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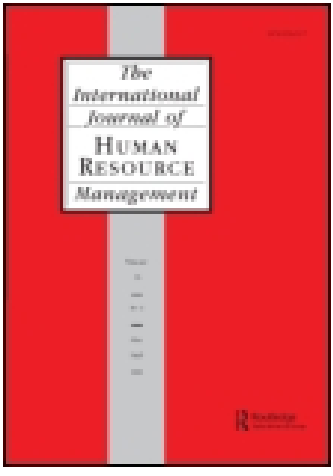

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Strategic human resource management effectiveness and firm performance

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Strategic human resource management effectiveness and firm performance

Orlando C. Richard and Nancy Brown Johnson

Abstract This study tests whether strategic human resource management (SHRM) effectiveness significantly affects organizational level outcomes. Using the resource-based view of the firm, this study examines the effective use of human capital on organizational performance. Further, the role that a contextual factor – capital intensity – plays in modelling is explored. Results show that SHRM effectiveness significantly reduces employee turnover and increases overall market performance assessment. However, SHRM effectiveness affected both firm productivity and return on equity only when moderated by capital intensity.

Keywords Human resources; strategy; effectiveness; outcomes.

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The interest of strategic management in examining the role of human resources as value-added has evolved (Baird and Meshoulam, 1988) to broaden the focus of human resource management research from a micro (i.e. individual effectiveness focus) approach to a macro (i.e. organizational effectiveness focus) or strategic approach (Butler *et al*., 1991). The strategic human resource management perspective (SHRM) makes evident the importance of human resource practices for organizational performance, such as employee turnover, productivity and financial performance.

The current focus on HRM as integral to firm's strategic processes involves viewing HRM activities as a resource contributing to firm profitability as opposed to a cost of production (Butler *et al*., 1991; Delery and Doty, 1996; Huselid, 1995; Lado and Wilson, 1994). However, previous work has concentrated on linking the existence of individual or sets of HR practices to firm performance. Huselid *et al*. (1997) note that future research needs to go beyond the mere presence of HR practices and their relationship to financial performance to examining the effectiveness of the practices compared to the desired outcome. They argue that effective use of HR practices should have a greater impact on firm performance beyond the simple existence of HR practices. Russo and Fouts (1997) note that it is the firm's ability to employ its organizational capabilities, its ability to assemble, integrate and manage human resources, that matters because human resources are not inherently productive. Pfeffer (1994) also argues that sustained competitive advantage emanates from effective workforce management. Following Huselid *et al*. (1997: 173) we define strategic human resource effectiveness as practices that create a 'unique pool of human capital'.

This research expands upon traditional strategic human resource management literature by examining SHRM effectiveness with respect to HR policies and practices.

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Employing the resource-based view, we posit that HR effectiveness relates directly to firm-level outcomes, particularly when considering firm context (Wernerfelt, 1984).

Theory and hypotheses

Resource-based view

A strategic approach to HRM seeks to provide competitive advantage proactively through its human resources. Resources confer enduring competitive advantage to a firm to the extent that they remain scarce or hard to duplicate, have no direct substitutes and enable companies to pursue opportunities (Barney, 1991). The resource-based view posits that human and organizational resources, more than physical, technical or financial resources, can provide a firm with sustained competitive advantage because they are particularly difficult to emulate (Lado *et al*., 1992; Lado and Wilson, 1994; Wright and McMahon, 1992).

Consequently, HRM should ideally work to enhance the firm's competitive position by creating superior human capital skills, experience and knowledge that contribute to firm economic value (Snell and Dean, 1992). How well the HRM function achieves these goals determines overall HRM effectiveness. Huselid *et al*. (1997) define HRM effectiveness as 'the delivery of high-quality technical and strategic HRM activities'. Successful implementation of HRM policies and practices remains difficult, making effectiveness elusive. Many firms may adopt a policy or practice for institutional reasons, in contrast to those policies competently implemented to provide a potent organizational force (Huselid *et al*., 1997). These authors distinguish between two types of effectiveness. Technical HRM effectiveness involves using traditional HR practices, such as recruiting and selection, efficiently. SHRM effectiveness, in contrast, stems from the firm building human resource complexities through innovations such as team-based job designs, flexible workforces and employee empowerment. We are concerned with the latter SHRM effectiveness because this form of HRM effectiveness is a firm-specific capability that yields economic benefits not readily duplicated through competitive actions. Therefore, consistent with the resource-based view, we propose the following hypothesis:

Hypothesis 1: Firms that achieve higher levels of SHRM effectiveness will have higher levels of organizational effectiveness.

Contingency/resource-based views

Recently, Miller and Shamsie (1996) note that resource-based theory must consider context (i.e. predictable versus uncertain environments) within which various kinds of resources will best influence performance. Contingency theories posit that the relationship between the relevant independent variable and the dependent variable varies for different levels of a critical contingency variable. The organization's strategy remains the primary contingency factor in the SHRM literature (Delery and Doty, 1996). The contingency perspective remains a viable approach to SHRM and numerous studies empirically support it (Arthur, 1992, 1994; Lee *et al*., 1995; Ichniowski, 1990; Kochan and Osterman, 1994; Youndt *et al*., 1996).

The resource-based view of the firm has also considered contingency variables (Wright *et al*., 1994, 1995). Researchers posit that internal processes require nurturing but this nourishment must take place in the appropriate context (Collis and Montgomery, 1995; Russo and Fouts, 1997). Consistent with Koch and McGrath

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(1996), we investigate the moderating role of capital intensity, a key strategic variable from the strategic management literature.

Capital asset intensity Firms are likely to vary in the amount that they invest in physical assets. Some firms desire direct control over their physical assets and perform most work internally. Others prefer to concentrate on their core business and contract out ancillary operations. For example, some airlines perform their own aircraft maintenance, requiring substantial investment in hanger facilities and repair equipment. Others prefer to subcontract maintenance operations. The advantage of maintaining capital asset intensity is control over operations and quality. However, this control comes at a price.

Superior performance becomes crucial in firms that make large investments in plant, equipment and other assets (Hayes and Wheelwright, 1984; Koch and McGrath, 1996). Firms need performance and productivity to recoup investments in assets and equipment (i.e. sunk costs). For example, in the banking industry, some firms create large fixed costs by spreading assets across many branches (i.e. high capital intensity) while others minimize fixed costs by concentrating assets in a single location. Variation in capital asset intensity in banking arises from such factors as bank age (older banks tend to have more branches), urban versus rural location (rural banks have no need for branches) and retail versus commercial markets (retail operations require more facilities to reach the customer). More recently, technology and innovations also influence capital intensity as exemplified by electronic banking through web sites and the placement of bank branches in grocery stores and shopping malls.

Effective asset management becomes essential for those with large capital investments in order to cover the investment cost and receive a return. In particular, Koch and McGrath (1996) note that, in situations with high capital intensity, obtaining higher productivity per employee becomes salient. Thus, SHRM effectiveness becomes essential for those firms with high levels of capital intensity. For capital-intensive firms, organizational effectiveness gains from SHRM effectiveness will be magnified, suggesting a positive interaction effect between HR effectiveness and firm capital intensity.

Hypothesis 2: Strategic HRM effectiveness and capital intensity will influence organizational effectiveness through a positive interaction effect.

Methodology

Data

The current study was conducted in a single industry to examine within-industry differences: banking. Until the 1980s the banking industry was characterized by stability. More recently, banking industry deregulation has stimulated a highly competitive environment. During the 1980s and 1990s the industry has experienced the removal of interest-rate ceilings, reductions in reserve requirements, expansion of bank powers and a relaxation of geographical restrictions. These regulatory changes coincided with such technological advances as ATMs, telephone banking, PC-based banking and information system advances within the banks. The industry responded to these changes with a significant wave of consolidation that has reduced the industry from 12,000 to 8,000 banks between 1987 and 1995 (Berger *et al.*, 1995).

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Johnson *et al*. (1989) argued, and found, that regulation essentially prevents firms from implementing the full range of their strategic choices in the airline industry. Deregulation, as has occurred in both airlines and banking, has allowed banks the freedom to exercise strategic choice. The overall effect of the structural and technical changes has contributed to HR practices, as a source of competitive advantage, taking on more import. These banks have moved from being order takers to being customer-oriented sales organizations continually searching for more products and markets. Hunter (1997) states that banks are currently exploring new ways to organize work. Thus, banking currently offers a highly competitive environment that allows firms to exercise differing business strategies. Because of its service orientation, human resource management rises to prominence as a significant factor in strategic implementation as the employees are the product (Zeithaml and Bitner, 1996).

The unit of analysis for this study was the organization. We employed both a questionnaire and secondary data information sources. Information on strategic human resource effectiveness, stage of organizational development and employee turnover was obtained from the questionnaire. Objective measures of performance and capital intensity, as well as control variables, were drawn from the Sheshunoff Bank Search database. Sheshunoff Bank Search database obtains data from government reports that result from mandates to banks to formally report financial data.

The population of banks in California and Kentucky was surveyed to gain greater variation across capital intensity and performance. After pre-testing and modifying the questionnaire, each bank was contacted to obtain the name of the human resource director. When possible, that person was contacted directly. In round one, seventy contacts initially refused to participate, resulting in a total of 406 surveys being mailed out. In week two, we forwarded a reminder card to those who had not responded. In week three we sent another survey to the non-respondents. We began round two in week four by repeating the same series of steps, beginning with phone contact of the HR directors, mailing surveys, forwarding a reminder card and an additional questionnaire mailing. Another eighty-three HR executives declined to participate after re-examination of the survey, mainly due to (1) time constraints posed by the volatile nature of the banking industry (mergers, acquisitions) and (2) unwillingness to provide organizational demography (race and gender composition) data. The number of surveys returned was seventy-three of the 323, representing a 23 per cent overall response rate of those agreeing to be surveyed.

Dependent measures Research testing hypotheses should include multiple performance measures to avoid misleading descriptive and normative theory building (Lumpkin and Dess, 1996). Such measures should include intermediate and bottom-line measures of firm effectiveness. We collected annual turnover (not full-time equivalent) directly from the HR executives' response to a question about the annual percentage rate of employee turnover. We define employee productivity as the natural logarithm of net income per employee. This output measure, obtained from Sheshunoff, reflects employee efforts isolated from market variations (Huselid, 1995; Huselid *et al*., 1997).

Return on equity (ROE), also obtained from Sheshunoff, was also an objective bottom-line output measure employed in this study. Return on equity represents the ultimate measure of the strength of any financial institution (Earle and Mendelson, 1991) and is preferred as a measure of a bank's financial performance (Hopkins and Hopkins, 1997). This measure reflects what type of rate of return is earned on the book value of an owner's equity.

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Independent variables Strategic human resource management effectiveness was measured from a scale derived by Huselid *et al*. (1997). They define strategic human resource effectiveness as 'perceptions of how well the HRM function developed a firm's employees to support its business needs including facilitating teamwork, communications, and involvement, enhancing quality, and developing talent to serve the business in the future' (1997: 175).[1] Thus, this measure examines perceptions of how well the HRM function is performing. The strategic HRM effectiveness items include: employee participation and empowerment; teamwork; workforce planning-flexibility and deployment; advanced issue identification-strategic studies; management and executive development; succession and development planning (managers); work-force productivity and quality of output; and employee and manager communications. This measure differs from traditional assessments that simply ask employers to indicate the existence or non-existence of specific human resource policies in that we are concerned with whether managers believed that these programmes were performing satisfactorily. All eight items ($\alpha = .89$) were measured on a Likert-type scale ranging from (1) highly satisfied to (5) very dissatisfied with the results that were achieved.

To measure capital intensity, the strategic orientation measure, the branch intensity index was used. The index is the natural logarithm of the number of branches/total assets. Bank branches represent the main 'capital' investment for banking and dividing by total assets adjusts for size. The higher the index, the greater the asset dispersion across the bank's network of branches. The lower the index, the greater the asset concentration across the bank's network of branches. This measure was also obtained from Sheshunoff.

Controls Several control variables were used. Firm size was operationalized by using both total dollar value of assets and number of employees. Previous research has shown a relationship between size and profitability in the banking industry (Delery and Doty, 1996; Ramaswamy, 1997). An indicator variable was included to indicate whether or not the bank is part of a holding company (= 1 if holding company; = 0 other). All of the above measures were from Sheshunoff. A dummy variable was coded to control for which state the bank was located in (= 1 if California, = 0 if Kentucky).

To assess stage of organization development, respondents were asked to identify the variable that best described the current stage of their organizations' development consistent with Lumpkin and Dess (1996). We included start-up, growth, maturity and decline (coded 1 to 4, respectively).

Analysis

Hierarchical regression analysis was employed to test the hypotheses. In the first step, the control variables were entered. As the second step, capital intensity was added to capture strategy. The third step was the entering of HR effectiveness to test Hypothesis 1, which examines whether SHRM effectiveness related significantly to organizational effectiveness after accounting for the controls and capital-branch intensity. Step 4 tested the interaction effect proposed in Hypothesis 2. We shall use an interaction to test the fit relationship between strategy and HR effectiveness. The use of the interaction follows the conceptual discussion of Venkatraman (1989). He states that the use in contingency research of two variables to predict a third variable is a statement of an interaction effect between the first two variables. This is consistent with many of the contingency studies in the SHRM literature (Delery and Doty, 1996; Huselid, 1995).

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Table 1 *Descriptive statistics*

Variable	*Mean*	*SD*	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
1 Total assets	414,000	1,146,575	1.0									
2 Employees	144	312	.99**	1.0								
3 State	.79	.41	−.23*	−.21	1.0							
4 Holding	.50	.50	.29**	.32**	−.22**	1.0						
5 Stage	2.41	.62	.17	.20	.03	.04	1.0					
6 Capital intensity	2.45E-05	3.89E-05	−.07	−.04	−.02	−.03	.17	1.0				
7 SHRM Effectiveness	27.25	4.99	−.02	−.03	−.28*	.08	−.16	.08	1.0			
8 Productivity	3.04	.88	.24*	.20	−.22**	.12**	−.11	−.03	.08	1.0		
9 Turnover	16.42	9.98	.20	.23	.26*	.06	.04	.15	−.40**	−.19	1.0	
10 ROE	10.01	14.21	.19	.18	.18	−.28*	−.25*	−.07	.14	.63**	.01	1.0

Notes
* $p < .05$, ** $p < .01$ (two-tailed tests).

We obtained a regression equation for all dependent measures, resulting in a total of three models. Significant R^2 change in steps 3 and 4 shows support for the hypotheses.

Results

Descriptive statistics

Table 1 provides descriptive statistical information (e.g. means, standard deviations and correlations) for all measures. Table 2 shows the results of our hierarchical regression across for the intermediate and bottom-line measures of turnover, productivity and return-on-equity.

Hypothesis 1 states that there will be a positive relationship between SHRM effectiveness and organizational effectiveness. In step 3 of the outcome regressions, with total assets, holding company ownership, state and life-cycle stage controlled, SHRM effectiveness was significantly and negatively related to firm turnover (beta = −.32, $p < .01$). However, no support was found for productivity or ROE. Thus, these results suggest that effectiveness is unrelated to productivity and firm performance but is correlated with lower turnover.

Hypothesis 2 states that SHRM effectiveness and capital intensity will influence organizational effectiveness through a positive interaction effect. Table 2 shows that in step 4 an interaction effect significantly resulted in a change in R^2 increase for both productivity (beta = 1.91, $p < .10$) and ROE (beta = 3.02, $p < .01$). Table 2 shows that the interaction effect did not significantly improve the variation explained in turnover. Thus, no support was found for turnover. In sum, the results suggest that alignment between SHRM effectiveness and capital intensity increase both firm productivity and ROE. Turnover, however, appears driven by direct HR effectiveness effects.

Table 2 *Simultaneous hierarchical regression results for dependent outcomes*

Variable	*Turnover*		*Productivity*		*ROE*	
	R^2 *Change*	β	R^2 *Change*	β	R^2 *Change*	β
Step 1: Controls	.12		.14*		.16*	
Total assets		.34		1.24**		−.04
Employees		−.12		−1.07		−.18
Holding		.04		.07		.24†
Stage		−.06		−.11		−.24*
State		.22†		−.10		−.01
Step 2: Strategy capital intensity	.05†	.71	.00	−1.91	.00	−3.02**
Step 3: SHRM effectiveness	.09**	−.32	.00	−.18	.01	−.17
Step 4: Interaction strategy × SHRM	.01	−.52	.04†	1.91†	.11**	3.02**
N		63		68		68
R^2	.27		.18		.28	
Equation F-value	2.58*		1.64		2.89**	

Notes
† $p < .10$, * $p < .05$, ** $p < .01$.

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Discussion

The purpose of this manuscript was to examine the role that SHRM effectiveness plays in contributing to organizational effectiveness. The results, in general, support the argument that firms with higher levels of SHRM effectiveness experience performance gains. However, depending on the performance measure some effects worked directly to influence performance where other performance effects were moderated through the strategy variable.

The turnover results indicate that HR effectiveness results explain an increase of 9 per cent of the variance over and above the control variables. This suggests that an effective HR system may contribute to turnover reductions. At the same time, the interaction between capital intensity and HR effectiveness was not significant. Thus, the turnover effects do not depend upon strategy. This result most likely occurred because turnover is an intermediate outcome measure between the HR policies and the individual employee. Intermediate measures, directed toward individual employee behaviours, need not depend upon organizational goals and objectives for success. Rather, outcomes such as turnover are not likely to be moderated by strategy as they operate below the strategic level of analysis.

On the other hand, interaction effects, but not main effects, were found for productivity. In other words, HR effectiveness did not appear to contribute significantly directly to increased productivity. However, the productivity results show that the interaction term explained an additional 4 per cent of the variance in productivity over the control and main effects. These results are consistent with Koch and McGrath (1996) who found that the match between sophisticated HR practices and capital intensity resulted in improved labour productivity. Main HR effects were probably not found because effectively implementing such practices as teamwork, employee empowerment and participation could actually lead to short-term productivity decreases as these activities remove employees from their specific jobs and the productivity benefits may take time to occur (Huselid and Becker, 1996).

Strategy also appears to moderate HR effectiveness and return-on-equity. We found that the HR effectiveness and strategy interaction term explained an additional eleven percentage points of variance over control and main effects for ROE. These effects are of similar magnitude, as are the productivity effects. Thus, as with the productivity effects, there were no main effects from HR effectiveness. Effective HR programmes are costly and time consuming to implement and may detract directly from bottom-line performance in the short run. However, when these programmes are executed in conjunction with a strategy that particularly meshes with effective HR implementation, then firm performance is more likely enhanced.

Taken together, these results raise interesting questions. Why does HR effectiveness have direct effects for some outcome measures and contingent effects for others? In sum, main effects were found for the relationship between SHRM effectiveness and turnover. These results support the universalistic notions of 'best practices'. But we also found support for the contingency/resource-based view in that SHRM effectiveness and capital intensity together explained increased variance for both productivity and ROE. Thus, it appears that the level of analysis is a key factor in examining outcome variables. Intermediate outcome measures of employee behaviours may not be influenced by strategic orientation. In a sense, employees do not care about business strategy in deciding whether to attend, quit or increase effort. However, outcome measures, operating at higher levels of analysis, may in fact be moderated by strategic orientation.

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These measures are operating at the strategic levels, and, thus, performance does in fact depend upon strategic orientation.

Implications

These results imply, first, that HR effectiveness is clearly a variable that merits further study. Beyond this, the relationship of HR effectiveness to the outcome variable (functional form) may vary with respect to the outcome examined and its level of analysis. This suggests that researchers need to understand clearly the context in which their relationships are specified. Further, the SHRM field has tended to focus exclusively on business strategy as the contingent variable but environment also remains crucial. For example, productivity may not be a critical performance variable in service industries as it is in manufacturing. Or, it may take on increasing salience once the industry becomes more stable.

We concur with Becker and Gerhart (1996) who note that the use of multiple measures at multiple levels of analysis increases confidence in the causal direction between independent variables and dependent measures. With only one measure of performance, one would argue that high-profit firms implement more SHRM activities, thus leading to higher HRM effectiveness. Since SHRM effectiveness has a different effect on measures which are correlated (i.e. productivity and turnover), we feel more assured of the causal relationship hypothesized. In addition, introducing contingency variables allows more holistic modelling of SHRM effects.

Scholars have just begun to explore the effectiveness of the HR function and its effect on financial performance. In order to obtain resources needed to enhance efficacy, HR executives must show how their activities affect the bottom-line. Without this support, many of these SHRM activities may be outsourced to external constituencies. The results of this study support the notion that firms vary in their effectiveness of the SHRM activities and that higher SHRM effectiveness correlates positively with organizational performance. However, it could be that firms with higher performance simply have more resources to devote to their HR practices.

Finally, these results go beyond previous research by exploring whether firms 'practise what they preach'. Many respondents may actually have HR practices that are not effectively employed. Thus, this research extends past the mere presence of SHRM practices and firm performance to investigate the link between SHRM effectiveness and firm performance. Practising focuses on the impact of overall HRM quality on firm performance while preaching involves the HRM practices firms have in place and whether or not they are truly deployed. We argue that it is the quality or effectiveness of the HRM practices that matter and not the quantity. What appears on the surface to be a best practice is often baseless in that managers implement the practice half-heartedly simply because it represents the latest fashion or fad rather than because the practice is sincerely believed to work within the organizational context to improve workforce effectiveness. Most likely, a simple number count of best practices does not examine whether these practices make sense in terms of the organization's culture and strategy or whether the resources have been effectively instituted genuinely to implement the policy or practice. We believe that our measure of SHRM effectiveness gets at 'whether' firms successfully implement HRM practices in a manner that actively affects firm performance. However, future researchers may wish to compare whether the 'effectiveness' measure yields stronger predictions than does the 'count' measure.

As the role of SHRM effectiveness in creating a sustained competitive advantage is explored, several interesting research questions arise. Going beyond our research, which

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investigated one specific condition (i.e. capital intensity) in which SHRM effectiveness contributes to firm performance, what are other important contingency factors? A social context conceptualization should incorporate other contingency variables, such as organizational culture, climate, political considerations (Ferris *et al*., 1998) and business strategy (Richard and Johnson, 1999). For example, is SHRM effectiveness more beneficial to firms with a growth strategy, where human capital is extremely important, or with a downsizing strategy? Also, what processes work to contribute to SHRM effectiveness? An understanding of the process might enable more companies to achieve higher levels of SHRM effectiveness. Finally, how does SHRM effectiveness impact on other stakeholder measures of organizational effectiveness? For example, do managers and employees agree on their assessment of the HRM system's effectiveness? Is agreement between these two groups necessary for organizational effectiveness? The answer to these questions will provide practitioners with much needed information to facilitate their success in the new millennium.

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Note

1 As Huselid *et al*. (1997) note, this measure cannot differentiate between the presence of operationally appropriate HRM practices and the quality of their implementation. This measure does depend upon managerial expectations of appropriate HRM practices and could either overestimate or underestimate the effect of HRM effectiveness in that managers in higher performing firms could have higher expectations of HR effectiveness (Huselid *et al*., 1997).

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