Human Resources
The value of internal referrals

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"Human resources are like natural resources; they're often buried deep. You have to go looking for them, they're not just lying around on the surface. You have to create the circumstances where they show themselves."

— Ken Robinson

Abstract

Introduction

Personal Experience

In this section our personal experience and thoughts related to the value of internal referrals are stated. This section was written before any of the relevant theory and models were researched to avoid any biases in our observations. The effects of internal referrals are measured on two different levels, the personal level that is the effects on a person making the referral and the organizational level which measures the effects based on the organizational as a whole. To give some contexts to our personal experience first our backgrounds are discussed after which the effects on the two levels are mentioned.

Background

Since three years I have been working at small risk consultancy firm with approximately ten employees.All the employees have the same background education and are working in a very specific field. The projects are done in very small groups which consist of one to three persons. Being so small means the communication lines are short and a lot of situations are discussed with the whole firm. Recently a new student position opened up and sollications poured in. Now one of my college friends which I now know for about ten years was searching for such a position. From the ten employees four of those came directly from referrals made by the employees themselves so the culture of referrals was there. After a few moments of thought I decided to go through and later on he was hired for the position. In the next section this decision is elaborated upon and the thought process is carefully.

Personal Factors

This section covers the personal factors involved into internal referrals. Referring a friend or acquaintance often involves numerous trade offs and carefull examination. Each of the following subsections contains a question or thought process that lead to making the referral decision.

Does the person being referred fit into the team?

What dangers do I run when I stick my stick my neck out for this person?

What are the consequences of breaking the seperation of business and private life?

Organizational Factors

In this section the organizational factors of internal referrals are discussed. As stated in the introduction a lot of firms have bonus referral programs which reward employees to refer friends or acquaintances. Therefore it seems there are only benefits to referrals and no downsides. These benefits and possible downsides are discussed in each of the subsections.

What are the main differences between external or internal referrals?

Do referrals create islands in the team?

Does the personal atmosphere hurt the performance?

Theory and models

Conclusion

Annotated Bibliography

In this section the basis for the conclusions made in the main sources that are used throughout this paper. The basis containes excerpts from the original source.

Who gets the job referral?, *Beaman, L. & Magruder, J.* [1]

"By interacting initial OP ability with performance pay in column (3), we see that the differential performance of referrals recruited by high ability OPs is driven by OPs who face performance pay incentives. Therefore, high ability individuals refer high ability people only when properly incentivized, suggesting that the networks of high ability OPs are heterogeneous and that high ability OPs do have the capacity to screen."

This laboratory experiment by Beaman tries to find out who gets job referral by how capable this person was by performing ability test. The OP (original participants) conducted a test and were asked to refer a friend to the "job". This friend also conducted the same test and varying fixed referral and perfomance referral fees were tried out. The above conclusion came out.
"Thus, while all OPs change their referral choices in response to changing contractual conditions, only high ability OPs do so in a way which results in higher ability referrals. As the model emphasized, a variety of possible differences between high and low ability OPs could explain why performance incentives did not induce low ability OPs to recruit higher ability referrals: they may not know high ability referrals; they may lack information on the ability of their network members; or the tradeoff between their network incentives and the performance incentives may be too large"

Here a conclusion is drawn that low ability OPs did not produce good referrals even with a performance incentive. The authors note a couple of possible reasons.

The relationship between recruiting source and employee success, *Caldwell, D. & Spivey, W.* [2]

TABLE 3
Employee Job Success by Recruiting Source for Each Racial Group

		Source of Referral				
Group	*n*	Employee Referral	In-Store Notice	Employment Agency	Media Announce-ment	Chi Square
White						
Unsatisfactory	475	68%	54%	60%	56%	
Satisfactory						
Short term	182	12%	22%	20%	27%	14.11*
Long term	175	20%	24%	20%	17%	
Black						
Unsatisfactory	249	78%	70%	74%	57%	
Satisfactory						
Short term	64	11%	15%	0%	27%	16.85**
Long term	57	11%	15%	26%	16%	
Other						
Unsatisfactory	109	47%	60%	70%	50%	
Satisfactory						
Short term	49	25%	20%	20%	32%	6.15
Long term	40	28%	20%	10%	18%	

* $p < .05$.
** $p < .01$.

"First, while employee referral was relatively less effective in recruiting satisfactory employees, a disproportionate number of those were long term."

This study was performed on 1400 store clerks which exhebit an extremely high turnover. After 3 years none of the clerks were still employed at the company. The observation made above is therefore of importance. Employee referral at jobs with high turnover does not lead to better results (or in this case even worse).

The Effect of Workplace Genderand Race Demographic Composition on Hiring Through Employee Referrals, *Taber, M. & Hendricks, W.* [3]

"For example, when an individual comes from a distinct racial minority in the workplace (0 to 15 percent of the workers are of the same race),that person is almost three times more likely to have been hired through formal sources than employee referral."

This study tries to model the likelihood of a person being referred or employed through formal sources. The argument made is that employees refer to people like themselves as these are available within the network. The above argument shows that other racial minoritities almost do not get referred by the employees if these minorities are not highly present within the firm. Workforce diversity is therefore lowered by employee referral programs.

Recruiting through advertising or employee referrals, *Rafaeli, A. et al.* [4]

"Two parameters were calculated for each of these recruiting sources: Yield ratio was the proportion of new hires from the total number of applications through a given source; cost per new hire was the direct cost of hiring an applicant, which was computed by dividing the total expenditure per hiring source by the number of new hires recruited through the source."

The paper tries to model the cost and yield of referral programs.

"As is evident in Table 1, the average cost of hiring through advertising was significantly higher than hiring through employee referrals (22,652 per new hire, compared to nothing for hires recruited through referrals). This may not be surprising given that employee referrals are cost-free, yet the average cost of recruiting employees through national advertising is a striking 81,000 per hire, confirming the importance of considering cost-per-newhire in evaluations of recruitment processes. Furthermore, consistent with our analysis geographically focused ads were far less expensive than unfocused ads costing 1140 per hire as compared to the striking 81,000 per hire."

Employee referral leads to significantly cheaper employees compared to formal channels such as advertising. This company did not have a bonus referral program in place and hence no incentives were given to employees to refer.

"Paradoxically the yield ratio of the less costly employee referrals was significantly greater than that of employment advertising: .133 (109 new hires out of 821 applicants) as compared to .032 (23 new hires out of 724 applicants). The yield ratio of geographically focused (local) advertising (.073) was also better than that of geographically unfocused (national) advertising (.018)."

Employee referral has the highest yield ratio (propertion of new hires) implying that screening done by the employees themselves is effective and leads to better applications than just the advertisement.

Do informal referrals leads to better matches?, *Brown, M. et al.* [5]

"Our central finding is that referred applicants are indeed more likely to be hired. Among the set of applicant sources, internet job boards produce the largest number of observed applicants, and so we employ job boards as the omitted category. Relative to job board applicants, referred applicants are estimated to be 7.3 percentage points more likely to be interviewed for the position, and 2.4 percentage points more likely to receive an offer. Conditional on having been interviewed,referred applicants are 13.9 percentage points more likely than job board applicants to receive offers."

The hypothesis of *referred candidates are more likely to be hired* was comfired and is in line with the results found in the previous subsection.

"The estimated coefficient on referral in the log salary regression, reported in Table 7, indicates a 2.1 percent starting salary premium for referred workers. The coefficient is significant at the one percent level. The magnitudes of the referral coefficient estimates in the linear and log salary regressions are roughly consistent, given mean and median salaries of 102.740 and 97.377, respectively."

Interestingly, referred also receive a higher salary compared to external sources. No clear reason for this in the paper.

"As discussed in Section 3.3, however, current theory of labor market referrals predicts that the referral effect will dissipate over time, and the salaries of referred and non-referred workers who remain with the corporation will converge. The log salary estimates reported in Table 7 provide a test of the referred salary premiums time trajectory. We find that the referral effect does indeed diminish over time. In all linear tenure specifications in Table 7, the coefficient on the interaction between the referral indicator and tenure in the organization, is negative and significant at the one percent level."

This salary advantage diminishes over time however. Theory explains that this is because external market workers will separate over time and therefore some of the lower quality workers will leave the sample.

Data mining to improve personnel selection and enhance human capital, *Chien, C. & Chen, L.* [6]

"In addition, for the employees of function C, we found that the employees who had more than one year of previous work experience and were hired from external channels would be more likely to quit within three months than those who were hired from internal channels. This finding was supported by domain knowledge

since the employees recruited from internal channels usually stay longer, since the referrals should have shared more information about the job and the company. Thus, this company has adapted this finding and developed a strategy to raise a campaign for promoting the referrals by giving cash bonus to successful hiring."

An interesting argument is made why the tenure of the reffered is longer than external workers is longer. It gives another explanation besides the usual screening process done by the employee them selves. The paper argues (ungroundedly) that the reffered stay longer because they have a better idea of the job than the external workers.

References

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