The Value of Human Capital: Macro-Level Research

By Jack J. Phillips, Ph.D.

While continuing to explore strategies for valuing human capital, it is important to look at the empirical approach, presenting data that show the linkage between investments in human capital and subsequent payoffs. As shown in the first part of this series ("The Value of Human Capital: What Logic and Intuition Tell Us," August 2005)—which focused on the value of human capital based on testimonials, anecdotal evidence, logic, intuition and personal successes—most executives know that some level of investment must be made. But does the evidence show that investments in human capital yield positive business results? Many macro-level studies have examined relationships between variables across organizations or functions.

Index of HR Effectiveness

A few organizations have attempted to develop a single composite index of effectiveness for the HR function. One of the first examples of such an index was developed and used by General Electric in the 1950s. This Employee Relations Index (ERI) was based on eight indicators, including absenteeism, initial dispensary visits, terminations, grievances and work stoppages. Index values were compared to plant profitability. According to its users, the ERI was intended to help managers evaluate policies and practices, trace trends in employee relations, find trouble spots, perform human relations duties more effectively and control personnel costs.

A few organizations have developed a Human Resources Index (HRI) to compare progress over time and with other organizations. In the 1980s, pioneering work in cross-organizational exchange of attitudinal data was done by the Mayflower Group, which consists of more than 30 companies, including Xerox, IBM and Prudential Insurance. According to its developer, the HRI was proven effective in many organizations for measuring attitudes, overall satisfaction and commitment to organizational goals, as well as pinpointing trouble spots and issues requiring concentrated efforts.

One of the first major studies to show empirical support for the relationship between the investment in the human resources function and organizational effectiveness was conducted in 1987 using Saratoga Institute data involving 71 firms across several industry segments. This study examined correlations among several HR measures and organizational effectiveness. Significant correlations were found between HR performance measures and productivity and profitability. The investment in human capital was one of the measures of HR performance.

Profit-Center Approach

According to some executives, the ultimate approach for HR is the profit-center concept: shifting from the traditional view of the HR department as an expense center where costs are accumulated to a

This article was previously published in *CLO Magazine*, September 2005

© 2005 ROI Institute, Inc. All rights reserved.

view of HR as an investment, which can achieve a bottom-line contribution and, in some cases, actually operate with a profit. The underlying premise of this approach is that user organizations—such as production, sales and accounting—are charged for the services of the HR department and have the option of using external services in lieu of those offered by the HR department. This concept can expand to include selling HR services to outside firms, thus generating additional income for the organization. In this approach, the HR department makes a profit, breaks even or experiences a loss. It represents a shift in perspective for the HR department from an expense center to an investment center. Although several organizations have made progress with this approach, the profit-center is still in its early stages of development. There are just too many operational issues for widespread adoption.

The Gallup Studies

Over the course of the past 25 years, Gallup researchers have assessed employee perceptions of management practices. Researchers have focused on important human resource issues on which managers can develop specific action plans and the researchers compared the responses to company success. Gallup's "12 questions" about the work environment evolved from a number of qualitative and quantitative studies. Most of the questions are connected to customer satisfaction, profitability or productivity. Examining the linkages between key elements of a healthy business, Gallup developed a model that describes the path between the individual contribution of employees and the ultimate business outcome of any company—an overall increase in value.

The Service-Profit Chain

The link between investment in human capital and profitability is most apparent in service organizations. The new economics of service are perhaps most evident in American companies where a radical shift has occurred in the way businesses manage and measure success. In this concept, customers and employees are key. The impact of employee satisfaction, loyalty and productivity is linked to customer satisfaction and growth of customer loyalty. The service-profit chain attempts to clarify how:

- Customer loyalty drives profitability and growth.
- Customer satisfaction drives customer loyalty.
- Value drives customer satisfaction.
- Employee productivity drives value.
- Employee loyalty drives productivity.
- Employee satisfaction drives loyalty.
- Internal quality drives employee satisfaction.
- Leadership underlies the chain's success. Leaders of successful service companies emphasize, by their words and actions, the importance of each employee and customer.

HR: Increasing Market Value

In 1999, Watson Wyatt, a human capital consulting firm, surveyed HR executives in more than 400 U.S.- and Canada-based publicly traded companies. A wide range of questions were asked about how organizations administer human resource practices, including pay, talent development, communications and staffing. The responses were matched to objective financial measures, including market share, three- and five-year total returns to shareholders and Tobin's Q ratio, which measures

This article was previously published in *CLO Magazine*, September 2005

ROI INSTITUTE™

Phone: 205-678-8101 · Fax: 205-678-8102
Email: info@roiinstitute.net

© 2005 ROI Institute, Inc. All rights reserved.

an organization's ability to create value beyond its physical assets. Publicly available data were used to access the financial information needed. Statistical analyses were performed to investigate the relationship between human capital practices and the objective financial measures. A significant improvement in 30 key HR practices was associated with a 30 percent increase in market value.

A series of studies developed by Arthur Andersen & Company and continued by Deloitte & Touche in 2002 involved more than 200 U.S. and Canadian organizations across a wide range of industries. Deloitte collected data on human capital practices regarding pay, performance measurement, training and development, communication and leadership. This was compared to financial and organizational performance measures, including the most recent market-to-book ratio, three-to-five-year total return to shareholders, and voluntary and involuntary turnover. The results of these studies suggest that human capital practices may account for as much as 43 percent of the difference between one company's market-to-book value compared to another.

Throughout the 1990s and continuing today, Mark Huselid and Brian Becker have engaged in a program of research that shows the connection between HR systems and a variety of strategic outcomes. This research is based on the importance of HR systems rather than individual HR practices, and on the premise that for HR to be a strategic asset, those HR systems must have a demonstrated influence on the measures that matter to CEOs—namely, firm profitability and shareholder value. By using measures of shareholder value, this research was also unique in that it focused on the level of the firm as opposed to individual employees or work groups.

Another interesting study attempted to compare the investment in human capital to stock prices. This research was conducted by Laura Bassi, a former vice president of research for the American Society for Training and Development (ASTD). Her findings suggest that over the past five years, portfolio firms that made unusually large investments in employee education and training outperformed the S&P 500 by a factor of two (113 percent versus 55 percent). This result holds in both bull and bear markets and across industries.

These are only a few of the key studies that show the connection between investing in human capital and organizational outcomes. While these studies are impressive, collectively they represent only the tip of the iceberg: There are literally hundreds of similar studies. The evidence is growing.

Optimism and Caution

Macro-level analyses provide perspective across the entire investment in an organization or across an industry, community or country. Data from these studies give executives insight into the contribution of human capital, as well as significant information for:

- Planning overall policies and connecting strategies in a general way.
- Appreciating the connections between specific practices, activities and processes used by human capital professionals and their contributions to the organization.
- Building respect for the human capital investment.

Some concerns inherent in macro-level analyses are:

This article was previously published in *CLO Magazine*, September 2005

Phone: 205-678-8101 · Fax: 205-678-8102
Email: info@roiinstitute.net

© 2005 ROI Institute, Inc. All rights reserved.

- These studies are often complex and difficult to replicate at the organizational level.
- The data usually does not show the cause-and-effect relationship.
- The macro-level view may not be helpful to a CLO or HR manager struggling with day-to-day or even longer-range decision-making.

Therefore, a micro-level analysis (which will be covered in December 2005) is needed to compliment the macro-level analysis.

Jack J. Phillips, Ph.D., chairman of ROI Institute, developed and pioneered the ROI process and has written more than 30 books on the subject.

This article was previously published in *CLO Magazine*, September 2005

ROI INSTITUTE™

Phone: 205-678-8101 · Fax: 205-678-8102
Email: info@roiinstitute.net

© 2005 ROI Institute, Inc. All rights reserved.