BUILDING COMPETITIVE ADVANTAGE THROUGH EFFECTIVE MANAGEMENT OF HR

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HR departments, in turn, have to show that they are no longer partners (that can be outsourced) but players who can score for the team. They have to move out of their "operational" mindset and be more strategic in thinking.

INTRODUCTION

Try asking your friends which company in the world has given the largest stock market returns in the last 20 years and why ? A version of this exercise was first suggested by Jeffrey Pfeffer (1998) in his book The Human Equation and I've been through this myself during my MBA program as well as in other corporate training programs a number of times. The answer to this question is important because it reveals people's perception of what makes a company successful over time. You may have noticed that individuals have similar views on what makes a company successful over time. They come up with names like Microsoft, HP, Cisco, Nokia, etc. The companies named are typically global firms who are market leaders, usually in high technology with a product that cannot be copied or imitated. When probed on how they came up with this company, their response was standard: they first picked an industry that they felt would give the highest returns (usually the technology sector) and then picked a company in that industry which had performed best. This logic is consistent with the conventional wisdom of the late 1980's and early 1990's.

Michael Porter (1985) (whose work is mandatory reading in all business strategy classes), in his book "Competitive Advantage" preaches that to get above average returns one should pick a firm in an industry that has barriers to entry for new competitors, no threat of substitute products, low bargaining power of buyers, low bargaining power of suppliers, and low rivalry among existing competition. Using his logic and conventional wisdom, one should then select a dominant firm that has the largest market share, which can realize the benefits of economies of scale.

But when we actually run numbers to see which companies have given the highest returns in the last 20 years we get some strange results. For example, Pfeffer (1998) in his study found that Southwest Airlines (21,775% return over 20 years), Wal-Mart (19,807%), and Tyson Foods (18, 118%), Circuit City (16,410%), and Plenum Publishing (15,689%) gave the highest returns in a 20-year period. Notice that none of them are technology companies. Twenty years ago (and in some cases even today), none of them were market leaders in their specific industry. The industries of these firms (airline, retail, publishing, and food processing) have seen massive competition, no unique technology, many substitute products, and widespread bankruptcies. Obviously, what Porter said does not apply here. So what is so unique about these companies? They all attribute their superior performance to their HR practices and use people as a source of competitive advantage.

A resource becomes a source of competitive advantage when the competition cannot easily duplicate it. As shown in Table 1, traditional sources of comparative advantage like technology, structural capital, protected markets, economies of scale, and financial resources may still provide some leverage but not to the extent it did in the past (Pfeffer, 1998). For example, in the 1980's

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TABLE. 1 : Sources of Competitive Advantage

Source	Unique	Long-term
Technology	No	No
Structural Capital	Yes	No
Protected Markets	No	No
Economies of Scale	No	No
Financial Resources	No	No
People	Yes	Yes

General Motors spent $40 billion dollars to modernize and build new facilities to take on the Japanese automakers. They could have purchased both Honda and Nissan for that amount of money. In reality, what they did was to substitute fixed costs for variable costs.

It is very hard to seek competitive advantage through technology. First, the company that sells you the technology can also sell it to your competition. Also, technology is no substitute for skilled work force. In fact, technology makes you more, rather than less dependent on the skills of your workface. Secondly, structural capital like physical resources, systems, information technology, and procedures can easily be copied and imitated. We do it all the time under the banner of "benchmarking." Information technology which was till a few years ago a source of competitive advantage is now available at an exponentially decreasing rate. Thirdly, protected and regulated markets are a thing of the past. There was a time in India when one's choice was limited to three domestic cars. Even when you purchased the car, the actual delivery was done months later. Today, thanks to liberalized government policies, one can buy and take delivery of a Mercedes right away. WTO has even forced China to open up their markets. Companies are setting up plants all over the world and are competing globally. Once a country deregulates its markets, it is very difficult to reverse the trend. Finally, like products, today capital too moves around the world. All you need is a good idea and a plan and you will find a venture capitalist somewhere in the world who will back you up. For example, most of the investors in biotechnology firms in the U.S. are Swiss. Today, a number of Indian firms ranging from banks to technology are listed on the NYSE and NASDAQ to raise capital. Thus, traditional sources of comparative advantage do not provide as much leverage as in the past

PEOPLE AS A SOURCE OF COMPETITIVE ADVANTAGE

It is not difficult to imitate HR practices but many firms just don't do it. Pfeffer attributed it to the "just don't get it" or "the knowledge-doing gap." According to him, nearly half of the organizations don't see a connection between sound HRM practices and profits. Actual trends in management practices show that many companies are trying to increase profits by taking steps that can have a negative impact on employee morale. This includes searching for the right portfolio by buying and selling assets, downsizing and outsourcing to reduce costs and increase profits, and/or reducing employee benefits. Even among those who understand the connection, only half will try to make comprehensive changes to enhance management of people. Of those who make comprehensive changes, only half will persist long enough to derive economic benefits. Thus, only about one-eighths will derive the economic benefits of using people as a source of competitive advantage while the rest will search for economic benefits at the wrong places.

CASE FOR MANAGING PEOPLE

Most of us in business education like to give company-specific examples to illustrate our point. But managers want detailed evidence and not stories and anecdotes to make critical business decisions. In this section I will ignore all case studies (e.g., NUMMI, Southwest, Nordstrom, etc.) done on this topic and give a databased, methodologically sound evidence to support the relationship between HR practices and economic success. Research has shown that this relationship is not unique to the type of technology used, specific industry, strategy, or specific country.

Mark Huselid (1995) in his landmark study examined the impact of various HRM practices of 3,452 U.S. firms on turnover, productivity (sales per employee), and the ratio of stock price to book price. As a part of his analysis he examined factors like size of company, intensity of capital, research and development expenses as a proportion of sales, and so on. Based on a number of estimation procedures, Huselid found that one standard deviation increase in high performance work practices above the mean was associated with a 7% decrease in turnover and increase of $27,044 in sales, $18,641 in stock market value, and $3814 in profits per employee respectively. A follow up study of 702 firms by Huselid and Becker (1996)

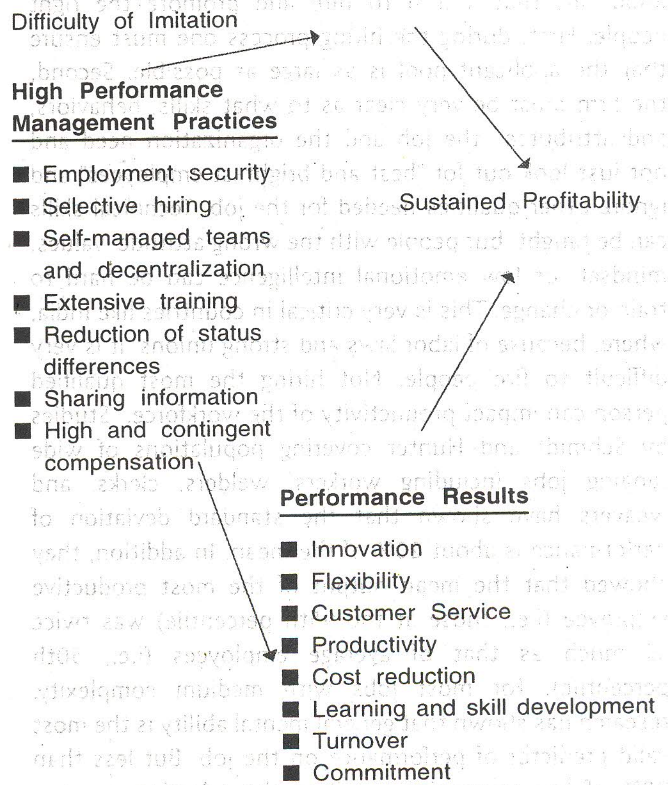
using a more comprehensive index of HRM practices found that a one standard deviation increase in HR system index resulted in a increase of $41,000 in shareholder wealth per employee. Bilmes, Wetzker, and Xhonneux (1997) in an article in Financial Times reported similar results in Germany. The German study also reported that such firms also created more jobs. A study of Japanese affiliates in China and Taiwan also found a link between HRM practices and financial performance. Studies done in specific industries like retail, semiconductor, public sector, banking, oil refinery, automobile, and paper production similarly show that effective HRM practices have a significant impact on firm performance (Bartel, 2004; Gould-Williams and Davies, 2004; Hatch and Dyer, 2004; Pfeffer, 1998). Studies in India have shown that specific HR practices can have a direct or indirect impact on organizational performance (Paul and Anantharaman, 2004; Paul and Anantharaman, 2002; Singh, 2004; Singh, 2000). Most of the studies discussed here did not use identical HRM practices, though many HRM practices were common. Let us now examine what are some of the common HRM practices used by successful companies.

HRM PRACTICES OF SUCCESSFUL COMPANIES

Literature reviews, empirical research and case studies on high performance work practices agree that there are a few key practices or HR bundles found in firms that use people as a source of competitive advantage (Luthans and Youssef, 2004). These practices when properly aligned reinforce each other and create synergy (see figure 1). While it is easy for the competition to copy one practice, it is much harder to copy an entire collection of aligned practices. Also, for the practices to be effective, they must match the overall strategy of the organization. For example, when compared to reactors, prospectors focus more on external hiring (to bring in people with cutting edge competencies for technical innovation). Key HRM practices identified by the literature are:

- selective hiring practices
- reinforced policy that people come first
- employment security
- decentralized decision making
- high contingent compensation
- extensive training
- shared performance and financial information
- reduced status differences (Pfeffer, 1998).

Figure 1 :



EMPLOYMENT SECURITY

Nearly all the research on high performance work systems has listed employment security as the most important dimension. People will not cooperate or work on sustainable productivity improvements if they feel they are working towards eliminating their own jobs. Most of the companies today have two types of human resources: core and peripheral. While the core workforce consists of full-time regular employees, peripheral workforce consists of temporary, outsourced, part-time, and contract employees. While the former are treated as an asset, the latter are considered an expense that has to contained or reduced. Research has shown that the peripheral employment should be no more than one-third the total workforce. Effective firms do not hire peripheral employees in the critical areas of the firm.

SELECTIVE HIRING PRACTICES

Firms that want to develop distinctive competence though people must ensure that they hire the right

people. Many of us have heard the phrase "people are a firm's most important asset." This is misleading. "Right people" are the firm's most important asset. Thus it is important that a firm to hire and promote the right people. First, during the hiring process one must ensure that the applicant pool is as large as possible. Second, the firm must be very clear as to what skills, behaviors, and attributes the job and the organization need and not just look out for "best and brightest employees" and ignore other qualities needed for the job. Technical skills can be taught, but people with the wrong attitude, values, mindset, or low emotional intelligence can be hard to train or change. This is very critical in countries like India, where, because of labor laws and strong unions, it is very difficult to fire people. Not hiring the most qualified person can impact productivity of the workforce. Studies by Schmidt and Hunter covering populations of wide ranging jobs including workers, welders, clerks, and weavers have shown that the standard deviation of performance is about 20% of the mean. In addition, they showed that the mean output of the most productive employee (i.e., those at the 95th percentile) was twice as much as that of average employees (i.e., 50th percentile). For most jobs with medium complexity, research has shown that general mental ability is the most valid predictor of performance on the job. But less than 20% of the companies use it in the selection process. Thus, a poor hiring decision can have serious implications for the organization on the long run.

HIGH CONTINGENT COMPENSATION

You get what you pay for. Above market compensation gets you a better applicant pool and helps you make a better selection decision. It also reduces employee turnover and sends a message that the company values its employees. High wages do not equate to high labor costs, just as low wages do not equate to low labor costs. Studies have shown that companies that pay above market tend to have more innovation, provide better customer service, have more productive employees and lower labor cost per unit. Also for many companies, labor cost may not be a major component of the total costs of the organization.

High performance work systems also pay contingent compensation including gainsharing, skill based pay, incentive plans, and stock ownership. This is a good way of resolving conflict between capital and labor. It is important to note that research has shown that stock ownership by itself does not impact performance. Employees are motivated by stock ownership only if it is accompanied by delegation of authority and information sharing by management along with training programs that provide employees useful, new skills.

TRAINING

Many see training as a perk or a reward for those employees who are doing well and something that can easily be cut in dire times. The economic fortune of the company typically dictates training budgets. It is interesting to note that training is more likely to be provided when the firm is doing well and the employees are the busiest and can least afford to be away from work. Many firms state that knowledge and skills are critical, but do not invest their training dollars wisely. Most of the training focuses on specific job skills and not on soft-skills and organization climate. Some firms waste training dollars by providing training in areas that don't have an impact on productivity at the workplace but makes the employee more marketable. Training in tacit knowledge, or organization specific knowledge, is non-transferable and forms a source of competitive knowledge.

What is amazing is that many training managers do a poor job of calculating the economic benefits of training. Training and development programs are an investment in the company's employees, and in today's business environment it demands some sort of return on investment. There has been a lot of work done in human resource accounting (Phillips, 1996; Fitz-enz, 2001) to address this issue but surprisingly HR Managers don't use these financial tools to support or make a case for training dollars. Many HR people are uncomfortable with numbers and may not be motivated to learn financial ratios.

ORGANIZATIONS THAT PUT PEOPLE FIRST

Such organizations clearly recognize that besides people, every other source of organizational success can be copied in a short period of time. Progressive firms act on this fact in a number of ways.

First, such organizations often publicly state that people come first in their organization. For example, Southwest, Wal-Mart, and the Virgin Group have often stated that employees come first, followed by customers and then shareholders. Employees will treat customers the way they are treated by management. If the employee treats the customer well, he/she will comeback again and again,

and that is how profits are made. Real profits are not made by splashy advertisements that bring in customers for one visit.

Second, such firms use words like associates, team members, and people and not words like "employee" or "worker" to address their staff which may imply a subordinate role or someone who deserves less respect than others. Such words alone would not ensure high performance management practices but they would certainly help create the impression that people are important.

Finally, such companies give their employees green light to make decisions on their own. For example, any worker at Saturn or Nummi, and major Japanese firms can stop the car assembly line if they feel something is wrong. Every employee in companies like Southwest, Virgin, and Microsoft can call the CEO's at home if they have a problem. Russi Modi former Chairman of Tata Steel used to host open houses with his managers where any employee could come to him with a concern or problem, and it was handled right away.

Next, people are organized in self-managed work teams with autonomy and discretionary authority. Over 20 years of organizational behavior research has shown that self-managed team typically outperform traditionally supervised groups. Also members of self-managed teams have greater job satisfaction and intrinsic motivation. Finally one sees very few status differences in such companies. They have an open office system, everyone wears the same uniform, eat at the same cafeteria, and park their cars or scooters in the same parking lot. This sends a signal that everyone is valued equally.

SHARING OF INFORMATION

This is another essential component of high performance work systems for a couple of reasons. Sharing of organizational, financial, and compensation information sends the message that we have no secrets, and we trust all our employees. Also, it is virtually impossible for motivated employees to contribute to enhance performance of their organization, department or unit if they do not have information on different dimensions of performance. Also, employees have to be trained on how to interpret and use this information.

Managers don't like to share information because sharing information diffuses their power. Another reason for not sharing information is that it could fall into the hands of the competition. The reality of the situation is that, in most cases, the competition already knows how you are doing. People from one company do talk to people in other companies and talk about how they are doing. If you are keeping secrets, it is typically from your own employees.

CHANGING ROLE OF HRM

The major role of HRM departments is to complement any product/market strategy by enhancing the firm's competitive advantage through superior "human capital." Unfortunately, many HR departments are not up to the task, or are stuck in traditional operational roles. The field of Human Resource Management (HRM) has gone through a couple of stages in the last century. It owes it birth to the industrial revolution in the 1800's, where factories set up "Personnel Departments" to recruit workers and maintain employee records and payroll. Under Scientific Management, the dominant management philosophy at that time, people were treated like inventory or parts and Personnel Departments were often the dumping grounds for people who failed in other functions. The next major transformation came after World War 2. Training blossomed as a function, thanks to the lessons learned from its success in the armed forces. Also, labor relations surged way ahead of other HR functions once unions started flexing their muscles after World War 2. The social legislation in a number of countries in the 1960's and 1970's empowered HR departments who then took the role of "personnel police." Globalization, mergers, and competition in the 1990's forced many firms to be concerned with costs, efficiency, planning, and implementation of people-related strategies to ensure that the organization had the right workforce to beat the competition. These firms realize that managing human resources is as, if not more important than other functions, and give it the appropriate status within the organization. In most companies, HR spends considerable time administrating processes like payroll, legal compliance, staffing, and various benefits. Currently, there is a trend to outsource many of these processes to vendors. The Gartner Group expects HR outsourcing in the U.S. alone to cross $32.7 billion. It is speculated that companies can save 15% to 20% of process costs by outsourcing HR. HR outsourcing is not a bad idea if it frees time to focus on core business and strategic work.

HR departments, in turn, have to show that they are no longer partners (that can be outsourced) but players who

can score for the team. They have to move out of their "operational" mindset and be more strategic in thinking. One way of doing this is to embrace human resource information systems to do the operational aspects of their function so that more time can be concentrated towards strategic HRM. They have to convince their CEO's to provide strong leadership in sustaining a high-performance workforce. For starters, they have to lay a foundation for measuring return on investment of human capital and other HR related financial ratios. This is the only way HR can show the CEO and top management that HR creates value to the organization. Publications like CFO and studies done by international consulting firm Ernst & Young have shown that it is possible to capture the value of knowledge workers (Betty, Huselid, and Schneider, 2004). Unfortunately, a worldwide study of 120 Board of Directors and C-level executives done by Accenture revealed that only 5% of the respondents stated that their firm had a robust system of measuring intangible assets like skilled workforce and leadership capability. Thirty-three percent of the respondents said that their firm had no system at all (Mirza, 2004). This is surprising because there are a variety of tools that firms can use to measure intangible assets like people.

Table 2 shows the utility analysis equation that a firm can use to calculate the utility of an HR intervention. Table 3 uses an example to show how the formula can be used. Table 4 gives the example of some additional calculations that can be done in various HR areas. Another tool that HR can use is an HR Scorecard. Based on a study of 3000 firms, Becker, Huselid, and Becker

TABLE. 2 : The Utility Analysis Equation

▲Utility	=	[TxN] x [(Zx x r + dt) x SDy] - Costs
?U	=	Utility change from the human resource intervention
T	=	Average future tenure of those affected
N	=	Number of employees affected (hired or trained)
Zx	=	Average Z-score of the predictor and criterion
r	=	Correlation between a predictor and criterion
dt	=	The average net gain in performance exhibited by employees affected by the intervention
SDy	=	Dollar value of an employee performing one standard deviation above average
Costs	=	Cost of acquiring and administering the human resource intervention

TABLE. 3 : Implementing a Structured Interview for Marketing Trainees

Parameters :

Number of people being hired : 8 per year
Number of applicants per position: 3
Average tenure of employees: 2 years
Validity improvement: increase in r of 0.12
Average employee annual pay: $20,800
SDy (Using 40-percent-of-salary rule): $8,320
Cost: One-time cost of $2,000
Other costs: None (no additional cost of implementing structured interview)
dt is not estimated or used in this example: we will assume it equals 0.

Zx:
The selection ratio is 1 out of 3, or 0.3333.
Looking this value up in Cascio to determine Zx = 1.09

Utility estimate:

▲U = T x N x (Zx x r + dt) x SDy - C
▲Utility = $15, 412
ROI=▲U/costs=15412/2000=771%

TABLE. 4 : Common Calculations in Various HR Areas

HR Performance Area	Method of Calculation
1. Human value added	(Revenue-Operating expense - Pay and benefits)÷Full-time-equivalent employees
2. Return on human capital vested	(Revenue-Operating expense - Pay and benefits)÷ Pay and benefits
3. Turnover cost	(Cost to terminate + Cost to hire + Vacancy cost + Productivity loss) ÷ Employees lost
4. Volunteer turnover rate	Total voluntary employee separations ÷ Total employees
5. Cost per employee hired	(Advertising expenses + Agency fees + Employee referral bonuses + HR recruiters pay and benefits + 10% misc. costs) ÷ Total number of employees hired

(2001) have proposed this powerful measurement to manage human resources as a strategic asset and implant HR systems within a firm's overall strategy. The HR Scorecard builds on Kaplan and Norton's Balanced Scorecard and shows executives how to link HR results to measures that top management appreciate, like profitability and shareholder value. It also is a good way of starting a conversation between line and HR on the role of HR within an organization on topics like succession planning, talent retention, training needs assessment, and poor performance management.

CONCLUSION

Many traditional HR departments justify their contribution by benchmarking their costs and outcomes. But over-reliance on benchmarking moves the focus on HR efficiencies of other organizations rather than performance relative to their firm's own strategy (Becker and Huselid, 2003). The former treats HR as a cost with the latter treats HR as an asset. There is currently no research or a case study that supports a causal relationship between HR benchmarks and a firm's value (Becker and Huselid, 2003). But, previous research has shown that strategy implementation is very critical for shareholder value. Executing a strategy successfully had a six time greater impact than choosing the right strategy. It is up to HR to ensure that people are contributing to activities that help strategy implementation. This means that HR measurement systems must focus more on internal strategy relevant contributions and less on what other firm's HR departments are doing. This is the only way to get the recognition they deserve as an important player in the long-term success of the organization.

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