

Optimizing HR Outsourcing through Business Strategy

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ABSTRACT

The paper aims at investigating on how HR outsourcing could be optimized by leveraging on different types of business strategy and the impact on human resource performance. Four types of business strategy, namely: quality-based, proactive, breadth and reactive were employed to test their influence on HR outsourcing. The data was gathered from survey questionnaire (232) on manufacturing organizations. The findings suggest that HR outsourcing was effective by espousing reactive business strategy. In fact, by relying on human resource outsourcing, the organizations manage to experience higher human resource performance. This study adds to the literature by providing information on HR outsourcing and business strategy.

Keywords: Human resource management, business strategy, outsourcing, performance

1. INTRODUCTION

Human Resource (hereinafter HR) outsourcing has become a major part of HR operations for the last few years. Smith, Vozikis, and Varaksina (2006) indicate that 61% of the organizations outsourced at least one HR function. Out of that percentage, 68% of them outsourced recruitment, 61% outsourced human resource information system followed by training (56%) and benefit administration (49%). 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).

Despite the dramatic increase in outsourcing practices by organizations, empirical investigations on either HR outsourcing or performance of outsourcing are still lacking (Leiblein, Reuer and Dalsace, 2002; Bolat and Yilmaz, 2009). In fact, empirical evidence to connect both variables is next to none. Currently, only general aspects of outsourcing such as managerial motivation, relationship with

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service providers, advantages, risks and how outsourcing affects organizations are reported. Therefore, this study is to address the existing gap in the literature on the relationship between HR outsourcing on HR performance. This is, however, carried out by identifying the business strategy as predictor of HR outsourcing and the impact on HR performance. In doing so, the paper will commence with the literature review on the concept of business strategy and HR outsourcing and HR performance. Next, the relationships among business strategy, HR outsourcing and HR performance will be discussed. Subsequently, methodology will be presented and finally, the results and discussion of the study will be forwarded.

2. LITERATURE REVIEW

2.1 Business Strategy

The term strategy has been defined in a variety of ways. Chandler (1962) refers to the term as the determination of the basic long-term goals the organizations and the adoption of courses of action and the allocation of resources necessary for executing these goals. Miles and Snow (1978), on the other hand define strategy as the consistent pattern in the decision that guide an organization in competing in a given business. Similarly, Mintzberg (1990) defines business strategy as a set of decisions about direction of an organization. Therefore, it can be derived that organizations regard business strategies as a continuous process of evaluation of their distinctive competencies and adaptation to the environment they operate. In line with the dynamic definition of business strategy, this study proposes integrated strategic dimensions (i.e. an integration of typologies - Miles and Snow's (1978), Porter's (1980), Schuler and Jackson's (1987) and Miller's (1987)) that resulted to four distinct business strategies namely: 1) Quality-based strategy; 2) Proactive strategy; 3) Breadth strategy; and 4) Reactive strategy.

Quality based strategy focuses on producing and delivering the highest quality of the products. Organizations that espouse quality based strategy attempts to produce and deliver products and services with the highest quality possible (Jackson and Schuler, 1987). Proactive strategy, on the other hand, concentrates on innovation and differentiation of the products, which attempts to differentiate products through unique designs and features (Miles and Snow (1978); Porter's (1980)). In contrast to breadth strategy that focuses on many product lines with bases of customers (Miller, 1987; Miles and Snow, 1978; Porter, 1980). Finally, reactive strategy strives to produce products cheaper than competitors. These organizations stress efficient scale facilities, the pursuit of cost reduction, mineralization of expenses of production, R&D, services, selling and advertising (Porter 1980; Miles and Snow 1978; Miller 1987). They do very little product innovation and differentiation as this is disruptive of efficiency.

2.2 Outsourcing of HR functions

Outsourcing is defined as the purchase from external vendors of a value-creating activity that could have been performed in-house (Gilley and Rasheed 2000; Delmotte and Sel, 2008). In this manner, HR outsourcing is the practice of turning over all or part of an organisation HR functions to an external provider (Pelham 2002). For instance, initially only small segments of HR functions (non core) such as payroll and benefits administration (Adler 2003) are outsourced, but gradually core functions such as HR planning and development (Quinn 1992) are also outsourced. Others such as training, recruitment, compensation, relocation and HR information systems are potential functions of HR that could be outsourced (Lever 1997; Gilley, Greer and Rasheed 2004).

2.3 Human Resource Performance

Organizations outsource to increase performance and HR outsourcing should lead to increased HR performance. It is beneficial to focus on the factors that lead to HR outsourcing, but defining the appropriate situation in which to act to increase HR performance has not yet been established (Lilly, Gray and Virick, 2005). The proposed model is a starting point to connect HR outsourcing to HR performance since there is next to none literature on the circumstance the organisation should outsource HR functions to increase HR performance (Lilly, Gray and Virick, 2005).

However, a potential difficulty with HR performance is to adequately defining and measuring what is meant by HR performance. 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). Nevertheless, Jamrog and Overholt (2004) posit that measurement of HR performance would not be a problem to the organizations and assert that there are many indicators such as employee morale, satisfaction, turnover and others to measure HR performance. The point is that there is no shortage of HR measures but perhaps HR is simply not measuring the right things and therefore failing to accurately gauge HR's value proposition or the impact that HR has on the business (Lilly, Gray and Virick, 2005; Jamrog and Overholt, 2004; Ahmed, 1999).

However, in terms of HR outsourcing, some researchers contend that cost reduction can be an important measure in the HR departments (e.g. Laab, 1993; Marinaccio 1994). Shelgren (2004) asserts that HR performance can be measured by reducing HR cost, gain expertise and control over processes, and improve quality of service, According to Herbertson (2000), in order to improve HR performance, organization should aims for cost reduction, a greater focus on core business, a reduction in overheads and a service improvement. This is consistent

with Switzer (1997) that among the potential benefits of HR outsourcing will be on lower the headcount. As a result, cost saving is achieved in terms of time and money saving techniques for performing the work. Past researchers emphasise on the impact of HR outsourcing on organisational performance where 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.

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 minimized 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. Therefore, it is anticipated that outsourcing of HR functions may be lead to greater HR performance particularly reduction in HR employees.

3. MODEL DEVELOPMENT AND HYPOTHESES

The issues on HR outsourcing are related to many of the broader ‘make’ and ‘buy’ issues addressed in TCE (Williamson 1996). According to TCE, HR outsourcing may be viewed as relying on market contracting as a form of organization structure as opposed to depending on organizational hierarchy. In such a way, TCE encourages the organization to evaluate whether it is more efficient to make a service in-house or to buy it from the market. Outsourcing is appropriate when the organization achieves lower cost by transacting with external vendors rather than building the internal capacity for a service (Adler 2003; Cooke *et al.* 2005).

Apart from that, organizations outsource HR functions is to build core competencies (Quinn & Hilmer 1994; Ordanini & Silvestri 2008). In this respect, organization may seek greater focus on a limited set of core competencies which are high value-added skills (Pralhad & Hamel 1990; Quinn & Hilmer 1994). This concept of the resource-based view of the organization (e.g. Barney 1991; Delmotte & Sels 2008) presents arguments that outsourcing can be productive to the development of the core competence of the organization specifically in relation to HR functions. In this instance, 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.

3.1 Relationship between Business Strategy and HR Outsourcing

Lilly, Gray and Virick, (2005) posit that little is known regarding which HR activities should be outsourced heavily. Quinn (1992) argues that HR outsourcing should be limited to only non core HR functions whereas core HR functions should be done in house to maintain the competitiveness of the organizations. However, decision making on which area of HR to outsource depends on the business strategy of the organizations.

For instance, organisations that strive to produce the highest quality of the products benefit the most by performing and maintaining the HR functions in house particularly on recruitment and training activities (Lilly, Gray and Virick, 2005; Lepak, Bartol and Erhardt, 2005). Recruiting the right people with the right attitude, and train them with appropriate training are the starting point for organizations to produce highest quality products. Moreover, it is not easy to explain criteria needed to outside party since these processes most of the time is based on past experiences (Barney, 1991). By engaging with external vendors, it would require upfront investment in understanding the particular need of the organization. In short, organizations that emphasize on quality focus more on performing HR functions in house.

Proactive organizations, on the other hand, focus on distinctive practices and tend to be unique (Miles and Snow 1978; Porter 1980). Organizations frequently face with uncertain environment and this may require organizations to constantly recreate short run competitive advantage that becomes obsolete by the introduction of newer products and services (Porter 1980; Miles and Snow 1978). When the environment is uncertain, the organization needs to respond to market changes very rapidly. In this environment, the workloads become very unpredictable, dynamic and need frequent changes (Miller 1986). Therefore, under uncertainty condition, the best solution for the organization to avoid significant cost involved is by outsourcing the HR functions (Gilley and Rasheed 2000).

Breadth strategy de-emphasizes the importance of employees, as the goal is to produce a consistent but wide variety of products at low cost. Therefore, the orientation is more towards manufacturing efficiency resulting in a more tightly coupled production processes. The organizational logic behind this strategy is to design narrow jobs requiring multiple skill and flexibility, thus making employees an easily replaceable component to the production process (MacDuffie 1995; Snell and Dean 1992). Employees also do not possess specialized skills since their skills concentrate on producing variety of products. Employees require frequent training to adapt with wide variety of products such as job rotation, job enlargement and enrichment. In this case, the employees will go through more on the on-the-job training rather than off-the-job-training. As noted by Klaas, McClendon and Gainey (2001), activities that require frequent

modification of contract provisions means that market based governance mechanisms expose each party with higher cost and risk. Thus, to avoid unnecessary costs, it is better to execute these functions internally.

An organization pursuing reactive HR strategy tends to emphasis on outsourcing of HR functions. This is because reactive organization aims to reduce cost especially on repetitive work, non-core activities, non strategic functions and never ending burden works (Laabs 1993; Kremic, Tukel and Rom 2006). Organizations can use part-time employees, subcontractors, work simplification and measurement procedures, automation, work rule changes, and job assignment flexibility to increase productivity and efficiency (Cook 1999). In addition, since the external vendors often focus on a limited set of HR practices, they frequently realize a significant degree of economies of scale. The benefit for organizations is that they have access to relevant expertise that may be quite affordable. In fact, by outsourcing the HR functions organizations are able to shift the risk of technological obsolescence, skill obsolescence and updating onto vendors (Laabs 1993; Cook 1999). Moreover, cost saving from reductions in personnel and higher quality services from the service providers translate into higher value for the customers (Lever 1997). Ideally, by doing this organizations will experience production effectiveness and efficiency (Stroh and Treehuboff, 2003; Lever 1997).

Based on the argument above, it shows that different types of business strategy predict the outsourcing level of HR functions and have the impact on the HR performance. Therefore, it is clear to formulate the following hypothesis:

Ha: Quality-based strategy is negatively related with outsourcing of HR functions..

Hb: Proactive strategy is positively related with outsourcing of HR functions.

Hc: Breadth strategy is negatively related with outsourcing of HR functions.

Hd: Reactive strategy is positively related with outsourcing of HR functions.

He: Outsourcing of HR functions is positively related with HR performance

3.2 Model of HR outsourcing

The relationships hypothesized drive from extant literature and are tested in the context of the conceptual model. This proposed model is shown clearly in Figure 1.

4. METHODOLOGY

4.1 Data Collection

This study used mail survey questionnaire. The questionnaires were targeted to head of human resource department of Malaysian manufacturing organizations. The mailing list was obtained from Federation of Malaysian Manufacturers Directory (FMM) for year 2005. The survey yielded 23% response rate resulting in 232 respondents useable responses from an eligible sample of 990 organizations. The questionnaire was 12-pages long and part of a much larger research project.

4.2 Measurement Instruments

The construct of the study, which were adapted from established scales, were measured on a six-point semantic differential-likert scale. Thirty-two (32) questions were asked on the business strategy construct. From factor analysis, four factors of business strategy were produced with factor loading from 0.445 to 0.828 with KMO and Bartlett's test of 0.908 and 0.000. These four factors contributed 53.48% to item variance. The Cronbach (α 's) of each of the factor are as follow. Quality-based strategy $\alpha = 0.943$; proactive strategy $\alpha = 0.925$; breadth strategy $\alpha = 0.806$ and reactive strategy $\alpha = 0.600$. To measure the outsourcing level of HR functions, ratio scale was used to measures of percentage of each HR functions outsourced. To measure the HR performance that is to look into the cost saving by the reduction of the number of HR employee after outsourcing, In order to compute the cost saving from reduction of HR employees, information on total salary of HR employees and the total number of HR employees for the year of 2005 are required to get the average HR cost incurred by the organizations. Then, in order to get the cost saving, the average HR cost will be multiplied with the number of HR employees being reduced after outsourcing of specific HR practices in 2005.

4.3 Data Analysis

SPSS version 12 and AMOS 6 were used to analyze and test the hypotheses.

5. RESULTS

5.1 Profile of the Respondents

From 232 respondents, 48.7% (113) of them claim that they engaged with outsourcing of HR functions and the rest indicate that they do not involve HR outsourcing at all. Table 1 shows the profile of the 113 organizations that outsource HR functions. Most of the respondents were from machinery and

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

Table 1: Profile of the Organizations that Outsourced HR Functions

HR Outsourced Organisations	Percentage
1. Type of industry	
• 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
2. Total Employees	
• 150 to 300 employees	26.8
• 301 to 1000 employees	41.1
• Above 1000 employees	32.1
3. Total HR Employees	
• Below 5 employees	29.5
• 5 to 20 employees	46.4
• Above 20 employees	24.1
4. Years of establishment	
• Below 1980	36.6
• 1981 to 1990	34.8
• 1991 and above	28.6
5. The cost of HR employees	
• Below RM20000	5.4
• RM20000 – RM50000	7.5
• RM50001 – RM100000	16.1
• Above RM100000	3.6

5.2 The Confirmatory Factor Analysis for Business Strategy

The results of the Confirmatory Factor Analysis in Table 2 shows that different types of business strategy meet the criteria of goodness-of fit index (GFI), tucker-lewis index (TLI) and comparative fit index (CFI) of above 0.9 (Hair, Black, Babin, Anderson and Tatham 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 2: Confirmatory Factor Analysis for Business Strategy

Variable	Chi-square (χ^2)	P value	GFI	TLI	CFI	RMSEA
Quality-based	8.35	0.14	0.97	0.98	0.99	0.08
Proactive	1.67	0.20	0.99	0.99	0.99	0.08
Breadth	1.09	0.30	0.99	0.99	0.99	0.03
Reactive	4.12	0.25	0.98	0.95	0.98	0.06

5.3 Path Analysis

Figure 1 shows the conceptual model. Table 3 summarizes the findings. Overall, the data of the study fit the model well. The results of the fit are as the following: $\chi^2 = 6.891$, $p > 0.01$, GFI = 0.982, TLI = 0.963, CFI = 0.988 and RMSEA = 0.058. From Table 3, reactive strategy is positively associated with HR performance ($P < 0.1$) leading to support for *Hd*. For *Ha*, *Hb*, and *Hc*, the relationships were not supported, indicating there is no direct impact, HR outsourcing effect of quality-based, proactive and breadth business strategy for the organizations in this sample. HR outsourcing is positively associated with the HR performance ($p < 0.05$) leading to support *He*. This indicates that organizations experience reduction of employees by engaging with outsourcing strategy 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.

Table 3: Results of the Hypotheses

Hypothesis	Direction	S.E.	C.R.	β	Support
<i>Ha</i>	Quality-based → HR Outsourcing	0.47	-1.27	-0.18	No
<i>Hb</i>	Proactive → HR Outsourcing	0.42	0.09	0.01	No
<i>Hc</i>	Breadth → HR Outsourcing	0.44	-1.21	-0.17	No
<i>Hd</i>	Reactive → HR Outsourcing	0.54	1.78	0.21 [†]	Yes
<i>He</i>	HR Outsourcing → HR Performance	0.02	2.66	0.25**	Yes

Significance levels: ** $P < 0.01$, * $p < 0.05$, [†] $p < 0.1$

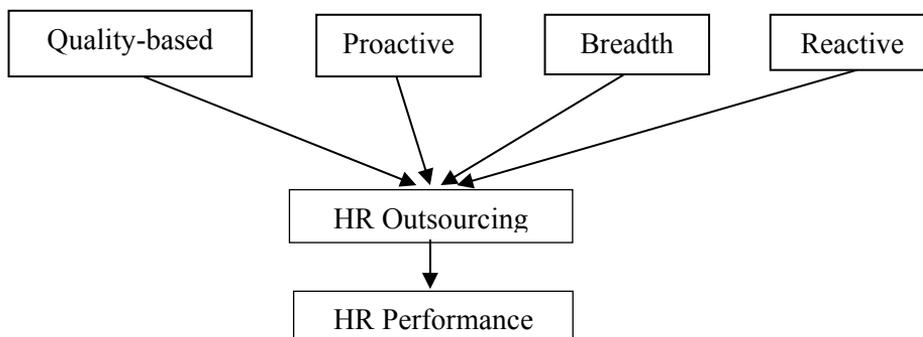


Figure 1: Conceptual model

6. DISCUSSION, IMPLICATIONS AND CONCLUSION

This study has provided a significant step towards better understanding of HR outsourcing among manufacturing organisations in Malaysia. Past research only concentrates on the reasons and risks towards HR outsourcing in particular. The research to date has not yet determined the factors that predict the degree of HR outsourcing. Gilley and Rasheed (2002) have demonstrated different types of business strategy as the moderator between outsourcing and performance. They found several significant interactions with strategy to predict performance. Subsequently this research has developed business strategy as the antecedent of HR outsourcing. Reactive strategy had positive significant association with HR outsourcing. This indicates that organisations that emphasise on cost efficiency tend to engage with external vendors to perform HR functions. This result is consistent with Klaas, McClendon and Gainey (1999) where organisations that face with cost pressure engage with external vendors to perform HR functions as this generate more benefits and immediate saving. External vendors may be able to manage these functions more efficiently and attain economies of scale.

Nevertheless, the result shows that quality-based, proactive and breadth business strategy cannot be claimed as the predictor to the assessment of HR outsourcing strategy. It is highly likely that the outsourcing decisions require proper estimating of the cost of a service or product, the time horizon of the outsourcing decisions and any associated opportunity costs (Kee and Robbins 2003). Additionally, there is a wide range of outsourcing arrangements: from short-term contracts to full ownership of and, or, merger between service purchasers and service providers (Bensaou 1999). Therefore, the relationship between two parties in a market transaction must have overlapping motives in order to enter into, develop and maintain a relationship. Moreover, HR outsourcing is likely to

be made on the basis of the management team's skill level, interest, and preferences. So, the outsourcing decision may be decided of talent, interest in performing the activity and convenience rather than how business strategy predicts HR outsourcing.

Furthermore, there are very limited studies of the performance effect of HR outsourcing. In fact, there is no empirical study on the impact of HR outsourcing on the HR performance. Although this study emphasises on the impact of HR outsourcing solely on the cost saving resulting from the reduction of HR employees, it somehow gives impetus to study on the effect of HR performance. Thus, this study provides additional information on the HR performance effect of outsourcing level of HR functions to the literatures.

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 desired the most. While only reactive business strategy is a significant predictor to HR outsourcing, organisations experience better HR performance by outsourcing HR functions to external vendors. Although it is desirable to have a strategy that promotes competencies inside the organizations, effective HR outsourcing are not merely adopted but are shaped for specific organizations with specific competitive needs to produce best results. In short, this study has made important contributions to managers and researchers by filling gaps in this kind of study. It specifically contributed to the existing practical business applications in terms of the business strategy, HR outsourcing strategy and HR performance. However, this might be missed with the exclusion of other characteristics such as human resource management strategy, structure and environmental factors as the antecedents to HR outsourcing which might provide additional insight for future research.

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