

HUMAN RESOURCE OUTSOURCING IN SMES - AN EXPLORATION OF CRITICAL ISSUES

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Small and Medium-Sized enterprises (SMEs) play an important role in all economies and are the key generators of employment and income all over the world (OECD, 2009). They form a major chunk in the economic activity of nations. SMEs play a vital role for the growth of Indian economy by contributing 45% of industrial output, 40% of exports, employing 60 million people, create 1.3 million jobs every year and produce more than 8000 quality products for the Indian and international markets. SME's Contribution towards GDP in 2011 was 17% which is expected to increase to 22% by 2012 (www.smechambersofindia.com.2011). There are approximately 30 million MSME Units in India. SMEs are the fountain head of several innovations in manufacturing and service sectors, the major link in the supply chain to corporate and the PSUs.

The SME sector is the most important employment-generating sector and is an effective tool for promotion of balanced regional development. These account for 50 percent of private sector employment. It produces a diverse range of products (about 8000 odd items), including consumer items, capital and intermediate goods. The SME sector in India employs around 26 million people and is involved with the production of over 7500 industrial items with the product range varying from very simple items produced with traditional technology to high tech products. At present, this sector accounts for over 90% of industrial units in the country, 40% of value addition in the manufacturing output and approximately 35% of India's exports. Indian entrepreneurs are making remarkable progress in various Industries like Manufacturing, Precision Engineering Design, Food Processing, Pharmaceutical, Textile & Garments, Retail, IT and ITES, Agro and Service sector.

However, majority of SMEs in emerging economy cannot compete in an effective way due to their internal resource gap (UNIDO, 2003). For example, resource- based view (RBV) argues smaller firms are more vulnerable than larger firms because they lack the necessary resources and capability for survival and growth. "SMEs in global value chains are even more vulnerable as they often bear the brunt of the difficulties of the large firms" (OECD, 2009). Indeed, SMEs face with resource gap and competitive pressures, they are forced to lessen their costs and create new opportunities through optimized utilization of external resources. Evidently, outsourcing practices is the best way to reduce costs and create opportunity for growth. Outsourcing not only looks at overall business improvement and competitive advantages but also it will cut costs (Gilley et al., 2004; Delmotte and Sels, 2008). Furthermore, outsourcing can add value through the higher quality available from external sources (Gilley and Rasheed, 2000; Gilley et al., 2004; Jiang and Qureshi, 2006). SMEs in India have been passing through a transitional period.

Though the SMEs have played a huge role in aspects of alleviating the employment pressure, guaranteeing social stability, promoting business prosperity, growing demand, drawing folk investment, improving existing economic structure, and so on yet , because of small scale and limited fund, most of the SMEs do not have a special human resource department; do not have a systemic human resource management system, and can not provide a good welfare treatment and training opportunity to the employees. The difficulties in aspect of attracting and retaining the

talented person are restricting SMEs' development. Given that, outsourcing of HR functions is an option for SMEs so as to sustain a competitive benefit in the competitive environment as outsourcing could diminish the burden suffered by SMEs. Because SMEs often lack the necessary skills and resources to carry out HR functions in-house, gaining access to the expertise and specialized knowledge of the professional organizations (Vender of HR Services) clearly has been the major reason to outsource.

THE CONCEPT OF HR OUTSOURCING

HR outsourcing is the contracting out of parts or the whole of the functions of HR to external providers, rather than performing all the HR functions in-house (Adler, 2003; Cooke et.al., 2005). HR outsourcing ranges from simply transferring noncore activities such as payroll and benefits administration to external providers, to the outsourcing of recruitment, training and even HR strategic planning (Cooke et.al., 2005; Klaas et al., 1999). HR managers are expected to be more flexible, responsive, and efficient than personnel managers of old, and to contribute to the strategic decisions of their organizations. In response to this paradigm shift, many HR managers are turning to outsourcing as a way of meeting these demands (Cook, 1999; Cooke et.al., 2005, Seth and Sethi (2011)).

HR outsourcing can be simply understood as the transfer of HR functions and/or processes to another company whose "core business" consists precisely of performing those same functions. This latter company will be responsible for supplying the former with the products and services deriving from the functions transferred to it and will contribute specialized knowledge. It will also advise on innovation and development of those functions.

Small companies pursue outsourcing where the HR function is relatively undeveloped. Extensive outsourcing is used to quickly fill voids in critical HR companies by purchasing services from outside the organization. In such circumstances, outsourcing has the critical advantage of providing HR capabilities while not adding to HR headcount. A company decides to outsource when someone else can perform the activity better than it. As SMEs do not have the resources as well as expertise to effectively manage their Human Resources, their next best alternative is to hire external HR vendors to perform activities that were formerly performed in-house. In addition to expertise, outside vendors can also be more objective than internal staff members. For example, companies hire outsourcing firms to conduct training program evaluations. Expected cost savings has been another substantial rationale for outsourcing. Such cost reduction rationales are consistent with the strategic management view of competitive resource allocation. Hence, all activities, except for those related to strategic core competencies, should be outsourced if vendors can perform them more economically. It was observed in a survey that because of the magnitude of their internal HR operations, specialized vendors were unable to achieve greater economies of scale and cost savings.

DRIVERS OF HR OUTSOURCING

Companies outsource some of their activities or processes for different reasons. Among the most frequently mentioned reasons for outsourcing is reduction of costs (Espino- Rodriguez, Padron-Robaina, 2004; Jennings, 2002, Arnold, 2000, Gilley et al., 2004; Kodwani, (2007); Delmotte and Sels, 2008). Ghodeswar and Vaidyanathan (2008) classify drivers of outsourcing into four categories: organizational drivers, improvement drivers, financial and cost drivers, and revenue drivers (Table 1).

Table 1. Drivers for outsourcing.

Organizational drivers

- (1) To achieve a greater focus on core business.
- (2) To increase flexibility to deal with ever changing business conditions.
- (3) To gain access to products, services and emerging technologies.
- (4) To assign operational issues to an outside expert.
- (5) To have greater thrust on market positioning and new product development.
- (6) To redirect resources from non-core activities to greater focus in serving the customer.

Improvement drivers

- (1) To improve operating performance, quality, timeliness, and productivity.
- (2) To obtain expertise, skills, and innovative ideas.
- (3) To obtain technologies which otherwise will not be available.
- (4) To improve management and control of operational process including risk management.
- (5) To improve credibility and image by associating with superior providers.
- (6) To eliminate the fixed cost of internal staff by moving the function to a supplier.

Financial and cost drivers

- (1) To reduce investment in assets.
- (2) To reduce the invested capital funds in non-core business functions.
- (3) To expanding its operations into a new geographical region.
- (4) To reduce or control operating costs.
- (5) To access an outside provider's lower cost structure.
- (6) To achieve cost reduction with enhanced performance.
- (7) To handle varying demand more efficiently because of economies of scale.

Revenue drivers

- (1) To achieve aggressive growth objectives by gaining increased market access.
- (2) To leverage on the service provider's best process, capacity and systems.
- (3) To expand capacity to design, test and build new products and service.
- (4) To stretch its limit in handling the increased volume of business.
- (5) To manage demand efficiently through outsider's automation, process maturity and the latest technology.
- (6) To focus on enablers of business growth and strategies to fulfill them

Source: Ghodeswar and Vaidyanathan (2008).

CONTENTS OF HUMAN RESOURCE MANAGEMENT OUTSOURCING

Theoretically, the scope of human resource management outsourcing is broad, including all human resource management work nearly. But in practice, HR outsourcing is generally divided into three kinds of services: affair service, consultation service and flow service.

AFFAIR SERVICE

Affair service includes computing and providing salary, computing and paying insurance welfare, managing staff file, and dispatching personnel. Affair service generally do not involve the progress of human resource management in interior of the enterprise, enterprise own human resource department still take charge of management function, service provider do not have any management responsibility. The disposal procedure of this service is unified, service provider does batch processing, and the enterprise can reduce cost from it.

CONSULTATION SERVICE

Consultation service includes program human resource strategy, design describe the organizational structure, writing work description, design human resource management flow, design performance and the salary system and staff retain plan, and planning e-HR. These kinds of service do a detailed diagnosis for enterprise, and provide a corresponding solution through professional management knowledge and experience; it also can help the enterprise to establish a human resource management system. The enterprise can obtain the advanced management knowledge and experience.

FLOW SERVICE

Flow service mainly includes salary management, bonus and welfare management, performance management, employment management and training management. Implementing this kind of service, the two parties should cooperate closely. Supervised by enterprises, the service provider undertakes part or complete technical human resource management function, their responsibility is to make these independent human resource management flows form a relative integrity system. The goal is to enable the enterprise to be concentrated to the strategic human resource management, promote the strategic value of human resource management.

ADVANTAGES OF HR OUTSOURCING FOR SMEs

The essential logic behind human resource outsourcing lies in the fact that the SME can focus on its "core business", delegating specific areas to external experts and thus freeing up resources that can be dedicated to core aspects of its business.

1. **Accessing top-level capabilities**-The major service suppliers are making important investments in technology, methodologies and people. They are gaining experience working with many clients that are confronting common problems. This combination of specialization and experience provides the clients with a competitive advantage and helps them to avoid the cost of continually keeping abreast of developments in technology and training. There are also better professional opportunities for professionals that join up with an outsourcing supplier.
2. **Freeing up resources for other purposes**- Every organization faces limited resources. HR outsourcing allows an organization to redirect its resources, particularly people, from lateral activities to those with superior 'added value'. People whose energy is focused internally can shift to a more external focus on the client.
3. **Commitment to the technological evolution**- In order to be successful, an outsourcing agreement should be based on a relationship of deep trust, between the service supplier and one's own staff. This closeness, linked to

contractual conditions that demand technological updating, ensures the ongoing satisfactory development of all technological infrastructures.

4. **Improving the company's focus Outsourcing-** It allows the company to focus on its core business, in delegating operational tasks to a third party. HR outsourcing implies there is an exclusive contact point for operational questions regarding the starting point, whereby numerous supervisors are involved who are dedicated to managing the relationship with suppliers and internal staff, planning, etc. These supervisors can now concentrate on increasing the business.
5. **Reducing operating costs-** Companies that try to do everything themselves often incur substantial costs for research, development, marketing and implementation, which they end up passing on to their clients. The external supplier's smaller cost structure resulting from economies of scale, along with the efficiency derived from specialisation, reduce the company's operational costs and thus provide a clear competitive advantage.
6. **Accessing resources not available internally-** Companies resort to outsourcing because they do not have the resources they need internally. HR outsourcing provides a viable alternative to build up the capacities they need from scratch.
7. **Freeing up financial resources-** HR outsourcing can reduce the need to invest capital funds in non-core business operations. Instead of acquiring the resources by using capital funds, these can be contracted whereby they are paid per service. HR outsourcing can also improve certain financial ratios for the company in eliminating the need to demonstrate a return on capital investments in non-strategic areas.
8. **Risk reduction-** The investments made by any business entity also reflect the risks due to the constantly changing markets, competition, standards, financial circumstances or its own technology. Staying up to date is very risky in the face of all these changes, particularly those that necessitate a sudden transition requiring substantial investments. The outsourcing suppliers make investments on behalf of various clients simultaneously. In sharing the investment, the risk is apportioned, thus significantly reducing the risk to each of the companies involved.
9. **Improving management of operations that are complex or difficult to control -** HR outsourcing does not imply the withdrawal of final responsibility for the processes or operations subject to the service agreement. When there are confrontations with an operation that proves difficult to manage or that is out of control, the organization should carefully analyse what is causing the problem.

RISKS OF HR OUTSOURCING FOR SMEs

For every study of HR outsourcing showing its advantages, there are studies pointing to its failure or actually increasing costs. Studies have led to some instances in the way outsourcing is conducted. Some outsourcing consultants now promote 'co-sourcing', where the client company keeps responsibility for the management of the outsourced activity, but the outside provider supplies consultancy services and experienced personnel on a 'needs' or 'projects' basis. While traditional outsourcing may be suitable for low risk peripheral activities like cleaning or car fleet management, companies want to retain more with higher risk strategic functions. However, the problems and disadvantages associated with HR outsourcing in SMEs include:

1. Co-ordination costs relate to the increased costs and difficulties of coordinating production and exchange with several external service providers rather than in-house control;
2. Quality and service issues arise when there is an incentive for the contractor providing the service to renege on quality, especially where quality is difficult to verify;
3. Costs of transacting refer to search and selection costs to find out an appropriate contractor. Contractors can often extract post-contractual revenue in the event of unforeseen circumstances due to bargaining advantages. The whole premise of transactions cost theory is that internal transactions are less costly than external ones, which is why firms arise in the first place, to internalise and coordinate market transactions;
4. Costs of monitoring are an important issue as, with all contractual relationships, the client firm may need to intensify the monitoring of the contracting firm's performance in order to minimize the latter's incentive to shirk or cut-back on quality and service;
5. Loss of Control is another worry factor that may hit a client firm over key areas, including the employment relationship and the management of employees.

THE FEASIBILITY OF HR OUTSOURCING

For years, outsourcing's singular purpose was to achieve cost savings in transaction-intensive, back-office business functions. Today, outsourcing has emerged as a flexible and powerful alternative that business leaders can use to achieve a wide range of more strategic goals:

1. **Drive Enterprise Value** - craft an outsourcing relationship that specifically meets the enterprise's needs, gaining access to technology and unique expertise immediately, at a fraction of the cost and time required to bring in-house.
2. **Competitive Superiority** - transform average business processes into competitive capabilities, increasing business disciplines through standardization, centralization, and new technology.
3. **Simplified Operations Management** - improve information flow to management, while streamlining the numerous business processes into a more efficient few.
4. **Renewed Investment in the Core Business** - lower recurring costs significantly, redirecting savings to more strategic aims.
5. **Guaranteed data integrity** - meet regulatory requirements to guarantee the integrity of employee data.
6. **Reduced Capital Expenditures** - Convert upcoming, planned capital expenditures to period operating expenses.
7. **Revived Management Focus** - redirect management time toward strategic initiatives that focus on the real profit drivers of a company, outsourcing repetitive operational processes.
8. **Managed Growth** - handle business fluctuations, support acquisitions and divestitures, stimulating company growth by achieving unique, competitive capabilities.
9. **Accelerated Time to Market** - launch new businesses, fully operational with state-of-the-art capabilities in weeks rather than months.
10. **Improved Integration** - reduce the number of outsourcing vendors, asking a single provider to handle multiple processes, simplifying relationships and improving integration.

11. **Enhanced Efficiencies** - share service centers, extending the operational boundaries of the company to utilize less expensive labor and increase efficiencies.
12. **Improved Service Levels**- accelerate technology roll out, beyond what any company could achieve by itself. Outsourcing applications that run on the Web offers the benefits of self-service processes for customers, vendors, and employees.

THE CRITICAL ISSUES IN EXECUTION OF HR OUTSOURCING IN SMEs

Outsourcing for HR function must be viewed as a business imperative, not a luxury. The approaches and applications must be tailored to fit perfectly. The partnership must be nurtured and closely monitored. Also there is a critical HR issue of potential loss of expertise in certain areas, which may be difficult to recover-a danger of hollowing out of organization. Outsourcing is not a complete bed of roses. The stakes are high but so are the payoffs. But then you win some, you lose some. Despite recognizing the benefits of outsourcing HR, half of small to medium sized businesses are not making the most of the opportunity. The issues they give for stalling on making the decision include, for example, that they are unclear how much it will cost them, compared with their in-house function.

The following seven steps need to be considered to ensure effective execution of HR Outsourcing in Small and Medium Enterprises:

- 1) **Planning Initiatives:** The first step is to announce initiative after the assessment of risks. Project team is to be formed, and advisers are to be engaged to train the team. Other resources are to be acquired and issues like resource management, information management and project management need to be addressed. Accordingly, objectives then be set.
- 2) **Exploring Strategic Implications:** The second step is to understand the organization's vision, core competencies, structure, transformation tools, value chain and strategies. Thereafter decision rights, contract length and termination date need to be determined. Aligning initiative should follow.
- 3) **Analyzing Costs and Performance:** The next step in the process is to measure activity and project failure costs. Existing and future performance is then to be measured along with the estimation of the cost of poor performance. It is also very important to benchmark costs and performance. Specific risks, asset values, make total costs, pricing models and final targets need to be determined.
- 4) **Selecting Providers:** The next crucial step is to select providers. For this purpose, the organizations need to first set qualifications and evaluation criteria. Providers are then identified and screened. An RFP is drafted. Proposals are then evaluated based on the qualifications and costs and the provider is finalized.
- 5) **Negotiating Terms:** Negotiations are then to be planned after addressing high level issues and deal breakers. Accordingly, term sheets are to be prepared. The contract then need to be negotiated based on the scope, performance standards, pricing schedules, and terms and conditions; and the relationship be announced.
- 6) **Transitioning Resources:** The next important step is to adjust team roles and to compare/merge transition plans. The transition issues like communication, human resources, and other production factors are to be addressed. The employees need to be taken into confidence. The organization and the provider are to meet them, make offers/termination, and provide counseling.
- 7) **Managing Relationships:** The last but the most vital step is to adjust management styles, set up oversight

council, and communicate. Meeting agendas, meeting schedule and performance reports need to be defined and designed. Poor performance is to be confronted and problems, if any, are to be solved. The ultimate effort is to build the relationship.

THE LAST WORD

HR outsourcing is one of the most important and powerful forces available to SMEs for building successful companies, creating growth, and positioning the organization on what it does best. No organization can stay competitive in today's rapidly changing global economy by relying solely on its own resources. HR outsourcing is a necessary response to today's hyper-competitive environment. HR outsourcing can be used by SMEs to achieve cost-effective solutions that leverage technology and knowledge to transform the business of human resource management. In today's competitive business environment, HR Outsourcing is an accepted management practice and an opportunity that should be embraced, not ignored. It is a tool that can be applied strategically to reap value for the organization. By outsourcing HR functions or processes SMEs can achieve different goals, such as flexibility, competitiveness, efficiency and effectiveness as well as innovativeness, while the primary purpose of HR outsourcing is to contribute to the company's efficiency. Outsourcing HR function, an SME can gain a competitive advantage as well as have access to professionals who can cut through the minefield of HR practices and deliver a positive impact on its business. This gives employees better benefits and the business owner the freedom to focus on the critical business issues. However, there are a lot of key issues of concern regarding HRO such as quality; security; confidentiality etc. that needs to be addressed by SMEs in order to exploit the available opportunity.

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