

The Effect of HRM Practices and Human Capital on Organizational Performance: A Literature Discussion From Indonesian MSME Perspective

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ABSTRACT

HRM practices have a significant effect on organizational performance. If HRM practices are effective, organizational performance will improve. This applies not only to large organizations but also to small organizations. However, in the literature of management, it was stated that the relationship of HRM practices with organizational performance is not yet clear (Armstrong & Taylor, 2014). There is a missing link (Yang & Lin, 2009) or black box (Huselid, 1995) in this connection. Therefore, researchers need to think about mediating factors. In theory, human capital can mediate these relationships because human capital has links both with HRM practices and with organizational performance. Various studies have been conducted to prove this relationship. However, researchers focus more on large organizations. In the context of small organizations, especially in Indonesia, this kind of research is rarely done. As a result, the literature on HRM practices, human capital, and organizational performance in the context of small businesses, especially in Indonesia, is very rarely found. This paper aims to discuss the effect of HRM practices and human capital on organizational performance in the context of MSMEs in Indonesia in the hope of adding resources in this context.

Keywords: MSMEs, Organizational Performance, HRM practices, human capital

1. INTRODUCTION

MSMEs have long been recognized as the backbone of the economy (Husin & Ibrahim, 2014) in both developed and developing countries (AlQershi, Abas, & Mokhtar, 2018). This can be seen from their contribution to Gross Domestic Product (GDP) and employment. In Indonesia, MSMEs have very large numbers so that they are able to accommodate a large workforce. Based on data from the Ministry of Cooperatives and SMEs, the number of micro small medium enterprises (MSMEs) in Indonesia reached around 64 million units or 99,7% of the total businesses operating in 2019. With this number, MSMEs are able to absorb 97% of the workforce from all available jobs. Regarding GDP, MSMEs contributed 60,34%. Therefore, it is not surprising that the Indonesian government is

trying to make this sector one of the leading sectors in the development of the national economy.

Along with changes in the business environment, MSMEs face enormous challenges. These challenges are not only internal but also external. One internal challenge that must be faced by MSMEs is the low quality of human resources. While an external challenge is increasingly fierce competition and dynamic changes of business environment. To deal with this, effective HRM practices are needed. Experts say that effective HRM practices can give companies high competitiveness.

Several studies, for example Octavia, Zulfarnetti, & Erida, (2017), have revealed that MSMEs in Indonesia tend to have low

performance . This phenomenon is indicated by the low productivity, low competitiveness, and low marketing performance of the sector. The low performance of MSMEs is thought to be caused by several factors. One of them is the lack of innovation (AlQershi et al., 2018). The low ability of Indonesia's MSMEs to innovate can also be suspected as a result of the low quality of human resources (HR). And the low quality of HR is a factor in the low practice of HRM.

HRM practices have an association with organizational performance. Effective HRM practices can improve organizational performance. However, experts argue that the relationship is still being debated. For example, Armstrong & Taylor (2014) revealed that the relationship of HRM practices with organizational performance is not yet clear. Yang & Lin (2009) and Huselid (1995) mention there is a missing link or a black box in the relationship. In other words, HRM practices do not have a direct relationship with organizational performance. Therefore, it needs to be studied in more depth what factors can bridge the relationship.

On this paper, human capital is proposed as one of the factors that can mediate the relationship. This is based on the idea that human capital has a relationship both with HRM practices and with organizational performance. In theory, a construct can be a mediator if the construct has a relationship with the exogenous and the endogenous variables (Baron & Kenny, 1986).

Although they play an important role in the economy, MSMEs rarely receive the attention of researchers, especially those related to the practice of HRM with human capital. In general, researchers focus more on large organizations. As a result, information about this sector in the literature is rarely found. This paper aims to fill this gap. Specifically, the purpose of this paper is to discuss: (1) How is the practice of HRM at MSMEs in Indonesia, (2) How is the effect of HRM practices on organizational performance,

and

(3) What is the role of human capital in the relationship. The next section of this article discusses methods, results and discussion, and conclusions.

2. METHODS

The discussion in this paper is not based on the results of empirical research but it is based on the result of synthesis from various sources. There are two main types of sources used in the discussion. The first source is reports issued by authorized institutions such as Badan Pusat Statistik (BPS/Agency for National Statistics) and the Ministry of Cooperatives and SMEs. The second source is previous research reports that are relevant to this paper. All of these sources were obtained from Google Scholar. The synthetic analysis in this paper is qualitative so there is no statistical analysis to prove the hypothesis.

3. RESULTS AND DISCUSSION

3.1. Organizational Performance

Organizational performance is an important issue for practitioners and academics for two important reasons. First, organizational performance can be used as an indicator of organizational success. Successful organizations are indicated by their high performance. Whereas an unsuccessful organization is indicated by their low performance. Second, performance measurements produce accurate information about organizational success. Managers need accurate information in making strategic business decisions.

Organizational Performance can be interpreted as a combination of organizational effectiveness and efficiency (Rezaei, Çelik, & Baalousha, 2011). Effectiveness is the ability of the organization to achieve goals while efficiency

is the ratio of achieving goals to the use of resources.

Organizational performance can also be interpreted as the level of achievement of objectives (M. Ahmed & Shafiq, 2014; Al-Tit, 2017), the ability to achieve goals by using resources efficiently and effectively (Daft, 2000; Wade & Recardo, 2001), the results of organizational and individual behaviors (Sharma, Bhagwat, & Dangayach, 2005). This definitions show that organizational performance has two aspects namely (1) the effectiveness of achieving goals and (2) the efficiency of resource use.

3.2. HRM practices

Armstrong (2012) suggested that the most significant factor in creating competitiveness for companies is HR. The reason is that HR has the ability to face challenges and changes experienced by the company. Therefore, HRM practices are imperative for companies.

Basically, HRM practices are activities that implement HR policies and programs. According to (Wright & McMahan, 1992), the practice of HRM is the deployment of HR that enable organizations to achieve their goals more easily. According to Ahmed, Ahmad, & Joarder (2016), the practice of HRM is an organizational activity aimed at improving employee welfare, productivity, and satisfaction.

Researchers classify HRM practice activities according to their respective points of view. However, these divisions, basically, have things in common. Khan et al. (2016) stated that HRM practices consist of (1) recruitment & selection, (2) training & development, (3) compensation and (4) performance appraisal. Recruitment aims to get quality employees in accordance with organizational needs. Training & Development basically aims to improve employee competencies in doing their jobs.

According to Goldstain (1991) and Hong, Hao, Kumar, Ramendran, & Kadiresan (2012), training is a programmed and systematic activity of developing employee competencies namely the knowledge, skills and attitudes needed to complete the tasks they carry in order to improve organizational performance. Research shows that employees who attend training have good performance and contribute positively to company performance. Bontis & Fitz-enz (2002) argues that the practice of training & development is an important investment in human capital. This is consistent with the view of human capital theory which says that companies must invest in employees through training & development activities to get employees who have unique and 'firm-specific' skills.

Compensation is something that is received by employees as the reward of their sacrifice to the organization. Compensation can be in the form of financial or non-financial. Geiger & Cashen (2007) argued that the compensation & reward system is an important key in getting qualified employees. Accordingly, to be more effective, compensation should be attractive and competitive (Terpstra & Honoree, 2003).

Competitive compensation can bring three benefits to the company. First, competitive compensation can increase employee commitment to the company. Second, competitive compensation can maintain a long-term employee relationship. Third, competitive compensation can help companies to accumulate human capital (Huang, Roy, Ahmed, Heng, & Lim, 2002; Roos, Fernström, & Pike, 2004).

In fact, performance appraisal is the most unpopular activity among employees and managers. Both managers and employees are reluctant to do it (Bratton & Gold, 1999). Employees consider it useless. Similarly, managers think it is a burden. However, all recognize that there must be a way to measure, monitor, and control performance (Barlow, 1989).

Failure of management to supervise is an extraordinary ineffectiveness.

Although HRM practices are recognized as being able to improve organizational performance, small organizations often ignore this practice (Amin, Heriberta, & Kurniawan, 2018). Frequently, MSMEs focus on production and marketing activities. In particular, HRM practices in Indonesian MSMEs have the following characteristics: (1) recruitment and selection are not based on objective criteria but are based on subjective criteria of business owners, (2) training and development practices are not based on needs analysis. In fact, often, it is very dependent on government assistance. As a result, employee performance has not improved despite of the various types of training, (3) performance appraisal is almost never carried out. Therefore, performance awards are neither objective nor reasonable. As a result, employees do not know whether they are working properly or not, (4) Compensation systems often cause problems that result in the decrease of employee motivation.

3.3. Effects of HRM Practices on Organizational Performance

The aim of the organization is to increase stakeholder satisfaction. This satisfaction is reflected in the high organizational performance. When organizational performance is high, stakeholders will feel very satisfied. Conversely, if the organizational performance is low, the stakeholders will feel dissatisfied. Therefore, managers strive to improve the performance of their organizations. To be able to improve organizational performance, managers need to know what factors influence it.

One of the factors that can influence organizational performance is HRM practice. In essence, HRM is a management activity that aims to increase employee contributions to the organization. HRM also aims to ensure that organizations obtain employees with high

integrity, motivation, commitment, skills, abilities, and expertise. Experts have proved that HRM practices correlate positively and significantly with organizational performance. The more effective the HRM, the higher the organizational performance. Conversely, the more ineffective HRM the lower the organizational performance (Banerjee, 2017).

3.4. Human Capital

Basically, human capital can be interpreted as an invaluable intangible asset. Human capital can provide long-term competitiveness. Human capital is inherent with the employees. Therefore, managing human resources is the same as managing human capital.

Human capital is a vital element for organizations because: (1) it has a role as a source of innovation and strategic change, and (2) reflects organizational performance (Obeidat, Tarhini, Masadeh, & Aqqad, 2017). High quality human capital can increase productivity, performance and competitiveness of the company. In other words, human capital can bring economic value to the company (Falmholtz & Lacey, 1981).

Human capital is the combination of competence, attitude and agility (Tovstiga & Tulugurova, 2007). Competence consists of knowledge, skills and abilities. Attitudes include motivation, commitment, and work behavior. Agility is a combination of creativity, flexibility and adaptability.

Research has proven that human capital is the company's most important asset. However, not all companies, especially MSMEs are aware of the importance of quality human capital. Many companies can be good at improving their financial performance. However, not a few companies fail to involve employees in achieving their organizational goals. In fact, according to Lawler (2008), human capital will not be able to provide long-term competitiveness to companies if it is not managed properly.

3.5. Effects of Human Capital on Organizational Performance

Human capital is a valuable asset of a company. If managed properly, these assets can create sustainable competitiveness for the organization. Therefore, the effective management of these assets is imperative. Human capital in the form of competencies, motivation, skills, innovation owned by employees is an important factor that can improve company performance.

In theory, human capital is supposed to be able to pose as a mediator in the relationship between HRM practices and organizational performance. This is due to human capital having a good relationship with HR practices and organizational performance. In theory, a variable can be a mediator if it has a good correlation with the endogenous variable and exogenous. Human capital meets these criteria. The following figure shows the mediating role of human capital in relation to HRM practices and organizational performance.

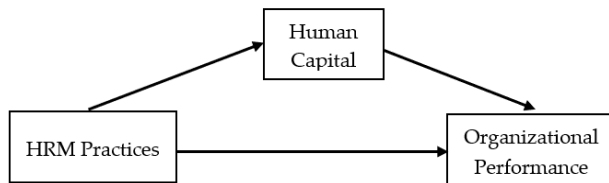


Figure 1. Relationship patterns of HRM practices, Human capital, and Organizational Performance

Based on this picture, it is clearly seen that human capital mediate the relationship of HRM practices and organizational performance. Accordingly, HRM practices first affect human capital, then affect organizational performance.

4. CONCLUSIONS

The above discussion has answered the three questions raised above. First, HRM practice is an

important factor in influencing organizational performance. HRM practices aim to increase employee contributions to the organization. However, this practice is often ignored by Indonesia MSMEs particularly. The lack of quality of human resources at MSMEs is one factor why HR practices are often ignored. Second, HRM practices are recognized as being able to influence organizational performance. With effective HRM practices, employees can contribute more significantly to the organization. Third, human capital is an important asset of the company. Human capital can provide sustainable competitiveness for organizations. Therefore, the management of human capital is imperative. To be able to increase human capital, companies need to conduct effective HRM practices. Effective HRM practices will create high quality human capital and ultimately affect organizational performance. The discussion in this article is only hypothetical. Thus, it still needs empirical evidence.

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