

They're Not Employees, They're People

by Peter F. Drucker



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They're Not Employees,

Two fast-moving trends are changing the way companies manage talent. If you don't pay attention, you'll lose your competitive edge before you know it.

TWO EXTRAORDINARY CHANGES have crept up on the business world without most of us paying much attention to them. First, a staggering number of people who work for organizations are no longer traditional employees of those organizations. And second, a growing number of businesses have outsourced employee relations; they no longer manage major aspects of their relationships with the people who *are* their formal employees. These trends are unlikely to reverse themselves anytime soon. In fact, they'll probably accelerate. And they're happening for some very good reasons, as we'll see.

That said, the attenuation of the relationship between people and the organizations they work for represents a grave danger to business. It's one thing for a company to take advantage of long-term freelance talent or to outsource the more tedious aspects of its human resources

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management. It's quite another to forget, in the process, that developing talent is business's most important task – the sine qua non of competition in a knowledge economy. If by off-loading employee relations, organizations also lose their capacity to develop people, they will have made a devil's bargain indeed.

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Every working day, one of the world's biggest private employers, the Swiss company Adecco, places nearly 700,000 temporary and full-time clerical, industrial, and technical associates with businesses all over the world – perhaps as many as 250,000 workers in the United States. Adecco is the temp industry giant, but it has only a small share of a totally splintered global market. In the United States alone, there are thousands of such companies that together place some 2.5 million workers each day. World-

wide, at least 8 million, if not 10 million, temp workers are placed each day. And 70% of all temps work full time.

When the temp industry first started nearly 50 years ago, it supplied low-level clerks to take the place of ledger keepers, receptionists, telephone operators, stenographers, or the ladies in the typing pool who were sick or on vacation. Today there are temp suppliers for every kind of job, all the way up to CEO. One company, for instance, supplies manufacturing managers who can lead new plants from their inception until the facilities are in full production. Another supplies highly skilled health care professionals such as nurse anesthetologists.

In a related but distinct development, the *professional employee organization* (PEO) was the fastest-growing business service in the United States during the 1990s. These businesses manage their clients' employees as well as

their clients' employee relations—that is, the administrative, HR kinds of tasks associated with managing those employees. PEOs were virtually unknown only ten years ago but by 2000 had become the “coemployers” of 2.5 million to 3 million blue-collar and white-collar U.S. workers. There are now at least 1,800 such organizations; they even have their own trade association and their own monthly journal.

PEOs, like temp agencies, have vastly expanded their scope in recent years. The first PEOs in the late 1980s offered to do bookkeeping, especially payroll, for their clients. Now PEOs can take care of almost every task in employee management and relations: record keeping and legal compliance; hiring, training, placements, promotions, firings, and layoffs; and retirement plans and pension payments. PEOs originally confined themselves to taking care of employee relations at small businesses. But Exult, probably the best known PEO, was designed from the start to be the coemployer for global *Fortune* 500 companies. It numbers among its clients BP Amoco, Unisys, and Tenneco Automotive. Founded just four years ago, it has already gone public and is traded on the Nasdaq. Another PEO, designed originally to handle payroll functions for businesses with fewer than 20 employees, is about to take on managing the 120,000 employees of one of the largest U.S. states.

Both the temp industry and the PEOs are growing quickly. Adecco is expanding at a rate of 15% a year. In the second quarter of 2001, Exult's revenue grew 48%, from \$43.5 million to \$64.3 million. And the PEO industry as a whole is growing at a rate of 30% a year. Collectively, PEOs expect to be the coemployers of 10 million U.S. workers by 2005.

The reader may wonder, How can a manager function if she's not in charge of hiring, promoting, or firing the people in her department? I posed this question to a senior executive at BP Amoco whose workers, including senior scientists, are now managed by Exult. His answer: “Exult knows it has to satisfy me if it wants to keep the contract. Sure, they make the decision to fire someone or move them. But normally only because I suggested it or after they consulted with me.”

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Clearly, something is happening in employee relations that does not fit with what the management books still write about and what we teach in business school. And it surely does not fit with the way HR departments at most organizations were designed to function.

Strangled in Red Tape

The reason usually offered for the popularity of temporary workers is that they give employers flexibility. But far too many temps work for the same employer for long periods of time – sometimes year after year – for that to be the whole explanation. And flexibility surely does not account for the emergence of PEOs. A more plausible explanation for the popularity of these trends is that both types of organizations legally make “nonemployees”

out of people who work for a business. The driving force behind the steady growth of temps and the emergence of the PEOs, I would argue, is the growing burden of rules and regulations for employers.

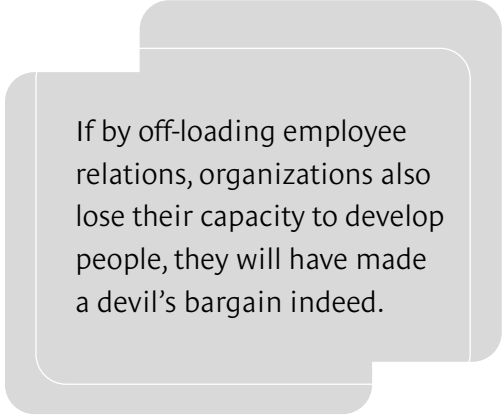
The cost alone of these rules and regulations threatens to strangle small businesses. According to the U.S. Small Business Administration, the annual cost of government regulations, government-required paperwork, and tax compliance for U.S. businesses

employing fewer than 500 employees was somewhere around \$5,000 per employee in

1995 (the last year for which reliable figures are available). That amounts to about a 25% surcharge on top of the cost of employee wages, health care, insurance, and pensions – which in 1995 was around \$22,500 for the average small-business employee. Since then, the cost of employment-related paperwork is estimated to have risen by more than 10%.

Many of these costs can be avoided altogether by using temporary workers in place of traditional employees. That's why so many companies are contracting with temp agencies for workers—even though the hourly cost of a temp is often substantially higher than the wage-and-benefit cost of a full-time, formal employee. Another way to reduce the bureaucratic costs is to outsource employee relations—in other words, to let a specialist do the paperwork. Aggregating enough small businesses to manage at least 500 employees as one workforce—which is, of course, what a PEO does – can cut employment-related costs by 40%, according to SBA figures.

It is not only small businesses that can cut their labor costs substantially by outsourcing employee relations. A 1997 McKinsey study concluded that a global *Fortune* 500



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firm—in other words, a very big company indeed—could cut its labor costs 25% to 33% by having its employee relations managed by an outside company. This study led to the foundation of Exult a year later.

The outsourcing of employees and employee relations is an international trend. Although employment laws and regulations vary widely from country to country, the costs they impose on businesses are high everywhere in the developed world. For instance, Adecco's biggest market is France, its second-largest market is the United States, and the company is growing at a rate of 40% per year in Japan. Exult opened an employee management center in Scotland in 2000 and has offices in London and Geneva.

Even more onerous than the costs of complying with employment laws are the enormous demands that the regulations place on management's time and attention. Between 1980 and 2000, the number of U.S. laws and regulations regarding employment policies and practices grew by about 60%, from 38 to 60. The regulations all require managers to file multiple reports, and they all threaten fines and punishment for noncompliance, even if the breach was unintentional. According to the SBA, the owner of a small or midsize business spends up to a quarter of his or her time on employment-related paperwork.

Then there is the constant, and constantly growing, threat of lawsuits: Between 1991 and 2000, the number of sexual harassment cases filed with the Equal Employment Opportunity Commission more than doubled, from about 6,900 a year to almost 16,000 a year. And for every case filed, ten or more were being settled in-house, each requiring many hours of investigation and hearings, as well as substantial legal fees.

No wonder that employers (especially smaller companies, which constitute the overwhelming majority) complain bitterly that they have no time to work on products and services, on customers and markets, on quality and distribution—that is, they have no time to work on results. Instead, they work on problems—that is, on employee regulations. They no longer chant the old mantra "People are our greatest asset." Instead, they claim "People are our greatest liability." What underlies the success of the employment agencies and the emergence of the PEOs is that they both enable management to focus on the business.

This argument, by the way, may also explain the success of *maquiladoras*—the manufacturing plants on the Mexican side of the U.S. border, and, increasingly, in Mexico proper, that assemble parts made in the United States, the Far East, or Mexico into finished products for the U.S. market. In fact, avoiding hours of paperwork is probably a stronger incentive for manufacturing companies to outsource this kind of assembly work than the often questionable savings in labor costs. The Mexican company that is the *maquiladora's* landlord acts as the coemployer, handling all employee regulations and activities—which are

as complicated in Mexico as they are in the United States—thus freeing up the U.S. or Japanese plant owner to focus on the business.

There is not the slightest reason to believe that the costs or demands of employment rules and regulations will decrease in any developed country. Quite the contrary: No matter how badly the United States needs a patient's bill of rights, that will undoubtedly create another layer of agencies with which an employer will have to deal—another set of reports and paperwork, another avalanche of complaints, disputes, and lawsuits.

The Splintered Organization

Beyond the desire to avoid the costs and distractions of regulations, there is another major reason for both the rise of temporary workers and the emergence of PEOs: the nature of knowledge work and, most particularly, the fact that knowledge workers are extraordinarily specialized. Most large, knowledge-based organizations have lots of experts; managing all of them effectively is a big challenge—one that temp agencies and PEOs can help to address.

Not so long ago, even in the 1950s, as much as 90% of the U.S. workforce was classified as "nonexempt"—subordinates who did as they were told. The "exempt" were the supervisors who did the telling. Most nonexempt employees were blue-collar workers who had few skills and little education. They typically did repetitive tasks on the plant floor or in the office. Today, less than one-fifth of the workforce is blue-collar. Knowledge workers now make up two-fifths of the workforce, and while they may have a supervisor, they are not subordinates. They are associates. Within their area of expertise, they are supposed to do the telling.

Above all, knowledge workers are not homogeneous: Knowledge is effective only if it is specialized. This is particularly true among the fastest-growing group of knowledge workers—indeed, the fastest-growing group in the workforce overall—knowledge technologists such as computer repair people, paralegals, and software programmers. Because knowledge work is specialized, it is deeply splintered work, even in large organizations.

The best example is the hospital—altogether the most complex human organization ever devised, but also, in the past 30 or 40 years, one of the fastest-growing types of organizations in all developed countries. A fair-sized community hospital of 275 or 300 beds will have around 3,000 people working for it. Close to half of them will be knowledge workers of one kind or another. Two of these groups—nurses and specialists in the business departments—are fairly large, numbering several hundred people each. But there are about 30 paramedic specialties: physical therapists, lab workers, psychiatric caseworkers, oncological technicians, the teams of people who prepare

patients for surgery, the people in the sleep clinic, the ultrasound technicians, the cardiac-clinic specialists, and many, many more.

Each of these specialties has its own rules and regulations, educational requirements, and accreditation processes. Yet in any given hospital, each specialty area comprises only a handful of people; there may be no more than seven or eight dietitians, for instance, in a 275-bed hospital. Each group, however, expects and requires special treatment. Each expects—and needs—someone higher up who understands what the group is doing, what equipment it needs, and what its relationship should be to doctors, nurses, and the business office. Also, there are no career-advancement opportunities within the hospital for any of the specialists; not one of them wants to be the hospital's administrator or has any chance of getting the job.

Few businesses currently have as many specialists as hospitals do, but they're getting there. A department store chain I know of now counts 15 or 16 distinct knowledge specialties—for instance, the retail buyers, the display people, the salespeople, and the promotions and advertising group—and employs only a handful of each kind of specialist in any one store. In financial services, too, there is increasing specialization among knowledge workers and fewer career opportunities for them within the organization. For instance, the experts who select the mutual funds to be offered to retail customers probably will not become salespeople, servicing individual accounts. And it is likely that they will not be particularly interested in managing anything larger than a small group at the firm—a handful of fellow specialists, at most.

Hospitals in the United States have largely tackled this problem of specialization through piecemeal outsourcing. In many hospitals, each knowledge specialty is managed by a different outsourcer. For instance, the group that administers blood transfusions may be managed by a company that specializes in this procedure and that simultaneously runs the transfusion departments at several other hospitals. Like a PEO, it is the coemployer of the blood transfusion staff. Within this network, the individual transfusion specialists have career opportunities: If they perform well, they can move up to manage the transfusion department at a bigger and better-paying hospital, or they can supervise several transfusion units within the network.

Both the large temp company and the PEO do across the board what in the hospital is done piecemeal. Each of their clients—even the biggest—lacks the ability to effec-

tively manage, place, and satisfy highly specialized knowledge workers. Thus, temp firms and PEOs perform a vital function for employees as well as their employers. This explains why PEOs can claim, and apparently document, that the people whose coemployer they have become report high job satisfaction—in contradiction to everything human relations theory would have predicted. The metallurgist in a midsize chemical company may be well paid and have an interesting job, but the company needs and employs only a handful of metallurgists. No one in upper management understands what the metallurgist is doing, should be doing, could be doing. There is no opportunity, except a remote one, for the metallurgist to become an executive; that

would mean giving up what he has spent years learning to do and loves to do. The well-run temp agency places the metallurgist where he can make maximum contributions. It can place the successful metallurgist in increasingly better-paid jobs.

In a PEO full-service contract (and many PEOs won't offer any other) it is expressly provided that the PEO has the duty and the right to place people in the jobs and companies where they

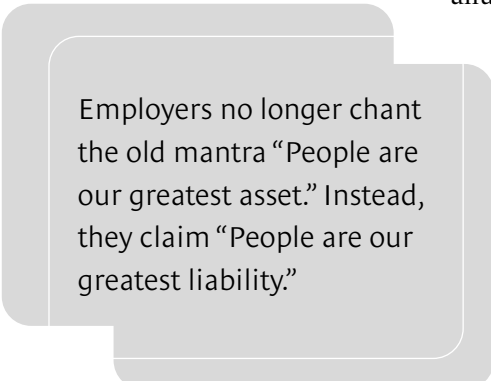
best fit. Balancing its dual responsibilities—to the corporate client and to the employee—is probably the PEO's most important and challenging job.

Companies Don't Get It

HR policies still assume that most if not all of the people who work for a company are employees of that company. But as we have seen, that is not true. Some are temps and others are employees of the outsourcers who manage, say, the company's computer systems or call center. Still others are older part-time workers who have taken early retirement but still work on specific assignments. With all this splintering, no one is left to view the organization in its entirety.

Temp agencies claim to be selling productivity—in other words, to be doing the organization's oversight job for them—but it's hard to see how they can deliver. The productivity of the people they supply to a customer depends not only on how and where those workers are placed but also on who manages and motivates them. The temp agency has no control over those last two areas. The PEO, too, manages only its clients' formal employees, not necessarily part-time, temp, or contract workers.

This lack of oversight is a real problem. Every organization must take management responsibility for *all* the people whose productivity and performance it relies



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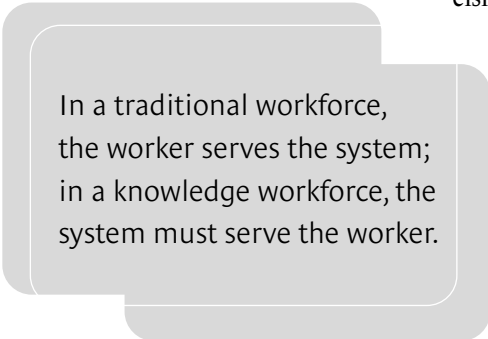
on—whether they're temps, part-timers, employees of the organization itself, or employees of its outsourcers, suppliers, and distributors.

There are signs that we are moving in that direction. A European multinational consumer goods maker is about to spin off its large and highly regarded employee management function into a separate corporation that would act as the PEO for the parent company and its employees throughout the world. This PEO would also manage the multinational's relationships with, and utilization of, people who are not traditional employees of the organization. Eventually, this in-house PEO will offer itself as the coemployer for those who work for the multinational's suppliers and distributors and for its more than 200 joint ventures and alliances.

A Source of Competitive Advantage

It is actually more important today for organizations to pay close attention to the health and well-being of all their workers than it was 50 years ago. A knowledge-based workforce is qualitatively different from a less-skilled one. True, knowledge workers are a minority of the total workforce and are unlikely ever to be more than that. But they have become the major creators of wealth and jobs. Increasingly, the success—indeed, the survival—of every business will depend on the performance of its knowledge workforce. And since it is impossible, according to the laws of statistics, for an organization to hire more than a handful of “better people,” the only way that it can excel in a knowledge-based economy and society is by getting more out of the same kind of people—that is, by managing its knowledge workers for greater productivity. The challenge, to repeat an old saying, is “to make ordinary people do extraordinary things.”

What made the traditional workforce productive was the system, whether it was Frederick Winslow Taylor's “one best way,” Henry Ford's assembly line, or W. Edwards Deming's “total quality management.” The system embodies the knowledge. The system is productive because it enables individual workers to perform without much knowledge or skill. In fact, on assembly lines and in TQM shops, a highly skilled individual can be a threat to coworkers and to the entire system. In a knowledge-based organization, however, it is the individual worker's productivity that makes the entire system successful. In a traditional workforce, the worker serves the system; in a knowledge workforce, the system must serve the worker.



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There are enough knowledge-based organizations around to show what that means. What makes a university a great university is that it attracts and develops outstanding teachers and scholars, making it possible for them to do outstanding teaching and research. The same is true of an opera house. But the knowledge-based institution that most nearly resembles a knowledge-based business is the symphony orchestra, in which some 30 different instrumentalists play the same score together as a team. A great orchestra is not composed of great musicians but of adequate ones who produce at their peak. When a new conductor is hired to turn around an orchestra that has suffered years of drift and neglect, he cannot, as a rule, fire any but a few of the sloppiest or most superannuated players. He also cannot hire many new orchestra members. He has to make productive what he has inherited. The successful conductors do this by working closely with individual orchestra members and with groups of instrumentalists. The conductor's employee relations are a given; the players are nearly unchangeable. So it is the conductor's people skills that make the difference.

It would be difficult to overstate the importance of focusing on knowledge workers' productivity. The critical feature of a knowledge workforce is that its workers are not labor, they are capital. And what is decisive in the performance of capital is not what capital costs. It is not how much capital is being invested—otherwise the Soviet Union would have easily been the world's foremost economy. What's critical is the productivity of capital. The Soviet Union's economy collapsed, in large part, because the productivity of its capital investments was incredibly low. In many cases, it was less than one-third that of capital investments in market

economies, and sometimes actually negative—consider the huge investments in farming made during the Brezhnev years. The reason for failure was simple: No one paid any attention to the productivity of capital. No one had that as his or her job. No one got rewarded if productivity went up.

Private industry in the market economies teaches the same lesson. In new industries, leadership can be obtained and maintained by innovation. In an established industry, however, what differentiates the leading company is almost always outstanding productivity of capital.

In the early part of the twentieth century, General Electric, for instance, competed with rivals like Westinghouse and Siemens through innovative technology and products. But in the early 1920s, after the era of rapid technology innovation in electromechanics had come to an end, GE concentrated on the productivity of capital to give it

decisive leadership, and it has maintained this lead ever since. Similarly, Sears's glory days from the late 1920s through the 1960s were not based on its merchandise or pricing—the company's rivals, such as Montgomery Ward, did just as well in both areas. Sears prevailed because it got about twice as much work out of a dollar as other American retailers did. Knowledge-based businesses need to be similarly focused on the productivity of their capital—that is, the productivity of the knowledge worker.

Free Managers to Manage People

Temps and especially PEOs free up managers to focus on the business rather than on employment-related rules, regulations, and paperwork. To spend up to one-quarter of one's time on employment-related paperwork is indeed a waste of precious, expensive, scarce resources. It is boring. It demeans and corrupts, and the only thing it can possibly teach is greater skill in cheating.


Companies thus have ample reason to try to do away with the routine chores of employee relations—whether by systematizing employee management in-house or by outsourcing it to temps or to a PEO. But they need to be careful that they don't damage or destroy their relationships with people in the process. Indeed, the main benefit of decreasing paperwork may be to gain more time for people relations. Executives will have to learn what the effective department head in the university or the successful conductor of the symphony orchestra have long known: The key to greatness is to look for people's potential and spend time developing it. To build an outstanding university department requires spending time with the promising young postdocs and assistant professors until they excel in their work. To build a world-class orchestra requires rehearsing the same passage in the symphony again and again until the first clarinet plays it the way the conductor hears it. This principal is also what makes a research director in an industry lab successful.

Similarly, leaders in knowledge-based businesses must

spend time with promising professionals: Get to know them and be known by them; mentor them and listen to them; challenge them and encourage them. Even if these people are not traditional—read, legal—employees, they are still a capital resource for the organization and critical to its business performance. The administrative tasks that are involved with employee relations can, and should, be systematized—and that means they can, perhaps should, become impersonal. But if employee relations are being outsourced, executives need to work closely with their PEO counterparts on the professional development, motivation, satisfaction, and productivity of the knowledge workers on whose performance their own results depend.

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Modern organizations emerged from the Industrial Revolution. The cotton mill and the railroad were first. But while unprecedented, they were still based on manual labor, as was all earlier work, whether it was farming, manufacturing, clearing checks by hand, or entering life-insurance claims into a ledger. This was the case as late as 50 or 60 years ago, even in the most highly developed economies. The emergence of knowledge work and the knowledge worker—let alone their emergence as the chief source of capital in our knowledge-based society and economy—is thus as profound a change as the switch to a machine-driven economy was all those years ago, perhaps an even greater one.

This shift will require more than just a few new programs and a few new practices. It will require new measurements, new values, new goals, and new policies. It will predictably take a good many years before we have worked these out. However, there are enough successful knowledge-based organizations around to tell us what the basic assumption has to be for managing employees in today's companies: Employees may be our greatest liability, but people are our greatest opportunity. 

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