (Gilley & Rasheed, 2000; Gilley et al., 2004) and Lilly, Gray and Virick (2005) posit that HR outsourcing will have impact on HR performance. Jamrog and Overholt (2004) assert that there are many indicators such as employee morale, satisfaction, turnover and others to measure HR performance. However, many researchers state that cost benefits appear to be a compelling argument for contracting out services previously performed internally (e.g. Greer et al., 1999; Lever, 1997).

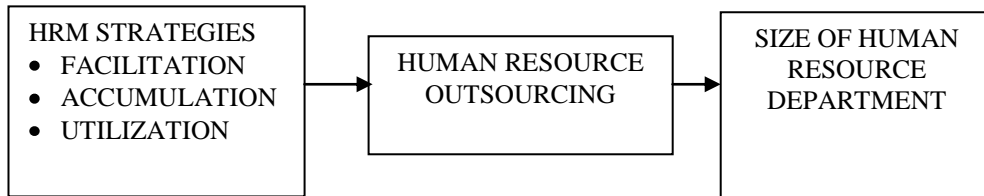
Bettis, Bradley and Hamel (1992) mention that as outsourcing increases, cost may decline, investment in facilities and equipment may be minimised and the importance things manpower can be reduced. This is consistent with a study done by Siegel (2000) where he claims that the impact of relying on external vendors is to confront reduce staffing HR department accompanies by increased responsibilities. HR employees include not only staff members who deal with recruiting, retaining, firing, motivating, and developing the organization's employees, but also HR employees that deal with personnel functions such as wage administration and training (Brewster et al., 2006).

Therefore, it is anticipated that outsourcing of HR functions may be lead to the reduction of HR employees. It is hypothesized that:

*H4: Outsourcing of HR functions is related to a smaller size of HR department*

### 3. Conceptual Framework

The relationships hypothesized drive from previous literature and are tested in the context of the proposed model (see figure 1)



**Figure 1 Conceptual model**

### 4. Methodology

#### Data Collection

This study used mail survey questionnaire. The questionnaires were targeted to senior HR manager of Malaysian manufacturing organizations. The mailing list was obtained from Federation of Malaysian Manufacturers Directory (FMM). The survey yielded 23 percent response rate resulting in 232 respondents useable responses from an eligible sample of 990 organizations.

#### Measurement Instruments

The construct of the study, which were adapted from established scales, were measured on a six-point semantic differential-likert scale anchored by 1 = strongly disagree and 6 = strongly agree. Ratio scale was used to measures of percentage of each HR functions outsourced and also the computation of cost saving by the reduction of the number of HR employee after outsourcing. Respondents were asked to provide absolute figures in order to tap the constructs.

#### Reliability Test

Confirmatory Factor Analysis (CFA) via AMOS 6 was conducted to check on the validity and the reliability of the measurement scales. Regression analysis via SPSS version 17 was used to test the hypotheses. The model fit was assesses using  $\chi^2/df$ , goodness-of-fit index (GFI) and the comparative fit index (CFI), Tucker-Lewis fit index (TLI) and root mean square of approximation (RMSEA). The threshold for  $\chi^2/df$  should be less than 3.0 and values of GFI, CFI and TLI should be over 0.90 and value for RMSEA should be less than 0.08 (Hair et al., 2006).

The results of the CFA in Table 1 shows that different types of HRM strategy meet the criteria of goodness-of fit index (GFI), tucker lewis index (TLI) and comparative fit index (CFI) of above 0.9 (Hair et al. 2006). These authors add that root mean square error of

approximation (RMSEA) values of less than 0.1 represent a good fit, while values below 0.05 represent a very good fit to the data.

**Table 1: CFA for HRM Strategy**

Variable	Chi-square ( $\chi^2$ )	P value	GFI	TLI	CFI	RMSEA
Facilitation	37.018	0.017	0.917	0.948	0.961	0.080
Accumulation	10.952	0.279	0.968	0.984	0.990	0.044
Utilization	16.856	0.264	0.960	0.973	0.982	0.043

## 5. RESULTS

### Profile of the Respondents

From 232 respondents, 48.7 percent (113 respondents) of them claim that they engaged with outsourcing of HR functions. Table 2 shows the profile of the 113 organizations that outsource HR functions.

**Table 2: Profile of the Organizations that Outsourced HR Functions**

HR Outsourced Organizations	Percentage
<b>1. Type of industry</b>	
• Food and beverages	7.1
• Textiles	8.9
• Wood products	5.4
• Chemical products	10.7
• Rubber and plastic products	8.9
• Metal products	8.0
• Machinery and equipment	15.2
• Electronics	14.3
• Radio, TV and communication	14.3
• Motor vehicles, trailers and semi-trailers	7.1
<b>2. Total Employees</b>	
• 150 to 300 employees	26.8
• 301 to 1000 employees	41.1
• Above 1000 employees	32.1
<b>3. Total HR Employees</b>	
• Below 5 employees	29.5
• 5 to 20 employees	46.4
• Above 20 employees	24.1
<b>4. Years of establishment</b>	
• Below 1980	36.6
• 1981 to 1990	34.8
• 1991 and above	28.6
<b>5. The cost of HR employees (RM)*</b>	
• Below RM20000	5.4
• RM20000 – RM50000	7.5
• RM50001 – RM100000	16.1
• Above RM100000	3.6

\*RM – currency for Ringgit Malaysia

Most of the respondents were from machinery and equipment industry (15%). 41 percent of the organizations employed 301 to 1000 employees with about 46 percent of them employed five (5) to twenty (20) HR employees. Then, almost 37 percent of these organizations were established below the year of 1980. Moreover, 16 percent of these organizations incur RM50001 to RM100000 of the HR labour cost.

**The Effect of HRM strategies on HR outsourcing**

Linear regression was performed to examine the direct relationship between different types of HRM strategy and HR outsourcing. The result is presented in Table 3.

**Table 3: Regression for HRM Strategy and Size of HR Department**

Independent Variable	Std Beta
Facilitation	0.160*
Accumulation	-0.099
Utilization	0.210**
R	0.35
R Square	0.13
Sig.	0.00
F value	5.037***

Note: \*p< .10, \*\*p< .05, \*\*\*p< .01

The results show that 13 percent of the variations in HR outsourcing can be explained by the types of HRM strategy. The significance of F change is 0.00, thus this implies that there exist significant relationship between different types of HRM strategy and HR outsourcing. The results show support for hypotheses H1 and H3. Organizations with facilitation HRM strategy were found to have higher reliance on HR outsourcing. Similarly, organizations with utilization HRM strategy relied heavily on HR outsourcing. The beta value of 0.21 indicates that facilitation HRM strategy is the most influential variable in explaining HR outsourcing. In contrast, accumulation HRM strategy was found to be not statistically significant with the HR outsourcing. As a result hypothesis H2 was not supported.

**The Effect of HR outsourcing on Size of HR Department**

The result of the relationship between HR outsourcing and the size of HR department is shown in Table 4.

**Table 4: Regression for HR Outsourcing and Size of HR Department**

Independent Variable	Std Beta
HR outsourcing	0.361***
R	0.36
R Square	0.13
Sig.	0.00
F value	16.67***

Note: \*p< .10, \*\*p< .05, \*\*\*p< .01



The result demonstrates that HR outsourcing is positively associated with the smaller size of HR department ( $p < 0.05$ ) leading to support H4. This indicates that organizations experience reduction of employees by engaging with HR outsourcing whereby, they can redirect the higher cost of hiring specialist or expatriate to the external agency as well as experience cost saving resulting from the reduction of the number of HR employees. Summarized, the number of employees engaged in the HR function will tend to be smaller when the organizations engaged with HR outsourcing.

### **Discussion and Conclusion**

The rapid growth of HR outsourcing demonstrates that for many organizations the decision to either 'make' or 'buy' HR functions swings toward the latter. Hence, it is crucial for the researchers to give attention on the factors that trigger the decision to outsource HR functions. This study has provided a significant step in this direction by examining the predictors to HR outsourcing. Furthermore, this study takes a first step towards a better understanding on the antecedents of HR outsourcing among manufacturing organizations in Malaysia. Most of the past research only concentrates on the reasons and risks towards HR outsourcing in particular. Thus, this research has developed the antecedent of HR outsourcing namely HRM strategy. This is not shocking as HRM strategy is designed for the whole HR departments' functions. Therefore, it is an exploratory nature to investigate whether HRM strategy is the force behind the outsourcing of HR functions.

The findings indicate that facilitation HRM strategy was significantly related to HR outsourcing. It interprets that organizations outsource heavily with facilitation HRM strategy. This is not surprising as these organizations operate in dynamic and vigorous environments. Since the needs of these organizations are unpredictable, performing most of HR functions in house requires frequent changing and altering. Therefore, by outsourcing, external vendors are able to monitor the frequent modifications of the functions as well as to avoid significant amounts of investment costs (Stroh & Treehuboff, 2003).

Organizations with utilization HRM strategy also found that it is pertinent to have higher reliance on HR outsourcing. In this case, organisations that outsourced hope to take advantage of lowering their cost and grab the up-to-date technology possessed by external vendors. In fact, outsourcing can bring relief to the organisation by avoiding the need to hire extra personnel and shift staff around. A lower number of HR employees mean less initial training and less subsequent training. All this translates to lower labor costs (Lever, 1997; Ulrich et al., 2009). Furthermore, investments in new software, systems and equipment become unnecessary. Organisations can rely on the external vendors to create adaptable systems that meet unique and complex requirements (Jarvis, 1999).

Apart from that, the finding shows that by having higher reliance on HR outsourcing, organizations will experience significant reduction in the number of HR employees. HR outsourcing will inevitably lead to significant changes to the organization as a whole. The changes have impact on HR employees and require support from the organizations. Effective communication and change management are important to develop such new environment and being accepted by the employees.

The findings of this study have significant practical implications. First, this study offers to assist the HR managers to understand the concept of HR outsourcing and to guide them on

what conditions the HR outsourcing is most desired. HR outsourcing is a potentially strong instrument for organizations attempting to empower their HR function. The arguments derived from transaction cost economics, would have led this study to expect that HR outsourcing is saving the cost and enhance the core competency.

Secondly, HR managers are re-assessing the delivery of HR functions. There are many alternative delivery mechanisms that remove the delivery of HR practices from HR department (Lepak et al., 2005). HR outsourcing is not the only option available. There is also some evidence that a large number of HR functions are shifted to line management (Larsen & Brewster, 2003). For HR managers it is important to scrutinize these alternatives delivery mechanism, to weigh their pros and cons and to select the mechanism that match the HRM strategy of the organizations.

Finally, when making decisions on HR outsourcing, HR managers need to carefully analyse under what conditions are the best to outsource HR functions and also to conduct in-depth research on whether their objectives can be achieved. The most important facet is not to abolish entire HR departments and ensure that a back-up system is put in place if this takes place. The drastic cuts in HR employees engaged in the affected HR functions may add to problems of morale and motivation. The difficulty of handling the higher management expectations of line managers also showed that the role of 'employee champion' was perceived to be a complicated and uncomfortable one for many HR employees.

This study is not without limitations. Firstly, the generalizability of this study's findings may be limited to size and years of experiences of the organizations. Thus, future research should attempt to gather information from the organizations regardless of the size of employees and the years of establishment. It would be interesting if future study could generate the scenario of HR outsourcing among small organizations. Secondly, the respondents of this study are from the manufacturers, thus generalizing the findings to service organizations may be difficult. It is possible that the pattern of outsourcing may be different for service organizations than it is for manufacturers, because service industries are characterised by less tangible outputs and simultaneous consumption and production (Boddewyn, Halbrich & Perry, 1986). Future studies should therefore allow for generalizations regarding this subject and must cover service organizations in different sizes and sectors. Thirdly, this study did not categorize HR activities into core and non-core HR functions. In future, the study should focus on core and non-core activities as organizations tend to outsource non-core activities to external vendors and keep core activities in-house (Gilley & Rasheed, 2000).

This study also only focused on the size of HR department as the consequences of HR outsourcing. Perhaps, future research should focus on financial metrics to provide objective evaluation of performance. Indicators such as productivity, cost savings or reduction in overhead costs might be very interesting. In addition, future studies should also examine the consequences of HR outsourcing on HR performance such as turnover rate, absenteeism, employee morale and other HR effectiveness measures. Finally, future research such as the inclusion of other characteristics such as business strategy, structure and environmental factors might enhance the future contribution of the research.

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