International Journal of Science and Research (IJSR)
ISSN (Online): 2319-7064
Index Copernicus Value (2015): 78.96 | Impact Factor (2015): 6.391

Effect of Human Capital on Organizational Performance: A Literature Review

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Abstract: ***The current decline in the various economies of the world has resulted in human capital gaining wider importance with increasing globalization and saturation of job market. For increasing the economic growth by giving more time and putting in more effort, both developed and developing countries are emphasizing on human capital development. To get into the international arena, human capital development is one of the basic solution. For this, the firms need to invest necessary resources for developing human capital which is having greater impact on performance. This paper review effect on human capitals have direct impacts on firm performance from various critical perspectives. Firm performance is viewed in terms of financial and non-financial performance. Finally, this paper proposes an initial model that explains the relationship between human capital and firm performance.***

Keywords: Human capital, firm, performance

1. Introduction

Human capital development is the process of helping people to acquire expertise. In an organizational context, it is the process by which organizations help their employees in a continuous and planned way in order to: acquire or sharpen the abilities required to perform various functions associated with their present or expected future roles; develop their general skills as individuals, discover and utilize their inner potential for their own and/or organizational development purposes; develop an organizational culture in which supervisor subordinate relationships, teamwork and collaboration among sub-units are strong and contribute to the professional well-being, motivation, and pride of employees.While analyzing the issue of what contributes to competitive advantages ,more emphasis has been laid on the internal resources which are seen as crucial to sustain effectiveness rather than on external positioning in the industry and the relative balance of competitive forces Penrose' work [1]shows the beginning of the resource based view of the firm which was later polished [2], [3]and [4].The significance for an organization to build a valuable set of resources and binding them in different and unique ways to develop firm succe4ss has been established by RBV. Unlike traditional assumption competitive advantage doesnot depend on natural resources, technology or economies of scale because they are easily copies.According to RBV competitive advantages depend on the valuable, rare hard to imitate resource that sets within organization.Human capital in a real sense is an 'invisible asset' [5] The importance of the human capital pool (the collection of employee capabilities), and how it is managed through HR processes, becomes apparent, then, to the strategic aims of the organisation.

2. Literature Review

2.1 Definition of Human Capital and Firm Performance

What is human capital? According [6], the term "human capital" has been defined as a key element in improving a firm assets and employees in order to increase productive as well as sustain competitive advantage. To sustain competitiveness in the organization human capital becomes an instrument used to increase productivity. Human capital is basically a way that is attached to education, training, and other professional initiatives to enhance the levels of knowledge, skill, abilities and social assets of an employee. This eventually leads to the satisfaction and performance of employees and resulting on firm performance. Thus, the definition of human capital is referred to as "the knowledge, skills, competencies, and attributes embodied in individuals that facilitate the creation of personal, social and economic well-being'. The constantly changing business environment requires firms to strive for superior competitive advantages via dynamic business plans which incorporate creativity and innovativeness. It is basically significant for long term sustainability. There is no doubt in the fact that human resource input performs an important role in increasing competitiveness of a firm [7].Significant studies were carried out on human capital and its implication on firm performance, thus human capital enhancement will result in greater competitiveness and performance. Under human capital philosophy, there exists strong relationship between innovativeness and firm performance. The definition of firm performance may differ from one another. However, certain clear definitions of firm performance with regard to capital enhancement could be given.Besides, return on investment (ROI), earnings per share (EPS) and net income after tax (NIAT) can also be used as measures of financial performance [8]. Interestingly, researchers also tend to benchmark managerial accounting indicators against the financial measures in six dimension; 'worker's compensation' (workers' compensation expenses divided by sales); 'quality' (number of errors in production); 'shrinkage' (e.g. inventory loss, defects, sales return); 'productivity' (payroll expenses divided by output); 'operating expenses' (total operating expenses divided by sales) [9].Perceived performance approach (referred to as subjective performance measure) can be used to measure firm performance. Firm performance from top management can be measure by using Likert-like scaling.

The Relationship between Human Capital and Firm Performance The human capital focuses two main components which is individuals and organizations. [10]

further explains that human capital has four basic attributes.: (1) flexibility and adaptability (2) enhancement of individual competencies (3) the development of organizational competencies and (4) individual employability. It shows that these attributes in turn generate add values to individual and organizational outcomes. There are various findings that incorporate human capital with higher performance and sustainable competitive advantage [11]; higher organizational commitment [12]; and enhanced organizational retention [13]; All this discussion focuses on individual and organizational performance. [14], [15] finds out that significance of human capital depends on the degree to which it contributes to the formation of firm performance. Economically speaking, transaction costs show that firm gains a competitive advantage when they own firm specific resources that cannot be imitated. Thus, as the uniqueness of human capital increases, firm have incentives to invest resources into its management and the aim to reduce risks and capitalize on productive potentials. Hence, individuals need to enhance their competency skills in order to be competitive in their organizations. The human capital theory has undergone a rapid development. Within its development, greater attention has been paid to training related aspects. This is much related to the individual perspective. Human capital investment is any activity which improves the quality (productivity) of the worker. Therefore, training is an important component of human capital investment. This refers to the knowledge and training required and undergone by a person that increases his or her capabilities in performing activities of economic values. Some recent literature shows the importance of training. In any case, it is fitting to point out that the workforce's lack of training is related to low competitiveness [16]. In turn, a greater human capital stock is associated with greater productivity and higher salaries [17]. Likewise, training is linked to the longevity of companies [18] and greater tendency to business and economic growth [19]. [20] found out that human capital motivates workers, enhance their commitment and also creates expenditure in R & D and finally creates a way for the new generation for the economy and society in general. Moreover, it is a valuable for small business which is positively related to business performance. Finally, investment in training is desirable form both a personal and social perspective. From the organizational level, human capital plays an important role in the strategic planning on how to create competitive advantages.According to [21] the two dimensions of human capital of firm are value and uniqueness. Firm indicates that resources are valuable when they allow improving effectiveness, capitalizing on opportunities and neutralizing threats. In effective management context, value emphasises on enhancing profits rather than the associated costs. In this way, firm's human capital can increase value if it contributes to lower costs, providing increased performance.

Another study by [22] and [23] analysed on the relationship between human capital and organizational performance of software companies. They pointed out that on organizational performance human capital indicators had a positive association. The indicators like training attended and team work practices resulted in awesome performers where more productivity could be translated to organizational performance. This was also supported by [24], who found a significant positive correlation between the quality of developers and volume of market shares. Based on the above arguments we can conclude that human capital indicators enhanced the firm performance directly or indirectly.

According to the study of [25] and [26] found the result of human capital management. They developed relationship between human capital management and economic and business outcomes. Almost 25 firms in the financial services have been selected in this study. The four metrics were used to measure human capital effectiveness: revenue factor, expense factor, income factor and HC ROI. The fundamental aspects of any organization are to generate more revenue and income per employee. Human capital directly influence the intellectual capital assets which gives higher financial results per employees. The educational level of employees and their overall satisfaction positively influences the development of human capital. That is why ROI of firms are directly influenced by the development of human capital. [27] developed a casual model using a set of cross-sectional data. Indicates that human capital enhancement paves a way for greater innovativeness and this in turn offers positive implications on firm performance. Meanwhile, human capital and firm performance can be seen in the context of high performance work systems[28]. The much debated point is that high performance or high performance work system will be resulted out from the formation and emphasis on the human capital enhancement. No doubt human capital enhancement in an organization creates significant contribution on organizational competencies. This in return encourages for further enhancing innovativeness and the current literature which supports the fact that firm performance is positively influenced by the human capital. Some even endorsed that human capital development is a prerequisite to good financial performance [29] and in addition, the importance of organizational human capital with regard to firm performance was further supported by [30].Moreover, it is cleared through evidences that human capital is relevant to firm performance which has become prevalent among the technology based new ventures. It appears as if the use of human capital (emphasizing employee's quality) per say in small technology based new ventures seems to have great influence on the success of firms [31]. Meanwhile human capital enhancement can be seen in the context of top management (TMT) Heterogeneity which sometimes can be referred as diversity in TMT will lead to greater performance. The reason is that the debate is heterogeneity develops various characteristics ,to be absorbed in the workforce team. It involves the people of different age groups, functional backgrounds, educational backgrounds, gender and tenure. All these characteristics have positive influence on firm performance as argued under the upper echelon theory [2]. Studies show that heterogeneity results in greater knowledge, innovation and creativity among the team members members [14], [33], and [21]. Heterogeneity is positively attached to better problem solving and offering creative solutions [17].Hence, diversity is positively related to performance. Even in the context of an organization, the implementation of certain management approaches or philosophies also deals with the infusion of human capital (e.g quality circles, team of employee's experts) especially

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when faced with problems []. Again, in a very broad discussion, especially in the context of total quality management (TQM), firms can be assessed using financial and non-financial performance.

Functional performance includes employee productivity, defect rates and market share whereas non-functional performance involves workflow improvement, innovation, customer satisfaction and skills development [4]. Along with this diversity attracts and retains best talent available, lesser costs due to lower turnover and few lawsuits, enhanced market understanding and marketing ability, greater organizational flexibility, better problem solving and ober all better performance and improvement in decision making at strategic level [6].Heterogeneity is considered to be positively attached to better problem solving and offers creative solutions [1]. A recent study in the related area also provides some insightful information about the heterogeneity effect on firm performance [33] Undoubtedly, heterogeneity (in the form of human capital) can be a significantly important input to human capital development and enhancement as it makes organizations to be more creative and innovative for long term survival in their international and global markets [30]. The input-based international human capital, transformational human capital and output-based international human capital supports the competency of TMT [2]. However, certain argument arises that the relationship between innovative human resource practices and organizational performance could be explained as 'non- linear' [14] and [15]

2.2. Human Capital Theory

The theory of human capital is rooted from the field of macroeconomic development theory [34] classic book, Human Capital: This domain is illustrated by a Theoretical and Empirical analysis with special emphasis on education. Consequently, it is fully in keeping with the capital concept as traditionally defined to say that expenditures on education, training, and medical care, etc., are investment in capital. These are not just the costs but they be considered as investment with valuable returns which can be calculated. Human capital can be considered as a commodity from the perspective of Classical, Economic Theory which can be traded in terms of purchase and sale.The classical theory emphasises on the exploitation of labour by capital, human capital refers to the expertise, knowledge and skill which one gets through education and training. [15] while emphasizing on social and economic theory, found out that investment in human being is one of the most valuable capitals.[15] differentiates firm specific human capitals from general purpose human capital The expertise obtained through education and training in management information systems accounting procedures and other expertise specific to particular firm are the examples of firm human capitals. Whereas general-purpose human capital is knowledge gained through education and training in areas of value to a variety of firms such as generic skills in human resource development. According to Becker education and training are the important investment in human capital.

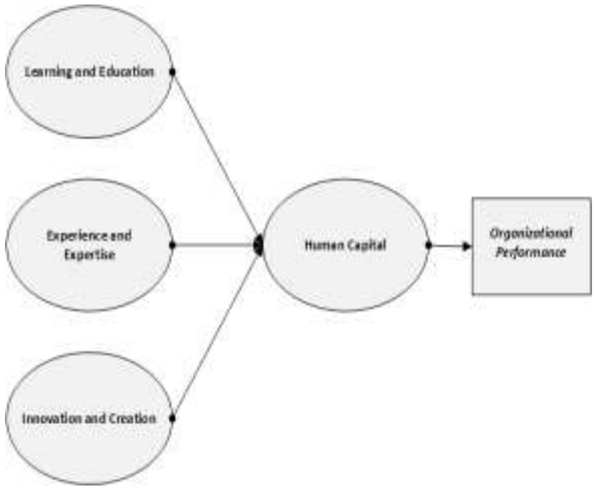

Figure 1: Propose Initial model

3. Discussion and Conclusion

A growing number of studies have attempted to show the link between human resources and performance. Although the case is not watertight, due to a number of methodological reasons, the weight of evidence is beginning to look compelling. An important finding of this research is that both contingency and best practice models can complement each other to create the conditions for effective human capital management. Meaning that the adoption of such high performance practices as incentive-based pay or selective staffing, is part of building an HR architecture. Commonality can be found in measurement of human capital. May be shows huge number of contingencies and abnormalities inherent in specific firm. However, depending only on financial measures of performance may result in highly partial evaluation.A stakeholder view or balanced scorecard approach is seen as most appropriate to capture the complexity of human capital activities. The emphasis on human capital in organisations reflects the view that market value depends less on tangible resources, but rather on intangible ones, particularly human resources. Recruiting and retaining the best employees, however, is only part of the equation. The organisation also has to leverage the skills and capabilities of its employees by encouraging individual and organisational learning and creating a supportive environment where knowledge can be created, shared and applied. In this review, we will assess the context in which human capital is being discussed and identify the key elements of the concept, and its linkage to other complementary forms of capital, notably intellectual, social, and organisational. We will then examine the case for human capital making an impact on performance, for which evidence is now growing, and explore mechanisms for measuring human capital.

This paper studied the current literature and its influence on firm performance. Human capital conceptualization is related to fundamentals of economic and firm performance. According to the literature there are strong evidences to show 'infusion of human capital enhancement' .in organizations and develops innovativeness and greater firm performance. According to the study, financial performance is positively influenced through the consideration of human capital. Based on this, firm performance in relation to human capital should not be considered as a phenomenon which adds zeros in firm's profit. Basically it is changing the whole workforce as the most valuable asset thus creating the way for the organization for greater achievements through creativity and innovativeness. Therefore, companies should bring some effective and useful plans for investing the various aspects of human capital. It not only direct firms to achieve greater performance but also makes firms to remain competitive for long term survival.

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