The Value of Hiring through Employee Referrals in Developed Countries*

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Author's Main Message

Hiring through employee referrals is a very common labor market practice for firms. Growing evidence supports the idea that there are benefits to firms in hiring through employee referrals. At the same time, hiring through employee referrals may entail various costs that firms should also attend to.

Pros

- Referred employees have lower turnover relative to non-referred employees.
- Referred employees may sometimes have higher productivity relative to non-referred employees.
- Referred employees may involve lower recruiting costs.
- "Good homophily"—firms get employees that share its values or desirable characteristics.

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Cons

- It is possible that referrals could disadvantage women or minorities in the hiring process.
- Referred employees may sometimes receive higher wages relative to non-referred employees.
- "Bad homophily"—firms get employees like their existing employee.
- Referrals may reflect nepotism, so that friends and family get hired instead of the best candidates.

Motivation

It is well known that social networks play a key role in labor markets. Many jobs are found through employee referrals, where existing employees at a firm refer a potential candidate for a job (Granovetter, 1974; Topa, 2012).

For firms, an important question regarding hiring through employee referrals is to what extent referrals help or hinder the firm from accomplishing its business objectives. Hiring is an extremely important topic for economists, but one that leading economists argue is under-researched, particularly relative to other topics (Oyer and Schaefer, 2011).

In this article, I summarize what economists know about the benefits and costs that firms receive from hiring through employee referrals. My main focus is on firms in developed countries, though there is also growing work on the importance of referrals in developing countries.

The study of employee referrals and worker social networks has a rich tradition in economics. It also has a very strong tradition in sociology. I believe that referrals are a topic where economists and sociologists may be able to work together fruitfully to make progress on difficult and un-resolved issues.

Discussion of Pros and Cons

Turnover

One important pattern for referred employees is that they tend to have lower turnover rates than non-referred employees. This pattern has been documented in various labor market settings, including the United States, Germany, and online labor markets. In the United States, lower turnover has been found in representative labor market studies, as well as in the context of particular jobs.

With turnover, one finding is that differences between referred and non-referred employees in turnover may be larger when the employee starts the job (e.g., Dustmann et al., 2016). This gap may fade as tenure increases. Thus, after two employees (one referred and one non-referred) have been at a company for long enough, the relative benefit in terms of turnover risk may start to diminish.[1]

Productivity

Besides turnover, another very important variable for businesses is worker productivity. To what extent do referrals lead to more productive workers?

We have less information about referrals and productivity because worker-level productivity datasets have traditionally not been common. As summarized by Pallais and Sands (2016), study findings have run the gamut, from referred employees having higher productivity (Castilla, 2005), to referred employees having lower productivity (Blau, 1990), to referrals and non-referrals having similar productivity on most metrics (Burks et al., 2015).

An important recent study, Pallais and Sands (2016), argues that selection during the hiring process can play an important role in whether referred employees are more productive than non-referred employees. Using an online labor market, the study obtained a large number of referred and non-referred applicants. However, rather than trying to hire the best

[1]Some work does not find that the turnover gap shrinks with tenure (e.g., Brown et al., 2016).

applicants, the firm hired all the applicants. This helped turn off the selection pressure that occurs when firms try to hire the best candidates, oftentimes favoring referred candidates in the process. The study can therefore shed light on whether referred applicants tend to be more productive than non-referred applicants. The study finds that referrals tend to be more productive than non-referrals, but that selection during the hiring process may be important for understanding productivity comparisons in general.

Less Recruiting Costs

Another way referrals could be valuable for firms is if they lower the costs that firms incur in hiring new workers. Various studies in sociology and in economics argue that referrals do indeed help reduce recruiting costs (Holzer, 1987a; Fernandez et al., 2000; Burks et al., 2015). That is, to achieve a hiring outcome through an employee referral, the total cost of recruitment may be lower than to achieve a hiring outcome for a non-referred individual.

Good Homophily

"Homophily" is a word often used by sociologists and refers to the tendency of people to associate with people like themselves. Homophily is observed across a wide range of social phenomena. For example, people tend to be friends with people of similar races.

One way that referrals can potentially be a positive for firms is if they help leverage homophily on characteristics that are desirable for firms. One recent study found that truck-drivers tended to refer people with similar productivity (either in terms of miles or accidents) (Burks et al., 2015). Thus, provided that individuals with higher productivity are more likely to make referrals, firms can potentially benefit from the tendency of those to refer people like themselves.

A recent study on referrals in online labor markets also found that homophily on productivity is a common feature of referral relationships (Pallais and Sands, 2016). That is, people who were more productive tended to refer people who are more productive.

Potentially Disadvantaging Women and Minorities

Referrals could be a challenge for firms if they do not contribute to diversity in the workplace. In fact, one recent study argued that referrals could actually decrease diversity in the workplace (Beaman et al., 2015). It used data from a field experiment in Malawi. It found that women seemed to be disadvantaged by the referral process relative to men. Specifically, the authors find that men are unlikely to refer women, and that women referred applicants who tended to perform worse (in terms of qualifying for a job) than applicants referred by men.

Turning to race and back to the developed world, Holzer (1987b) provides evidence from the US that black youth may receive less of a benefit from using informal methods than white youth. This occurs even though whites and blacks do not significantly differ in their likelihood of using friends or relatives in the job-finding process.[2] In contrast, Korenman and Turner (1996) do not find lower returns to referrals for Blacks (focusing on wages instead of job-finding), but they do find lower returns to referrals for Hispanics.

The interaction between job networks and characteristics such as race and gender is complex. In the sociology literature, an influential paper argued that reputational considerations play a large role in the referral process (Smith, 2005). Minorities may be hesitant to make referrals if they are concerned they will suffer reputational consequences from a referral that works out poorly.

Higher Wages

One limitation of hiring through referrals (from the perspective of the firm) is that firms may need to pay referred employees more compared to non-referred employees. Different studies have reached different conclusions whether referred employees earn more than non-referred employees (Loury, 2006).

Among other studies, one recent study examined differences over time between referred

[2]In a fascinating ethnography, Newman (1999) show that Blacks and Hispanics in New York frequently use social networks to find jobs. However, these social networks may lead to jobs in lower-skill work such as fast food jobs.

and non-referred employees in terms of wages at a large financial institution (Brown et al., 2016). It found that referred employees started off earning more than non-referred employees. Over time, however, that difference faded away. A similar set of findings was recovered using data from Germany (Dustmann et al., 2016).

"Bad Homophily"

Beyond possibly limiting diversity in terms of race, gender, and other background characteristics, referrals could also serve to perpetuate homophily along other dimensions. One of the main ones is diversity of ideas and opinions.[3]

Outside of ideas and opinions, homophily may be undesirable if referrals reflect nepotism. Using data from Sweden, Kramarz and Skans (2014) provide evidence that parents often help their children find jobs at the establishment where they work.[4] Wang (2013) shows that men whose father-in-laws die experience significant drops in earnings, consistent with nepotism. Giving too much weight toward family and family connections could lead people to lose faith that one's organization is a meritocracy.

It is not always easy to determine whether a source of homophily is "good" or "bad." Organizations often have distinct cultures for various reasons (such as the founders, the type of product they provide, or the style and preferences of top managers). Some employees may be an excellent fit in one organization, but may struggle in a different one. Some organizations thrive on a brash, argumentative style, whereas others value polite and measured discourse. Although referrals may attract individuals who are more like current employees, this is not necessarily a bad thing if it leads to individuals who are a better fit.

[3]Of course, diversity in terms of background characteristics may be linked to diversity of ideas (or may improve other aspects of decision-making). For example, Levine et al. (2014) argue that ethnic diversity increases market efficiency.

[4]See Hensvik and Skans (2013) for analysis on co-worker networks in Sweden.

Limitations and Gaps

Economics research on the value of hiring through employee referrals is still in its infancy. As such, a number of important limitations and gaps remain.

One very important question is why are there differences between referred and non-referred employees. Do referrals select better individuals? Or rather is there some feature of the workplace where referred employees behave differently for another reason? A recent study on online labor markets uses its experimental design to provide strong evidence for selection (Pallais and Sands, 2016). However, there is still much more research to be done on this important issue.

Another important question is why are people making referrals to start with. If an organization wants to see what it can do to increase the quantity or quality of its referrals, it needs to understand why people are making referrals to start with. Some exciting progress has been made on this question in a study using a field experiment in India (Beaman and Magruder, 2012). It shows that the quantity and quality of referrals is responsive to the level of bonus given for making referrals.

More research is also needed to measure the extent to which referrals may contribute to inequality. However, this issue may be viewed as conceptually separate from what are the main gains that firms experience from hiring through referrals.

Summary and Policy Advice

A growing body of research suggests that firms may experience significant benefits from hiring through employee referrals. The benefits are certainly not without costs, so I do not intend to suggest that firms should only focus on hiring referred candidates.

Rather, a message of the paper is that firms should carefully examine how referrals are (or are not) adding value in their organization. In addition, firms should examine whether more can be done to improve the quality of referrals.

Given the tendency for homophily, one possibility is that firms may wish to encourage referrals from their highest ability employees. Of course, referring employees often have higher ability to start with; thus, it is possible that referrals are already strongly taking advantage of this tendency.

Another message is that firms that encourage referrals should make sure that their referral program is equitable, and is not just re-producing the "old boys club." Diversity is important for firms for many reasons (e.g., various reason suggests that diverse teams may perform better). For example, a firm might seek to especially encourage referrals of women and under-represented minorities to make sure that strong women and minority candidates are not left out of the referral process.[5]

Researchers should continue to explore the value of hiring through referrals. While this article has focused primarily on developed economies (bringing in just a couple studies of developing economies), the value of hiring through referrals in developing countries is also a very important issue and topic of research.

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[5]For example, Accenture has announced it will use "enhanced" referral bonuses for successful referrals of Blacks, Hispanics, women, and veterans. See "Could this be the Secret to Hiring More Women and People of Color?" by Emily Peck, accessed through the Huffington Post and last accessed online on July 19, 2016.

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