HUMAN CAPITAL AND THE AMERICAN CORPORATION: Perspectives from Industry

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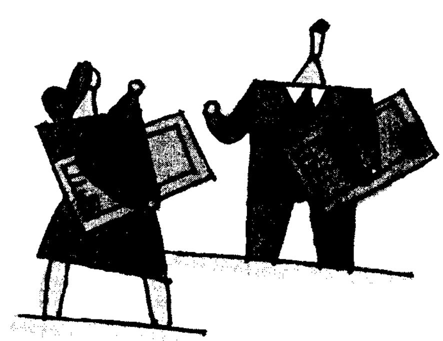
Recent developments in corporate strategies and employment relationships are said to herald the breakdown of traditional, internalized employment systems in which a workforce and the terms of employment were insulated from the fluctuations of the market.



The term "knowledge worker" is now part of the human resource vocabulary just as "human capital" became part of the economics lexicon several decades ago. Both imply that workers can be critical competitive assets and that human capital, like financial capital and other key resources, needs to be treated as both a cost and an asset in firm decision-making, accounting, and relationships. What does this mean in practice? Its implications are both potentially profound but under-appreciated, both among researchers and in discourse among professionals dealing with these issues on the front lines.

To deepen our understanding and promote broader dialogue on the role of human capital and the American corporation, a group of academics and industry leaders gathered at MIT's Endicott House Conference Center in January, 1998 to explore the growing importance of human capital and the implications of this trend for the future of American corporations.[1] We thought *Perspectives* readers would be interested in a summary of the key points that arose in the discussion of the papers presented at this meeting and therefore asked a panel of industry and academic participants to elaborate on the comments they made at the conference.

Three challenges emerged out of the discussion for firms that depend heavily on human capital as an asset are: (1) attracting and retaining highly mobile and scarce knowledge workers; (2) training and compensation of knowledge workers, and; (3) ownership and corporate governance.

What's at Stake?

The traditional view is that the central, if not the sole, objective of the American corporation is to maximize shareholder value. While in practice managers recognize the need to consider the interests of other "stakeholders" when making critical decisions, shareholders play the central role in the legal structure of firm. Financial markets and institutions exert a strong and, some believe, growing discipline on managers to remain focused on maximizing shareholder value. Yet the shareholder primacy perspective can be overstated and is being challenged both in some recent theoretical models of the firm as well as in practice in settings where employee skills and knowledge are critical, scarce, and mobile.

In her recent book, *Ownership and Control*, Margaret Blair, the conference co-organizer, suggested that employees share the residual risks of firm failure to the extent that they either have part of their compensation at risk in the firm or would experience significant reductions in wages or benefits if forced to search for a job on the external labor market. Moreover, Blair and others argue that as human resources become a more important source of competitive advantage, they are likely to begin challenging other, more conventional resources, such as finance capital, for influence in corporate governance and decision-making. The argument comes down to the following proposition: If human resources that are critical to the success of the firm are able to walk out the door and take critical assets with them, firms will experience increasing pressures (1) to modify their human resource practices to improve their ability to attract and retain these resources; (2) modify their investment practices to ensure these resources are fully developed, utilized, and do not depreciate, and; (3) modify their compensation and governance structures to better align the interests of employees and shareholders. In turn, as employees become more critical resources to the firm and recognize that they share the risks as well as the rewards associated with firm performance, they can be expected to demand a stronger voice in the governance process of the firm. If these propositions are correct and are carried to their logical conclusion, their effects go well beyond the traditional domain of human resource management and policy to affect the very objectives of the firm, the roles of employees and shareholders, and the behavior of financial markets.

To go from the theoretical to the practical, we asked several conference participants from industry and the research community to elaborate on their reactions to these propositions. Specifically, we asked them to reflect on how these general points play out in the way human resources are managed in their organizations and how they believe the growing importance of knowledge workers is affecting their practices and organizational arrangements.

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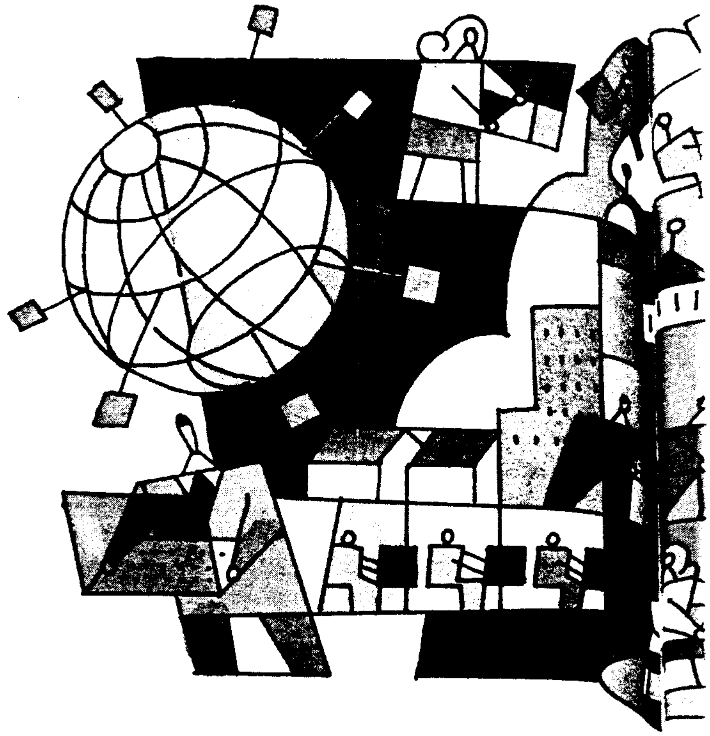
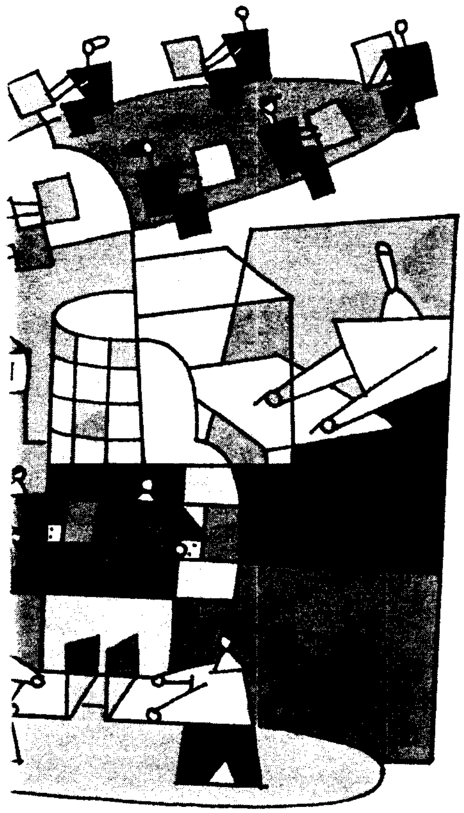


Attracting and Retaining Human Capital

The need for human resource policies that strengthen the ability of firms to attract, develop, and retain skilled workers is obviously not new. This is one of the forces that led to the development of "internal labor markets" in which firms created career ladders, provided long-term employment security, invested in training needed for employees to keep their skills current and marketable within the organization, etc. But recent developments in corporate strategies and employment relationships—an increase in outsourcing and contingent work, the disappearance of career ladders and life-long employment, and firms buying skills on the external labor market, rather than investing in human capital—are said to herald the breakdown of traditional, internalized employment systems in which a workforce and the terms of employment were insulated from the fluctuations of the market. While these new relationships are considered by many to be revolutionary best practices for the economy of the future, evidence summarized in a paper presented by Peter Cappelli indicates they were actually widespread in American industry one hundred years ago, when they served as the dominant model for managing firms and employees.

Many others have documented the breadth and depth of corporate downsizing and its effects on employee attitudes and expectations. But alas, what goes around comes around, and now as the labor market once again tightens for scarce knowledge workers, managers wonder what it will take to attract and retain these workers in the future. Will firms learn how to, as Cappelli puts it in a forthcoming book title, "Manage Without Commitment," of their employees? That is, will the market mediated model of workforce management dominate for workers whose skills are scarce and who have the general human capital and are prepared to move across organizations to where their assets are most highly valued and needed? Or will firms begin to rebuild their internal labor markets and will employee loyalty, scarred by recent downsizing and outsourcing strategies, be rebuilt in the years ahead as firms recognize the shortsighted nature of their recent actions?



Commentary

Ralph Craviso, Lucent Technologies, Inc.: "Let me tell you how most firms think about the challenge of attracting and retaining 'knowledge workers.' There is no single strategy for attracting and retaining people. For example, the individual contribution of a scientist is based on knowledge and individual capacity. They contribute along a geometric progression: The longer they're there, the more you lose if they go. Contrast that with a technical engineer. They tend to have knowledge in a specific area, but they don't contribute as much in terms of creativity in new areas. But they're still important because of the costs of turnover and the lost productivity that goes with it. If turnover goes up for these people, you have to raise your wages to compete. Contrast scientists and engineers with production people. Although they might not contribute as much in terms of knowledge, there is still a benefit to retaining them, but they are not as valuable to the enterprise's overall innovation. So firms look at what each employee contributes and what is lost if they leave."

Bill Hobgood, UAL Corporation: "Human capital has always been critical; now it's just becoming more critical. But it's important not to become infatuated with the high end. That can cause problems. For example, in the past we tended to push up the pay rates for top-level, senior information systems' people because we clearly need their expertise. But then this distorted the wage structure at the entry level and we were losing people there. In any organization where seniority matters, you have this problem. We have to develop people at all levels to prepare them to move up and to avoid costly turnover along the way. Even more importantly, in a service business like an airline, our customer service and reservation people are the first people our customers meet and interact with. These front-line employees have more impact on customer service—one of our three key corporate objectives—than most "higher level" managers, technical people, or executives. So we have to focus on total development of our workforce."

Bill Strusz, Xerox Corporation: "From a business perspective, when does human capital become an asset? When do we have to face it as a cost? When it comes to a downsizing, it is pretty easy to calculate labor cost savings. The challenge is to try to retain critical people in a downsizing process—exactly the people who have the most mobility. So downsizing cuts costs, but I'm not sure we really know the true costs of human capital losses associated with downsizing."

Ralph Craviso: "When you look at outsourcing, you first have to ask, is it good or bad for a company. Then look at the suppliers. Is it good for the suppliers? Does it mean an expansion of business for them? For example, Lucent used outsourcing to free up resources so we could become a supplier to someone else. In that case, our core competencies were expanded, not shrunk. Second, you need to look at all the reasons that a company outsources: capital investment, return on assets, investment in technology, transfer of risk, the constant evolution of core business functions, computerization and the opportunities to integrate functions in new ways. The availability of labor also drives the decision. There hasn't been a good understanding of the complete range of factors that drive these decisions from the firm's perspective. You can't assume that downsizing or outsourcing has a single purpose."

Michael Bennett, UAW/Saturn Corporation: "We also need to look at the long term. VW might achieve gains in the short term by outsourcing, but it may also lose the ability as an organization to manufacture key components. What happens if the supplier can no longer provide those key components?"

Training and Compensation Practices

Treating human capital as an asset similar to financial capital has two key implications: (1) training and development costs should be treated as investments for accounting purposes inside the firm and by external financial analysts, and (2) like other investors, employees will be sharing in both the risks and rewards associated with the assets of the firm.

The problem with the first point is that firms may know what their human capital *needs* are, but they do not necessarily know how to measure the extent of their human capital *investment*. But, if it is true that "what gets measured gets managed," then firms may be doing themselves, their shareholders, as well as their employees, a disservice by not tackling the problem of measuring human capital investment.

Commentary

Ralph Craviso: "We need to figure out how to measure the costs of investments, but we also need to know: What are we getting for them? What is an appropriate measure? Revenue per employee? Cost of goods sold per employee? It is important to know what you are getting to decide whether or not to invest in a person's skill or buy the expertise on the outside."

Lisa Lynch, Tufts University: "The big problem is measuring the benefits stream. For example, in the past IBM took a hit on the stock market because it was judged to be spending too much on training. So the danger is if you get the benefits measurement wrong or don't have good measures of benefits, the financial analysts will want you to cut human capital investments. The benefits are more than sales per employee per quarter. It's also important to distinguish between revenue, productivity, and profitability. Since training is part of a set of interrelated practices, if you look at training expenditures in a vacuum you also get misguided cost and benefit estimates and will probably make the wrong decisions. So we want to capture the entire decision-making process, taking into account the related practices that have to go along with training, asking what is the benefit stream and how does it depreciate over time. This is why measuring the costs and benefits of human capital investments is so hard."

Bill Hobgood: "Too often the knee jerk reaction to a budget or profit squeeze is to cut back on investment in people. Companies tend to use a negative measure to decide on training: 'Can we afford to spend the money now or do we need to cut back?' If we recognize that our people on the front line are now managing the business and meeting our customers, then the better measure of the value of training is the same bottom line performance measures we use to measure business success—productivity, quality, and profits. It's no longer possible to separate the 'returns to training' from these performance indicators."

Variable Compensation

One way to align employee and shareholder interests is through profit sharing or some other variable compensation program. Yet the long history of variable compensation programs (individual, group, or organization-wide incentives), teaches us two things: (1) employees have widely varying preferences for how much of their pay they are willing to put at risk, and (2) making variable pay systems work effectively over time requires complementary changes in other human resource and organizational practices. These two points featured prominently in the discussion of how to design and manage compensation systems that better align shareholder and employee interests.

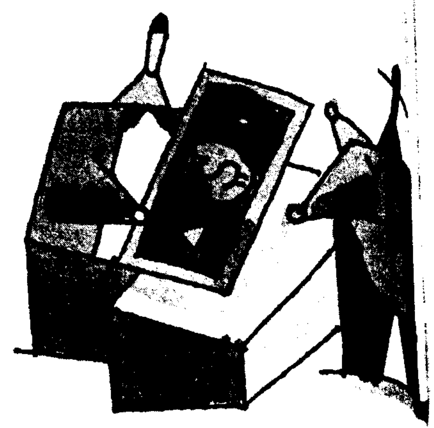
Several at the conference suggested that it is not demands from employees per se that is leading to a growth in variable compensation system but demands from the financial markets for both risk sharing and for simple and visible indicators that employee and shareholder incentives and rewards are positively aligned.

Commentary:

Jonathan Low, Center for Business Innovation: "Financial markets are looking to what degree of compensation is at risk as a proxy for how well employees' interests match those of shareholders. Inefficiencies of information are arising though, particularly considering the recent phenomenon of a rise in the value of stock when a company announces a layoff. Apparently, analysts still find it easier and more consistent with their mindset to view workers as a cost than as a capital asset."

Bill Hobgood: "United Airlines put the issue of profit sharing to the test. Employees were asked if they would agree to having 1 percent of their salaries put at risk. There was tremendous resistance.... As a mediator in the United Airlines negotiations, I know there was also enormous resistance to profit sharing by the unions. They bought the company to get control over job security rather than financial incentives."

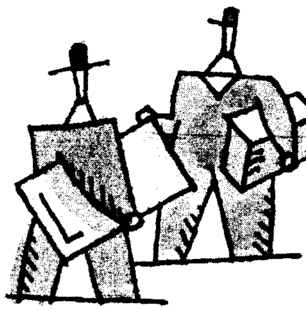
Ralph Craviso: "It comes down to the values that workers have. Blue-collar workers have less of a desire to put their



income at risk; profit sharing might be a fine arrangement, but not as a part of their base compensation. White-collar workers, on the other hand, may feel they have more discretion with their wages and have a higher tolerance for risking their incomes and linking it to the enterprise. It's important to consider employee value systems and expectations."

Michael Bennett: "We need to evaluate how unions view profit sharing and ESOPs. These things don't necessarily hurt employees, but some unions may simply have philosophical differences. There seems to be a lack of understanding of what these arrangements bring to workers. Employees may be more willing to take these risks if they have more control over decision making."

"At Saturn, we recently had to renegotiate the risk-reward formula to reflect the fact that GM had not given us a new product in time to offset the decline in market demand for small cars, including our product. We could only make this change in the formula because we are directly involved in the management of the firm and have the information needed to propose changes in the reward structure that fit our current business plan and those aspects of our current business plan that employees can influence. But employees made it clear to us that the partnership would not survive if we didn't make the adjustments. This shows me that workers who share risks will demand a voice in the critical decisions that affect both the long-term via-



bility of the organization (and their jobs). To make this work, management must design reward systems that sustain workers' involvement and contributions to firm performance."

Ownership and Governance

If workers commit their assets to the firm they become residual risk takers similar to shareholders. When a firm's output stems directly from its human capital, such as in consulting or legal services, or in knowledge-driven start-up firms in industries such as biotechnology, employees are likely to show an interest in gaining significant ownership stakes and governance rights. This is why many of these firms are organized as partnerships or provide key employees with significant equity as part of their compensation. From this we might speculate that as knowledge or intellectual capital becomes a more important resource, employees will expect and perhaps demand ownership and/or influence in the governance process. If we take this speculation to its logical conclusion, knowledge work, and knowledge workers, have the potential to transform the distribution of power and decision making in the corporation of the future. Yet it is not a forgone conclusion that governance rights—real influence—go along with employee ownership in the firm. The vast majority of firms with significant blocks of stock owned by employees do not give workers a voice in governance. Nor is it a forgone conclusion that employee-owned firms are destined to succeed and remain employee owned over an extended period of time, with or without employees in governance roles. These issues provoked considerable discussion.

Commentary

Paul Osterman, MIT: "It's important to distinguish among the motives for turning to employee ownership. The majority of ESOPs are driven by issues other than employee involvement—taxes and takeover protections are only two examples. It would be helpful to see the distribution of firms that have ESOPs only versus those that combine ESOPs with other forms of employee involvement or governance. Do they perform differently? The evidence available suggests this is the case, but we need to keep examining this issue and documenting the experiences with different forms of ownership and governance. It's important to look at changes over time as well. For example, do ESOPs become a precursor to further participation or broaden employee participation to other forms or areas of decision making?"

Ralph Craviso: "It makes a difference how and why a company becomes 'employee owned.' If a firm uses an ESOP as a substitute for compensation or as an attempt to reach a market value of compensation, it's transitory—employees will sell their shares in five or ten years if they accumulate value. In this case, the ESOP then is not an instrument for accumulating long-term wealth, as some of its original advocates envisioned.... Some companies are also looking at ESOPS, particularly with 401k matching, as an inexpensive way of providing benefits. That too is transitory. Will the value be there when employees retire? When you think about some of the reasons why companies are creating stock ownership, it's a little unsettling."

Bill Hobgood: "There's such a broad range of levels of ownership and governance. We have to be careful to distinguish among them. At United we now have representatives of the pilots and machinists on our board who have a major influence on the choice of the CEO. Non-represented managers and supervisors also have a representative of their own on the board. In contrast at Delta, there is only one person on the board and it is harder to have much influence that way. But you also have to look beyond board membership. Management now shares a tremendous amount of strategic information with employees. We have annual briefings on capital investment plans, route structures, possible new alliances with other airlines—all before we take these issues to the board. And, like many other companies, we are working hard to push decision making down to front-line employees and build a culture of ownership into everyday activities. This is where we need to get to in the long run if ownership and shared goverance is to produce its full potential pay off."

Robert McKersie, MIT: "I agree we need to distinguish among different systems of employee ownership, especially the effects of different levels of ownership. In some cases the degree of ownership is low (15–20 percent) and in no way affects market compensation of workers and there is very little control. If you move to about 30 to 40 percent employee owned, you might see a little less in terms of market compensation as a trade off, but you see an increase in the demand for control. If you move to 100 percent employee owned, compensation is really traded off because employees are not getting market wage rates; they expect to get their compensation in the future perhaps through an IPO (public stock offering). So I think we need to keep track of the different trade-offs between wages and ownership that employees will accept at these different levels of ownership."

Summary

These comments suggest that moving from the theoretical to the practical is not an easy journey. It is still easier to measure the costs of labor than the value produced by human capital investments. Human capital clearly resides at all levels of organizations, and as organizations push authority down to lower levels and as more employees have direct customer contacts, the collective human capital of the workforce may matter as much or more than the value of any single highly skilled individual. Yet it still is the threat of a key individual leaving the organization that gains attention. Profit sharing and other forms of contingent compensation are the easy indicators visible to investment analysts, yet they may be a misleading indicator and a blunt instrument for motivating employees and building a sense of ownership throughout the organization. So there is much more work to be done to move from the theoretical understanding that human capital is becoming a more critical asset to practical strategies for acting on this realization.

What do you think? How is your organization balancing the dual role of employees as costs and critical assets? Write to us and let us know and we will keep this dialogue going in future issues.

1. The conference was co-hosted by the Brookings Institution project on Corporations and Human Capital and the MIT Task Force on Reconstructing America's Labor Market Institutions with support from The Alfred P. Sloan, Ford, and Rockefeller Foundations and MIT's 21st Century Organization's project.

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Professor Blair is currently completing a three-year project titled "Corporations and Human Capital." A volume of essays with the same title will be published by Brookings in 1999.

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