

## STRATEGIC HUMAN RESOURCE MANAGEMENT AND SUSTAINABLE COMPETITIVE ADVANTAGE: THE ROLE OF DYNAMICS AND INNOVATION CAPABILITIES

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### ABSTRACT

*To achieve superior performance and continual competitiveness, a company needs to integrate and adjust among strategic choices with human resource policies in order to execute the best chosen strategy effectively. The existence of Inside-Out approach supported by Resource Based View is not absolutely changing the Outside-in approach in the formulation and implementation of Human Resource Strategies. Otherwise, this situation is forced to empower human resource functions to be more strategic to synergize with the challenges by creating real value added for a company to lead in fierce business competition. The roles and functions of Strategic Human Resource must be directed to produce core competitiveness of company, and managing the capabilities of company to more flexible and dynamic. This strategy is expected to stimulate a continual innovation which integrates human resource practices, so a company can manage itself to be more adaptive with environment changes.*

*Keywords:* Strategic Human Resource Management, RBV, Dynamic Capabilities, Innovational Capabilities, Competitive Advantage

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### Introduction

Recent strategic human resource management (SHRM) researches have paid a major attention to the overall issues of managing people which are integrated on corporate level. This is a criticism towards previous studies which focused on strategy and practices of HRM partially and independent from other firm strategies and policies (Lepak & Snell, 2002). The integration of human resource management into other strategies is critically important since the sustainability of firm's superior performance and competitive advantage is established by several factors that should consist of: accuracy of strategy, human resource and internal capability, and the organizational capability in response to every opportunity and threat from the internal and external environment (Michie & Sheehan, 2005). Therefore, the integration and appropriate between strategy chosen (strategic fit) and the policy and practices of human resource in executing the strategy are the primary determinants in this case (Michie & Sheehan, 2005).

The approaches used to explain the process of integrating selected strategy into human resource policy are developing from time to time as the environment keeps changing. Generally, there are two approaches in SHRM: outside-in which focuses on business problems and external environment analysis such as industry structure, competition, consumers, and other people issues as the starting points of human resource strategy management and inside-out approaches. The latter is established to overcome problem which rises since outside-in is not able to fulfill the need and challenges of competition in a dynamic environment. Inside-out is an alternative approach supported by *Resource Based View* (RBV) theory which defines the integration process between the human resource strategy and policy. In accordance with RBV approach that emphasizes the importance of firm's capabilities and resource in order to achieve rents and sustainable competitive advantage (Barney, 1991; Wernerfelt, 1984), inside-out pays major attention to the status quo of human resource management, that is, strategic human resource management is determined by a firm's internal capabilities and core competencies (Paauwe & Boselie, 2003).

However, the inside-out approach is not able to completely displace the outside-in. This is because the implementation of RBV concept is implicitly considered as static equilibrium; refers to its disability to provide sustainable indicators of success for firm in a dynamic and changing environment (Mahoney, 1995; Teece *et al.*, 1997 cited in Chan *et al.*, 2004). Besides, RBV concept is more focused on making the resources in-imitable, non-substitutable, and valuable than on complementing and co-specialize the human resource. (Amit & Schoemaker, 1993; Mueller, 1996; Powell, 1995 cited in Chan *et al.*, 2004). Despite the advantages and disadvantages, we believe that the inside-out approach with its RBV concept has increased the importance of human resource role in achieving and defending the competitive advantage of firm. This happens because RBV has provided theoretical and rational basis for the importance and potency of human resource management role as a strategic asset of firm (Wright & McMahan, 1992).

Based on the analysis above, it is obvious that each of strategic human resource management approaches has its own advantages and disadvantages. Therefore, as the gale of creative destruction is getting stronger (Schumpeter, 1942) indicated by a higher level of competition among firms the efforts of making firm able to maintain and achieve a sustained competitive advantage have gained major attention. The question is: how to do that? To overcome this problem, the integration process of firm strategy into the practice and human resource policy must be considered as a continual cycle that needs to be improved from time to time via strategic learning and strategic change. This condition is the essence of dynamic capabilities concept introduced by Teece, Pisano, and Shuen (1997), by which firm is enabled to adapt, integrate, and reformulate its internal and external resources to deal with the environmental changes.

Besides that, according to dynamic capabilities perspective, strategic fit is the keyword in the process of formulating and implementing strategy. The strategy must fit the contingency factors both in external environment and other organizational factors. Strategic fit with its more dynamic, multidimensional, and normative attributes, is the most important part of contingency or best fit approach and expected to act as a bridge between the outside-in and the inside-out approaches to obtain the synergy needed to gain a sustainable competitive advantage. Contingency or best fit approach argues that in order to improve business performance, consistency or compatibility between human resource policy and business strategy is a must (Michie & Sheehan, 2005). By this contingency approach, the role of human resource management becomes significant in creating a unique mechanism and system suitable to the social-cultural and institutional contexts of each firm (best fit).

Baumol (2004) and Danneels (2002) cited in Beugelsdijk (2008) supported this by arguing that to deal with the recent economic environment, process of organizational renewal based on product's innovation ability is the main challenge that must be handled if the firm wants to keep alive and success. That is why level of competency and dynamic capabilities of individual and firm, and the organizational structure that supports the process of continual innovation becomes very determining.

Considering all explanations above, this article is aimed to construct an approach that act as a bridge between outside-in and inside-out approaches by building firm's dynamic core competency with sustainable innovation capabilities of employee and firm. The existence of sustainable dynamic capabilities and innovation guarantees that the performance of firm will not be affected regardless the approach selected in the process of strategy formulation and implementation. Meanwhile, dynamic and innovation capabilities will be gained if the firm has a supporting culture that pushes both firm and employees to create value added through capabilities to create a dynamic advanced of creativity and innovation (Chan, *et al.*, 2004) as an answer to all challenges in the environment of the firm.

### **Strategic Human Resources Management (SHRM)**

SHRM has been used as a framework to test the relationship between human resource strategy and firm's performance (Rose & Kumar, 2006) as well as a resource of the firm's competitive advantage (Wright, Dunford, & Snell, 2001). SHRM is defined as an integrated cluster of practices, policies, and strategies, by which organization manages human capital that affects or be affected by business strategy, organizational factors, and economical-social factors. (Mulla & Premarajan, 2008). Meanwhile, Becker and Huselid (2006) says that SHRM generally explains the relation between HR architecture and its performance, where HR architecture consists of systems, practices, competencies, and an attitude-based employee performance that point out or reflect how the management and development process on human capital go on.

According to Michie and Sheehan (2005), there are three main approaches used in understanding the SHRM: universalistic approach, contingency approach, and configurationally approach. Universalistic approach, or known as best practice, considers that some human resource practices are universal and better than others so that firms which adopt and use that kind of practices will perform better than their competitors (Rose & Kumar, 2006). Despite the popularity, this approach receives many criticisms. Brewster (1999) cited in Mulla and Premarajan (2008) for example, claimed that universalistic approach is too simple to explain how a human resource practice can be appropriate and effective to be applied in different industry, situation, or culture contexts. Meanwhile, contingency approach believes that in order to improve its business performance, firm must make sure there is coherency between human resource policy selected, business strategy and other organizational aspects so that the employee behavior and the firm purpose will be aligned. Last but not least, is the configurationally approach. This approach relies heavily on firm capabilities for creating human resource as a planned system or pattern (planned human resource) that organizes every activity to obtain the horizontal consistency (internal consistency) and vertical consistency (external consistency) that will result in business performance. Horizontal consistency or horizontal fit shows the congruence among the various HRM practices while vertical consistency shows the congruencies between the HRM (functions, system, and strategy) and the firm strategy (Mulla & Premarajan, 2008).

### **Resource-Based View, Dynamic Capabilities, and Innovation Capabilities**

The emergence of RBV in the early of 1990s (Wernelfelt, 1984 and Barney, 1991) was motivated by strategy formulation approach that generally assesses the competency and resource of a firm (inside-out) where the distinctive and superior values are considered to be the advantages over competitors (Paauwe & Boselie, 2005). The fundamental principle of Resource Based View is that resources in a firm fuse into a bundle (resource heterogeneity) that provides the basis for production process of a firm which is different from its competitors'. Thus, by resource heterogeneity firm is able to use its resources and capabilities efficiently and gain a bigger opportunity of a more economical operation and a better service quality that will lead to the improvement of performance and sustainable competitive advantage. Another perspective reveals that the main focus of RBV is how to make the

resources and capabilities of a firm in-imitable (costly to copy). Therefore, firm is demanded to keep improving and combining its valuable and rare resources and capabilities which are in-imitable, non-substitutable, and adhered to the organizational process known as VRIN or VRIO concept (Barney, 1991; Barney & Clark, 2007).

Nevertheless, the implementation of RBV encounters some difficulties. RBV is implicitly assumed to be static equilibrium; disable to provide sustainable success indicators for a firm in a dynamic and changing environment (Mahoney, 1995; Teece *et al.*, 1997 cited in Chan *et al.*, 2004). Moreover, RBV is more focused on how to create a firm which is in-imitable, non-substitutable, or hard to take over than being a complementary or co-specialization to the firm's human resource (Amit and Schoemaker, 1993; Mueller, 1996; Powell, 1995 cited in Chan *et al.*, 2004). Dynamic capabilities concept (Teece, Pisano, & Shuen, 1997; Eisenhardt & Martin, 2000; Zollo & Winter, 2002; Winter, 2003) or dynamic core competencies (Danneels, 2002; Lei, Hitt, & Bettis, 1996) cited in Schreyogg & Eberl (2007) seems to be the answer to this problem.

Dynamic capabilities are defined as organizational capabilities to integrate, build, and reconfigure internal and external competences to address rapidly changing environments (Teece, *et al.*, 1997). Eisenhardt and Martin (2000) argued that the dynamic capability is a process; it is not only can be identified but also empirically proved. For example, a routine of product improvement, transfer process, resources allocation, co-evolution capability, knowledge creation, alliance, and acquisition are parts of dynamic capabilities discussion and therefore, this concept is also known as successful routine processes based on learning mechanism. This supports the argument of Zollo and Winter (2002) that focused on organizational learning as the source of dynamic capabilities. Furthermore, Zollo and Winter (2002) defined dynamic capabilities as "a fixed learning pattern of a collective activities where organization systematically obtains and modifies its operational routines to achieve and increase effective". This dynamic capabilities concept is in accordance with HR flexibility concept suggested by Bhattacharya *et al.*, (2005) and Martin *et al.*, (2008). These various theoretical meanings are also supported by various empirical evidences, such as Martin *et al.*, (2008) who argued that HR flexibility mediates the relationship between high performance work system and firm performance. Based on the suggestions above, it is concluded that dynamic capabilities or HR flexibility that has been adjusted with the development and dynamics of environment will highly determine the level of firm's performance.

Furthermore, Wright and Snell (1998) cited in Bhattacharya *et al.*, (2005) suggested that HR flexibility is a characteristic or trait of the internal of firm which is obviously seen from three components, i.e. employee skill, employee behavior and HR practices. Employee skill flexibility is the amount of potential alternatives of employee skill that can be used or applied by firm; or in another way it can be explained as how employee with different skill can be rehired quickly. Bhattacharya *et al.*, (2005) argued that employee skill flexibility can be measured from how easy and quick the employee learns about new skill and apply it to new tasks. Meanwhile, employee behavior flexibility refers to the capability of employee to behave and adapt with a specific demand or situation in a firm; or the capability to show tolerance to behaviors out of routine (Martin *et al.*, 2008). Finally, HR practices flexibility shows how HR practices and policies of a firm are applicable for each of different situations, or for different units in a firm, and how fast the adaptation and application process occurs. To achieve the HR flexibility as mentioned above, it is really important to unite these three flexibility dimensions into one integrated and interdependent unity based on the sustainable process of learning and improvement (Martin *et al.*, 2008).

With regard to innovation capabilities, many researchers suggested that competency and HR of a firm are determinants for sustained innovation process (Brown & Eisenhardt, 1995; Verona, 1999). Supporting Brown and Eisenhardt, Teece, Pisano and Shuen (1997) also claimed that dynamic resource is the main source necessary for creating competitive advantage when landscape of competition changes. Furthermore, Teece, Pisano and Shuen (1997) also suggested that dynamic capabilities is a part of competency or capability level which enables the firm to create and process new product in response to each of changes that occurs in marketplace.

From the explanation above, we can obviously see that dynamic capabilities and HR flexibility actualized in the form of knowledge capital play an important role in raising innovation of firm. Many researchers have tried to explain the role of knowledge capital in increasing innovation in a firm that will finally lead to dynamic core competencies. Many scholars (Ahuja, 2000; Dougherty, 1992; Tsai & Ghosal, 1998), suggested that knowledge capital is an antecedent variable for innovation which is measured as exogenous. This strengthens the important role of knowledge for the development of innovation capabilities in a firm. Many approaches are keep being performed by firms to accumulate knowledge capital as the source of innovation by differentiating the dimension of knowledge capital into human capital, social capital and organizational capital (Subramaniam & Youndt, 2005). Human capital is knowledge and skill that is adhered and belonging to each of individual who performs competencies. Social capital is knowledge adhered to unwritten values and norms in a firm used when individuals inside the firm interact with each others. Organizational capital is knowledge that has been institutionalized into patent, manual, system, process, and standard operating procedures.

Thus, social and organization capital play significant roles in establishing a dynamic capability which enables the firm to keep developing its innovation capability. Creative and innovative ideas alone are not enough to develop the innovation capability of a firm unless the value system supports the ideas through a sharing mechanism or idea transfer and individual knowledge. This is supported by Chan *et al.*, (2004) who emphasized that the knowledge capital and innovation capabilities will be gained as long as they are supported by appropriate corporate culture which respects involvement, consistency, ability of adapting, mission and flexibility that push both firm and employee to obtain value added through dynamic advanced-creating capabilities of creativeness and innovativeness (Chan *et al.*, 2004) that finally answers every challenge and problem in the firm's environment.

#### **Organizational Competences, Innovation Capabilities, and Sustainable Competitive Advantage**

Vakola *et al.*, (2007) argued that sustainable competitive advantage is highly affected by a firm's ability to use its resource (technology, capital, and labor). Therefore, the focus is on how the firm is able to increase and develop the competency of its members (McLagan, 1997 cited in Ozcelik & Ferman, 2006). The underlying reason is because technology and capital are easy to possessed by anyone and anywhere, they cannot guarantee the performance achievement nor become the source of firm competitiveness any longer (Ozcelik & Ferman, 2006).

As cited in Ozcelik and Ferman (2006), researches on competency in field of HRM have been conducted since the early of 1970s; firstly initiated by McClelland in 1973. McClelland said that behavioral traits and individual characteristics are more effective than intelligence test in order to explain which of the individuals gain success in their jobs. Boyazits, in 1982, then followed his steps by more concentrating on the importance of manager's competency. Boyazits also identified the characteristics of employees with superior performance pushed by the need of making the firm to be more effective through appropriate selection and development process and compensation. After that, research on competency and HRM keep developing up to now.

Based on the results of several researches as mentioned before, many scholars try to define the concept of competency. Spencer and Spencer (1993) cited in Ozcelik and Ferman (2006) defined competency as the combination of employee characteristics, skill, knowledge, attitude, personality, and motivation that will result in an effective and superior performance in the workplace. Meanwhile, Lucia and Lepsinger cited in Ozcelik & Ferman (2006) that competency is

*"A cluster of related knowledge, skill and attitude that affect a major part of one's job (a role responsibility), that correlated with performance on the job, that can be measured against well-accepted standards, and can be improved via training and development"*.

From those two definitions, we can conclude that competency is a characteristic of employee that determines his/her performance in the workplace and can be improved via continual training and development.

Considering the importance of employee competency for a firm, it is suggested that firm view the employee competency not only as his/her ability in conducting his/ her task and responsibility but also as a unique resource that is needed to win the competition. Therefore, firm has such a concern to construct the competency in an effective and efficient way. All this time, most of the firms tend to consider competency more as backward looking than forward looking in terms of firm strategy and changes. Thus, as the environment and challenges are changing from time to time, it is important to put the forward-looking approach forward (Vakola *et al.*, 2007)

In terms of business strategy changes as the result of environmental changes, competency is not only measured from the level of employee skill and knowledge but also from his/her ability to adapt with changes and to learn fast, and from his/her commitment to improve his/her professionalism and self development. Forward-looking and proactive approach eases the firm to adjust its process, structure, and performance with its need in response to changes. Thus, competency approach will be an effective communication media in the implementation of changing process in a firm (Vakola *et al.*, 2007). Besides that, forward looking and proactive approach are also expected to create an integrated system which is able to direct the behavior and attitude of the employees to empower their environment and their personalities for a sustainable innovation and creativity that will lead to the achievement of expected performance and sustainable competitive advantage.

The role of strategic HRM becomes crucial since the long-term implementation of competency is hard to be success unless the competency is adjusted with the long-term purposes of the firm. HRM is demanded to be able to provide an effective system that is able to support and direct the level of competency, creativity and innovativeness of its members, and to tell them how to behave, and develop the competency of its members in order to make it align with the selected strategy.

### **Outside-In and Outside-Out Approaches, Organizational Competence, and Innovation Capabilities**

Inside-out approach with support of Resource Based View that focuses more on status quo than HRM functions, that is building HRM strategy based on internal capabilities and core competency, will not completely displace the Outside-in approach that focuses more on the analysis of external environment and business issues such as industry structure, competition, consumers, and other people issues, as the starting points in arranging strategic HRM. This happens because each of the approaches has its own advantages and disadvantages. That is why we need another approach to bridge the differences between the two approaches and create a synergy between them in order to improve the betterment of HRM role and functions in achieving good performance.

The biggest problem in formulating strategy is not about choosing between outside-in or inside-out; instead, it is about creating synergy between those two approaches and firm's flexibility in analyzing the situation of competition environment to gain a comprehensive guidance for the benefit of firm strategy formulation. Another critical issue is how to make strategic HRM role and functions able to directly solve any challenge and create real solutions and add real value into the creation (value creation) that will support the firm to win the competition.

Therefore, the role and functions of strategic HRM must be aimed for creating and managing organizational competencies to stimulate the emergence of sustainable creativity and innovation that enables the firm to adapt, integrate, manage, and adjust its resource and capabilities with the changing environment. HRM practitioners can make it happen by improving the skills and capabilities of their employees, strengthening the positive attitude, motivating employees, and delegating some responsibilities to the employees in order to sharpen the employee skills and ability to make sure the sustainable innovation and improvement does exist. This is the essence of dynamic capabilities concept.

The dynamic capability concept that emphasizes sustainable improvement and innovation is a complement for RBV. RBV has enabled firm to have alternatives for strategy formulation approaches with the basis of resources and capabilities that will lead to the sustained competitive advantage and core competency. RBV also enables firm to have its own uniqueness which consists of being valuable, inimitable, and rare by creating system ambiguity and social resource complexity and capabilities. Therefore, the role of strategic HRM should be taken into account in order to generate a unique mechanism and system in adopting concepts of RBV theory which is aligned with social-cultural and institutional contexts of each firm (*best fit*).

Based on the explanation above, it is concluded that strategic HRM plays a strategic role in building the relationship between outside-in and inside-out approach via a cluster of processes especially in constructing sustainable dynamic capabilities, core competencies, and innovation capabilities in order to keep it aligned with the rapidly changing environment, which will result in a sustainable competitive advantage of a firm.

### **Integrating Dynamic Capabilities and Innovation Capabilities Concepts Into Strategic Human Resources Management**

Previous parts of this paper have obviously shown the position of resources and competencies as the main factors that determine the sustainable innovation process besides being the main source in creating the competitive advantages of a firm. In order to gain it, both role and functions of strategic HRM must be aimed to create and manage the organizational competencies so that firm is able to adjust its resources with the environmental changes as necessary.

Above all, the way a firm defines and integrates the dynamic competency into the strategy and practices of HRM, especially in recruitment and selection process, training and development, performance management, and compensation system that aligns the attitude and competency of the employees with the purpose of firm, is the most important thing.

#### **Recruitment and Selection:**

Recruitment and selection process based on particular competencies is commonly used by firms in making staffing decision. The aim of this process is to employ individual with appropriate level of competencies and behavior (Rowe, 1995 cited in Ozcelik & Ferman, 2006).

Dealing with rapidly changing and dynamic environment, and in order to defend its superior performance and competitive advantage, firm is always forced to face the demand of employee flexibility both internally and externally (Michie & Sheehan, 2005). This situation has a direct effect on the decision of recruiting employees and defending them in a long-term contract, or instead, in a shorter-term. Beugelsdijk (2008) argued that even though the relationship between employee flexibility and performance can be contingency according to the duties and tasks and even in short-time is profitable by reducing cost of wages and increasing the efficiency, in a longer-term this will likely affect the firm negatively, and the capability of firm to innovate continuously will be harmed in particular. Why? Because in short-term, employee doesn't get a continuous training related to his/her work; thus, dynamic competency improvement doesn't occur. Besides, short-term contract affects the emotional relationship between employee and firm where a short-term contracted employee has a low loyalty towards the firm he/she works for (Davis-Blake *et al.*, 2003 cited in Beugelsdijk, 2008). Therefore, if firm wants to focus on building sustainable innovation, it has to provide its employee with a long-term contract. (Beugelsdijk, 2008).

#### **Training and Development:**

Hatch and Dyer (2004) cited in Beugelsdijk (2008) claimed that "superior learning performance is obtained from the best HR practice and from the best practice to develop specific human capital owned by firm and a sustainable learning activity". Besides that, firm with an excellent training facility will motivate positive attitudes of employee and increase his/her organizational commitment (Benson *et al.*, 2004 in Beugelsdijk, 2008). Based on the two arguments above, it is concluded that higher innovative performance will be reached when firm provides sustainable training and development facilities aimed to improve employee capabilities so that he/she is able to perform his/her duty properly.

#### **Performance management and compensation system:**

An employee performance is not solely viewed as result of what one has done; the competency that he/she has used in order to perform the duty or solve the problem also matters (Ozcelik & Ferman, 2006). Performance management or performance assessment is one of strategic issues in the practices of HRM since it is a means for management to keep the alignment between employee activities and output and the purpose of the organization. Feedback obtained from this performance assessment will be such reference for the management in making decisions related to compensation, succession planning, career development, individual development planning, training, etc. that finally will be related to employee satisfaction fulfillment program, organizational development, and achievement of organizational competitive advantage.

Moreover, compensation strategy and policy is one of strategic functions and issues in HRM practices because compensation is a management tool to increase the motivation, commitment, and work satisfaction of employee as well as retaining the employee and reducing level of employment turnover. Compensation strategy is also related to the organizational capability in controlling employee attitude and behavior to keep working for the firm in a proper period of time. Therefore, organizational capability in designing and implementing a correct and fair compensation strategy is a must. This is to guarantee the existential of employee job satisfaction and commitment which play significant roles in improving employee performance inside the firm.

Related to innovation capability, Lau and Ngo (2004) cited in Beugelsdijk (2008) that individual performance based on compensation will increase his/her creativity. However, in creating an innovation, individuals are sometimes forced to deal with a complicated problem so that the problem needs to be solved collectively via team-based approaches. Thus, compensation system which is based on team is required (Beugelsdijk, 2008). Finally, compensation system is expected to motivate employee to do the best for the firm; this will force employee to keep learning and developing his/her capabilities and competencies as well as forcing the firm to be more innovative and creative.

## Closing

Researches on strategic human resource management have given major attention to the issues related to HR management (managing people) on corporate level as a whole and integrated, than solely focuses on individual practice of HRM which is independent from other strategies of firm. This is because in order to achieve sustainable superior performance and competitive advantage, integration and conformance between selected strategy and human resource policy are required to execute the strategy itself.

Inside-out approach supported by Resource Based View theory is not completely able to displace the outside-in approach in the process of HRM strategy formulation and implementation. This is caused by the fact that each of the approaches has its own advantages and disadvantages over others. The problem is how to make the role and function of strategic HRM able to directly answer all of challenges and create real solutions and add real value on the creation (value creation) so that firm wins the competition. Therefore, the role and functions of HRM must be aimed onto how to create and manage the core competencies to keep it dynamic and flexible (dynamic capabilities) to motivate the emergence of sustainable creativity and innovation which are integrated into every activity, practice, and strategy of HRM (HR Strategy) so that firm is able to adapt, integrate, arrange, and readjust its resources with the environmental changes as necessary.

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