Making or Buying Employees: The Relationship Between Human Resources Policy, Business Strategy and Corporate Restructuring

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Abstract

This study used cross level data from two different levels of management to examine the relationship between human resources policy, business strategy and corporate restructuring activities. The results suggested that corporate restructuring activities, not business strategy, accounted for a significant proportion of variance in the career patterns of managers. Organizations that had experienced more restructuring in the form of cutbacks in operations, reductions in force, voluntary terminations, and reorganizations had a remaining work force that had an external labor market orientation. These results challenge the theory of Miles & Snow (1984) and Sonnenfeld and Peiperl (1988) that suggests an organization's business strategy should be reflected in human resource policy.

Introduction

The link between an organization's human resources policy and business strategy has been a central focus of both the human resource and strategy literatures (Schuler & Jackson, 1987; Miles & Snow, 1984; Sonnenfeld & Peiperl, 1988). The underlying argument is that effective organizations have human resource policies that are aligned with the corporation's business strategy. Intuitively, if the implementation of different business strategies requires different employee behaviors, then human resource policies *should* vary systematically with strategy (Sonnenfeld & Peiperl, 1988). Despite theory which argues that human resource career systems should be internally consistent (Gerhart & Milkovich, 1990) and consistent with strategy (Miles and Snow, 1984), we have little empirical evidence documenting this relationship.

In this study, we focus on one element of human resources policy: the "make or buy" decision with respect to employees. We investigate organizational differences in reliance on internal versus external labor markets to supply an organization's human resources. Internal labor markets (ILMs) in their purest form are characterized by lifetime employment structures in which employees enter an organization at the onset of their career and are trained, developed and moved along a career system by the organization. In theory, ILMs provide important advantages to the firm. Organizations

benefit from reduced transaction costs of hiring due to lower turnover (Pfeffer & Baron, 1988), productivity due to firm specific knowledge (Pfeffer & Baron, 1988), and motivation because future remuneration is dependent on present performance. In addition, ILMs provide better information on a job change candidate (from performance appraisal, etc.) which should allow a better match between the individual and the job.

When firms rely on an external labor market (ELM) human resources policy, they hire outside of the company for new positions, minimally train their employees, and offer few benefits that might serve to attach employees to the organization (Sonnenfeld, Peiperl, and Kotter, 1988). The advantages of an ELM strategy include an increase in organization's flexibility in hiring needed talent. In addition, outside hires can act as "change agents" through the transfer of technology as well as through challenging stagnant beliefs and procedures in an organization (Kanter, 1983). Reliance on external labor markets also reduces some human resources costs, particularly in the areas of benefits and training. However, buying from the external market may generate substantial recruiting costs, unless an inexpensive source of quality labor can be relied upon.

The purpose of this study is to determine whether an organization's reliance on internal versus external labor

markets is aligned with two elements of organizational behavior: business strategy and corporate restructuring activities. Business strategy is defined as a pattern or stream of major and minor decisions affecting an organization's future (Miles & Snow, 1978, p. 7). We define restructuring activities to include the negative incremental changes associated with cutbacks in operations, reductions in force, voluntary terminations, and reorganizations (Reilly, Brett, & Stroh, 1993). We follow Gerhart and Milkovich (1990) in focusing on the actual career experiences of managers to assess an organization's strategic use of the internal or external labor market rather than relying on the perceptions of human resource managers. This method therefore uses career experiences reflecting strategies in action, as opposed to the ideal strategy which a human resource manager would like to see implemented.

Determinants of Human Resources Policy

Standard economic theory, including human capital theory (Becker, 1975), would argue that competitive forces dictate that competing organizations should have similar human resource policies. However, Gerhart and Milkovich (1990) concluded that market forces do not completely eliminate organizational differences in setting pay policy and suggest that organizational strategy, culture, financial performance, and historical accident may contribute, not just to pay policy, but also to differences in other aspects of human resource policy. Other factors, such as organizational restructuring, may also impact a firm's human resources strategy decisions (Hirsch, 1992).

Business strategy is the most widely discussed organizational characteristic that is expected to impact human resource policy (Miles & Snow, 1978, 1984; Purcell, 1989; Schuler & Jackson, 1987). Miles and Snow (1984) note that three of their dimensions have parallels in the human resource function. Sonnenfeld and Peiperl (1988) agree there is a "strategic parallel" between Miles and Snow's dimensions and the human resource policies and practices that affect the focus on internal versus external labor markets. Defender organizations have narrow, stable product markets, and their human resource career systems are primarily concerned with building and developing their internal labor market. Prospector organizations are constantly searching for new products and opportunities, frequently changing products and services; their career system focus is on acquiring or "buying" human resources. Analyzer organizations compete in two market domains, one stable and unchanging and the other a changing market environment. The result is a human resource strategy that uses both the internal and external labor market. As reactors have no consistent strategy, human resource policy is not expected to be consistent across such organizations (Shortell & Zajac, 1990). Based on the

work of Sonnenfeld et al. (1988) we offer the following hypotheses.

Hypothesis 1: Reliance on an internal versus an external labor market should be related to business strategy in the following manner: (a.) Those organizations using a defender business strategy are most likely to use an ILM to supply their human resources, (b.) Those organizations using an analyzer business strategy are likely to use both an ILM and an ELM to supply their human resources, and (c.) Those organizations using a prospector business strategy are most likely to use an ELM to supply their human resources.

As Gerhart and Milkovich (1990) suggest, there may be other organizational differences besides business strategy which contribute to differences in human resources policy, such as a reliance on ILMs or ELMs. We propose that differences in the level of organizational restructuring activities is one such factor. The 1980s was a decade of organizational restructuring. Hirsch (1992) points out that the internal labor market as an "idealized recipe for success" came under attack during this period. Many corporations engaged in significant downsizing, and turned to the external or "spot" labor market to purchase services of managers on an as-needed basis.

The result of corporate restructuring should be an increased dependence on the external labor market among those organizations that engage in restructuring activities. Presumably, these factors also make the link between an organization's business strategy and their human resource practices more fragile. For example, a defender organization having gone through reductions in force due to market and economic conditions may be compelled to alter its "make" (vs. buy) human resources strategy and hire from the external labor market. This might occur as organizations discover (after reductions in force) that they need employees for promotion or growth, and are forced to go to the external labor market to find the talent they need. Consequently, the corporate restructuring may be a better predictor of HR staffing policy than the overall strategy of the business unit. Furthermore, Sonnenfeld et al. (1988) maintain that "fortress" companies (which are analogous to reactors) do not develop their employees, and hence rely on the ELM. Since fortress companies are also more likely to be in financial difficulty, they are also more likely to be candidates for restructuring.

Hypothesis 2: Those organizations engaged in restructuring activities will rely more heavily on an ELM than an ILM to supply their human resources.

We also expect the size variable to impact an organization's choice of ILM versus ELM. Prior research has shown that large firms tend to adopt internal labor

markets to control labor demand (Blau, 1974; Katz & Kahn, 1966; Williamson, 1976). Compared to smaller companies, larger firms have the resources necessary to develop employee training and development systems.

Hypothesis 3: Those organizations with more employees will rely more heavily on internal than external labor markets to supply their human resources.

Methods

This study uses cross level data to investigate the relationship between an organization's use of the internal or external labor market, business strategy, and level of restructuring. The impact of organizational size is also examined. Company is used as a control variable for the data.

Sample

The companies participating in this study were selected from a total population of companies belonging to the Employee Relocation Council, a not-for-profit association serving corporations who relocate large numbers of employees annually. The opportunity for this study came from a larger research project studying mobile managers in *Fortune* 500 corporations. Twenty companies were selected to represent eight industries which represented different business strategies, and had experienced varying levels of restructuring during the 1980s: pharmaceutical and hospital supplies, communications, consumer products, professional and financial services, retailing, hotels, chemicals, and manufacturing.

The sample for this study was drawn from two different levels of management. Strategic business unit (SBU) managers provided the independent variable data about the organizations' business strategies, as measured by the Miles and Snow typology (1978) and a restructuring measure developed for this study. A random sample of middle level managers in these organizations provided the dependent variable data about their career experiences that were used to create a measure of an organization's use of the internal or external labor market (Sonnenfeld & Peiperl, 1988).

Surveys were sent to 102 managers in charge of a strategic business unit to determine changes experienced by their parent companies over the previous five years. Forty-nine SBU managers from 17 organizations returned surveys. The response rate was approximately 48%.

These top level executives had been with their parent company an average of 19 years and had worked in their current strategic business unit an average of 11 years. They had been in their current positions an average of 4 years and had worked, on average, for four other units

in their organizations. All of these top level executives were male.

Surveys were also sent to a random sample of middle level managers in these organizations. The response rate for this survey was 67%. The career experiences and perceptions of these managers ($n=231$) provided the data for the dependent variable. These managers were an average of 37 years old. Most of the men were married (87%), and most had children between the ages of 0-18 living at home (62%). Forty-five percent of the females were married and 20% had children living at home. The average level of education was a bachelor's degree. Ninety-six percent of the managers were White, and they had averaged 15 years in the work force, 10 years with their current company and had worked, on average, for 2.5 companies.

Dependent Variable

Labor market orientation. The degree to which managers' career patterns reflected an internal versus an external labor market orientation was operationalized by Sonnenfeld and Peiperl's (1988) concept of "supply flow." Supply flow involves the entry and exit of employees. In terms of labor market orientation, supply flow may be primarily internal, in which jobs are filled from the internal labor market, or it may be external, in which case the firm is likely to hire talent from the outside. Sonnenfeld and Peiperl (1988) also defined a second dimension of an organization's career system which they labeled "assignment flow." Assignment flow distinguished between career patterns reflecting specialist and generalist approaches to human resources. Assignment flow is not the focus of the current study, but in order to demonstrate the discriminant validity of the supply flow variables, both supply and assignment flow constructs were operationalized.

Table 1 presents the factor analysis of the items suggested by Sonnenfeld and Peiperl (1988) to measure supply and assignment flow. Supply and Assignment flow indices were formed by reverse scoring negative items and then summing the items that loaded .30 or higher on a dimension. No item loaded higher than .30 on both dimensions. This factor loading procedure is consistent with the recommendations of most statisticians (Gorsuch, 1983). These items included questions related to organization loyalty, career loyalty, job security and other variables that Sonnenfeld and Peiperl claim to be predictors of a supply flow construct. We factor analyzed these variables and then sent them to Sonnenfeld for further validation of the constructs (personal communication, February 15, 1992). We then labeled Factor 1, "Supply Flow" and Factor 2, "Assignment Flow" (see Table 1). The correlation between the two dimensions was .03, indicating that the two dimensions were unrelated. Coefficient alpha for the supply

Table 1
Factor Analysis for Supply and Assignment
Rotated Factor Matrix

Variable	(Supply) Factor 1	(Assign) Factor 2
People More Important Than Things	.73	-.01
Company Loyalty	.72	-.11
People Are Important	.70	.01
Training & Development	.70	-.01
Self Loyalty	-.63	.31
Training	.57	-.13
Years Expect To Stay With Co.	-.52	.22
Division Growing (market shares)	.47	-.10
Economic Status of Company	-.46	-.10
Job Security	.45	.12
Individual Performance	.42	.10
Rather Tell What I Do	-.36	.06
Division Growing (profits)	.36	-.14
Intrinsic Motivation	.32	.04
No. of Jobs Current Company	.05	.83
No. of Divisions Worked in Company	.03	.73
No. of Functional Areas Worked in Company	-.01	.71
No. of Promotions	.08	.56
Age	-.08	-.54
Years in This Division	.06	.47
No. of Jobs at Headquarters	-.13	.41
No. of Lateral Moves	-.06	.39
Age Impacts Career	-.27	-.34
Education Impacts Career	-.09	-.30

flow dependent variable was .74.

Independent variables

Business strategy. The business strategy measure was a measure adapted from Shortell and Zajac (1990) to measure Miles and Snow's four business strategy categories. Following Shortell and Zajac's (1990) approach, those SBUs classified as reactors were excluded from this analysis. Unlike Shortell and Zajac, however, we did not trichotomize the seven point scale, but left the scale in a continuous variable form (similar to Peck, in press). In order to determine whether our results could be accounted for by this decision, we also analyzed the data using Shortell's and Zajac's cutoffs. The results were the same.

Four vignettes describe four hypothetical strategic orientations. Strategic Business Unit (SBU) managers were asked to rate their unit on a scale from 1 representing the typical defender strategy to 7 representing the typical prospector strategy. The focus of this rating was the SBU as opposed to the organization as a whole. Because of the size and diversity of the organizations in the sample, we expected that within an organization, different SBUs could be following different business strategies. This expectation was confirmed by the data. However, within organizational variance in business strategy was not significantly less than between organizational variance.

Restructuring Activities. Each of the SBU managers were asked to rate the degree of change experienced in their parent companies during the prior five years for four types of restructuring activities by using a four point Likert scale using the anchors of "a lot", "some", "a little", and "not much at all". This scale includes the following variables: cutbacks in operations, reductions in force, voluntary terminations, and reorganizations. The alpha reliability for this measure was .74. Because many of the companies in the sample had multiple SBUs, and thus, multiple respondents,

we averaged their responses as the company index. Before doing so, we tested for convergence among the

reporting SBU managers using analysis of variance. For all four restructuring variables, the between-group organizational differences significantly exceeded the within-group organizational differences ($p \leq .05$).

Company. In order to test whether company differences not associated with business strategy, restructuring, or size were related to labor market utilization, and in order to simplify the interpretation of results, the company supply flow variable was transformed into a linear variable using the Gocka (1973) technique. According to the Gocka (1973) method, subjects were assigned the supply flow mean of their company. This created a company supply flow variable by assigning all managers from one company that company's mean on the supply flow dependent variable. In using the Gocka technique, the number of companies must be subtracted from the degrees of freedom residual and added to the degrees of freedom regression and the F must be re-evaluated. The reason for using the technique is that it is a more parsimonious way to demonstrate variance associated with company differences (Gocka, 1973). Using this method, one beta coefficient can represent the variance associated with company differences, rather than being forced to use a dummy variable for each company, thereby adding many more variables to the equation than is needed.

Size. Organizational size was measured by number of employees. Companies in the sample ranged in size from 4,000 to 275,000 employees.

Analysis

Factor analysis was used to construct the supply flow dependent variable (see Table 1). This form of analysis was used to be certain that the items comprising the supply flow construct identified related groups of variables. Factor analysis was appropriate to use because it allowed us to identify a number of variables that represent the more complex underlying phenomenon of the supply flow construct.

Table 2 denotes the means, standard deviations, and correlations of all variables used in this study. Regression analysis was used to analyze the relationship between use of the internal/external labor market and business strategy and restructuring.

Results

The results in Table 3 show that corporate restructuring activities account for a significant proportion of variance in the career patterns of managers in these 17 *Fortune* 500 corporations. Organizations that had experienced more restructuring in the form of cutbacks in operations, reductions in force, voluntary terminations, and reorganizations had a remaining work force that had an external labor market orientation.

Unlike the theoretical predictions relating business strategy to human resource policy, the business strategy of the unit in which the managers were employed did

Table 2
Means, Standard Deviations, and Correlations

Variable	M	SD	1	2	3	4	5
1. Supply Flow	-.26	7.53					
2. Business Strategy	2.67	.74	-.08				
3. Company ^a Supply	-.24	1.87	.26*	-.24*			
4. Company ^b Size	65	68	.01	-.31*	.10		
5. Restructuring Strategy	10	2.88	-.17*	.19*	-.40*	.01	

* $P \leq .01$

^a as noted in the method section the Gocka method was used to create this variable

^b in thousands

not account for a significant proportion of the variance in internal versus external labor market career patterns. Organizational size also did not account for internal versus external labor market career patterns of managers in these organizations.

When the Gocka variable for company was added to the regression equation, Table 3 shows that corporate restructuring remained significant, but that 2% additional variance could be explained by previously unaccounted for company differences.

Table 3
Predicting Use of the Internal/External Labor Market

Independent Variables	Supply Flow Beta
Step One	
Business strategy	-.05
Restructuring strategy	-.22**
Adjusted R ²	.05
F	7.44**
Step Two	
Business strategy	.03
Restructuring strategy	-.14**
Company	.18**
Company size	.03
Adjusted R ²	.07
F	5.59**

** $p \leq .01$

Discussion

These results challenge the emphasis in prior research (e.g., Miles & Snow, 1984; Schuler & Jackson, 1987) on the importance of intraorganizational consistency between corporate business strategy and human resource strategy. The organizations in this study were not basing human resources staffing policies on business strategy. There are a number of reasons which may explain this finding.

First, this study focused on a single dimension of human resources policy: labor market orientation. There are other elements of human resources policy, such as compensation (Gerhart & Milkovich, 1990), which may be more closely linked to competitive business strategy decisions.

Second, while labor market orientation tends to be an organization-wide policy, business strategy may be product or product line based. Different SBUs within a single organization may have different business strategies, as was true of the organizations in this study. This phenomenon weakens the relationship between business strategy and labor market orientation.

Third, human resources selection and training policies may be much slower to change than business strategies. A shift from an internal to an external labor market focus requires not just implementing a selection policy change, but also involves a change in the psychological contract with those who were hired under an internal labor market focus, and are expecting to be retained (Hirsch, 1992).

Our results also suggest that dependence on an internal versus an external labor market is associated with the restructuring activities engaged in during the 1980s. It is, of course, impossible to determine from a regression equation the direction of the relationship. Does an ELM focus result from organizations choosing to restructure? Or, are the organizations that did the most restructuring ones that already relied heavily on the external labor market? Further research using longitudinal data is required to sort out this connection.

Among this sample of large organizations (mean size was 65,000 employees), larger organizations were not more oriented towards an internal labor market than smaller firms. A limitation of this study, however, is that the sample was restricted to large corporations; thus, the results may not be generalizable to small firms. For example, a small business might rely on an external labor market hiring policy because it cannot afford an extensive internal training program. Consequently, future studies should not eliminate size as a potential predictor.

Despite the above noted weakness of this study, this empirical study had some important strengths. The sample size was good, the measures were standard and demonstrated discriminant validity, and the cross-level design was a research design strength, in that two different groups were used to measure the independent and the dependent variables. However, as in most cross-level studies, the variance accounted for was not large. Other factors clearly were influencing the ILM versus ELM orientation of the firms in this study.

One potential explanatory variable which may account for these effects involves managers' individual differences. Pfeffer and Baron (1988) suggest that demographic and personal value differences may account for some of the movement towards externalization of the labor market. The variables in the labor market orientation

index in this study may reflect those demographic and value differences. If organizations either select managers with similar values, or socialize managers to a common set of values, the significant relationship between organization and labor market orientation may reflect these value similarities.

Suggestions For Future Research

This study suggests some intriguing questions for future research and theory development. For example, are other aspects of human resources policy likely to be more closely related to business strategy than internal versus external labor market orientations? Is an organization's labor market orientation a cause or an effect of the type of employees it hires? The potential link between human resources policy and organization strategy is an important one which merits continued exploration.

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