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# Strategic human capital and the performance of public sector organizations

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## Abstract

Organization scientists have long considered human capital as a strategic asset that contributes to organizational effectiveness. Whereas the strategic importance of human capital has been widely studied in the case of for-profit organizations, measurement difficulties and the role of human capital in the public sector have received little attention. The present study attempts to bridge this gap by suggesting a behavioral approach to measuring organization-specific human capital and examining its impact on the financial performance of local government authorities in Israel. The results confirm the strategic importance of human capital. Local government authorities that possess strategic human capital—namely, a workforce that is highly educated, that exhibits organization-specific competencies and experience, and that is valuable, unique, and imperfectly imitable—exhibited a better financial performance, as measured by a three-financial ratio scale over 2 fiscal years.

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## 1. Introduction

Research has paid a considerable amount of attention to the strategic importance of human capital in creating competitive advantage and superior performance. The literature of two complementary theories—a resource-based view of the firm (Barney, 1991; Peteraf, 1993; Wernerfelt, 1984), and strategic human resource management (SHRM) (Becker & Gerhart, 1996; Becker, Huselid, Pickus, & Spratt, 1997; Delaney & Huselid, 1996; Huselid, 1995; Pfeffer, 1994)—suggests that organization-specific human capital is of strategic importance in that it has a positive effect on the performance of the organization concerned.

Although organization scientists have widely recognized the critical role of human capital in creating value, studies have thus far paid too little attention to (1) the measurement of organization-specific human capital, and (2) the applicability of core arguments of both theories to organizations outside the profit-making sector.

The present study represents a first effort to bridge these gaps by providing a more accurate measure of organization-specific human capital, and discussing the impact of such capital on the performance of public sector organizations (local government authorities) in Israel. Specifically, the study uses a relatively large sample to examine the impact of organization-specific human capital on the financial performance of local government authorities. With this study I hope to extend existing research on human capital and to suggest new angles for a more systematic examination of some of the core concepts of the resource-based view. In addition, the study offers a route towards overcoming a key difficulty—one of the many other shortcomings that appear to be in the resource-based view (for a review, see Foss, 1997; Priem & Butler, 2001).

## 2. Theoretical background and hypotheses

Human capital has been a central concept in a variety of theories. Notions regarding the role and importance of human capital in organizational efficiency and effectiveness can be found in (1) *human relations theory*, also known as ‘the behavioral school’, which, following Hawthorne’s research, emphasizes the human factor in organizational failure and success (Likert, 1967; Mayo, 1946; McGregor, 1960; Roethlisberger & Dickenson, 1939), (2) *transaction cost economics*, according to which organizations seek the optimal way of managing the human resource system, which depends on the relation between transaction cost and the market-organization relation, as well as on the organization’s internal operations (Klein, Crawford, & Alchran, 1978; Williamson, 1975), and (3) *human capital theory*, which focuses on the educational level of the employees as a source of labor productivity and economic growth (Asefa & Huang, 1994; Becker, 1993; Mincer, 1974; Schultz, 1961; Wykstra, 1971). Despite the important contributions of these theories to the evolution of the concept of human capital, it seems that the resource-based view and strategic human resources management (see below) have made the most powerful impact on its dominant position in organization science.

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