

The Newsweek logo is displayed in white, bold, sans-serif font against a solid red rectangular background.

# Lay Off the Layoffs

*Our overreliance on downsizing is killing workers, the economy—and even the bottom line.*

February 05, 2010

On Sept. 12, 2001, there were no commercial flights in the United States. It was uncertain when airlines would be permitted to start flying again—or how many customers would be on them. Airlines faced not only the tragedy of 9/11 but the fact that economy was entering a recession. So almost immediately, all the U.S. airlines, save one, did what so many U.S. corporations are particularly skilled at doing: they began announcing tens of thousands of layoffs. Today the one airline that didn't cut staff, Southwest, still has never had an involuntary layoff in its almost 40-year history. It's now the largest domestic U.S. airline and has a market capitalization bigger than all its domestic competitors combined. As its former head of human resources once told me: "If people are your most important assets, why would you get rid of them?"

It's an attitude that's all too rare in executive suites these days. As the U.S. economy emerges from recession, Americans continue to suffer through the worst labor market in a generation. The unemployment rate dipped in January, from 10 percent to 9.7 percent, but the economy continued to lose jobs. There are currently 14.8 million unemployed, and when you count "discouraged workers" (who've given up on job seeking) and part-time workers who'd prefer a full-time gig, that's another 9.4 million Americans who are "underemployed." While the pink slips are slowing as the economy rebounds, the lack of jobs remains the most visible—and politically troublesome—reminder that despite what the economic indicators may tell us, for much of the population, the Great Recession hasn't really gone away.

Companies have always cut back on workers during economic downturns, but over the last two decades layoffs have become an increasingly common part of corporate life—in good times as well as bad. Companies now routinely cut workers even when profits are rising. Some troubled industries seem to be in perpetual downsizing mode; the U.S. auto industry, to take just one example, has been shedding employees consistently for decades. (NEWSWEEK is familiar with these pressures: its head count is down significantly in recent years.)

There are circumstances in which layoffs are necessary for a firm to survive. If your industry is disappearing or permanently shrinking, layoffs may be necessary to adjust to the new market size, something occurring right now in newspapers. Sometimes changes in technology or competitors' embrace of cheaper overseas labor makes downsizing feel like the only alternative. But the majority of the layoffs that have taken place during this recession—at financial-services firms, retailers, technology companies, and many others—aren't the result of a broken business model. Like the airlines' response to 9/11, these staff reductions were a response to a temporary drop in demand; many of these firms expect to start growing (and hiring) again when the recession ends. They're cutting jobs to minimize hits to profits, not to ensure their survival. As for firms that have no choice but to cut jobs, if your company is the 21st-century equivalent of the proverbial buggy-whip industry, don't fool yourself—downsizing will only postpone, not prevent, your eventual demise.

For many managers, these actions feel unavoidable. But even if downsizing, right-sizing, or restructuring (choose your euphemism) is an accepted weapon in the modern management arsenal, it's often a big

mistake. In fact, there is a growing body of academic research suggesting that firms incur big costs when they cut workers. Some of these costs are obvious, such as the direct costs of severance and outplacement, and some are intuitive, such as the toll on morale and productivity as anxiety ("Will I be next?") infects remaining workers.

But some of the drawbacks are surprising. Much of the conventional wisdom about downsizing—like the fact that it automatically drives a company's stock price higher, or increases profitability—turns out to be wrong. There's substantial research into the physical and health effects of downsizing on employees—research that reinforces the seemingly hyperbolic notion that layoffs are literally killing people. There is also empirical evidence showing that labor-market flexibility isn't necessarily so good for countries, either. A recent study of 20 Organization for Economic Cooperation and Development economies over a 20-year period by two Dutch economists found that labor-productivity growth was higher in economies having more highly regulated industrial-relations systems—meaning they had more formal prohibitions against the letting go of workers.

In the last decade layoffs have become America's export to the world. At a conference in Stockholm a few years ago, business executives told me that to become as competitive as America, Sweden needed to make it easier to lay people off. In Japan, lifetime employment, which never applied to most of the labor market, is under attack. There are daily calls for European countries to follow the U.S. and make labor markets more "flexible." But the more you examine this universally accepted tactic of modern management, the more wrongheaded it seems to be.

It's difficult to study the causal effect of layoffs—you can't do double-blind, placebo-controlled studies as you can for drugs by randomly assigning some companies to shed workers and others not, with people unaware of what "treatment" they are receiving. Companies that downsize are undoubtedly different in many ways (the quality of their management, for one) from those that don't. But you can attempt to control for differences in industry, size, financial condition, and past performance, and then look at a large number of studies to see if they reach the same conclusion.

That research paints a fairly consistent picture: layoffs don't work. And for good reason. In [Responsible Restructuring](http://www.amazon.com/exec/obidos/ASIN/B001NGNQDI/?tag=nwswk-20) (<http://www.amazon.com/exec/obidos/ASIN/B001NGNQDI/?tag=nwswk-20>), University of Colorado professor Wayne Cascio lists the direct and indirect costs of layoffs: severance pay; paying out accrued vacation and sick pay; outplacement costs; higher unemployment-insurance taxes; the cost of rehiring employees when business improves; low morale and risk-averse survivors; potential lawsuits, sabotage, or even workplace violence from aggrieved employees or former employees; loss of institutional memory and knowledge; diminished trust in management; and reduced productivity.

There are a number of myths that have taken hold to justify managers' urge to downsize. Many of them aren't true. For instance, contrary to popular belief, companies that announce layoffs do not enjoy higher stock prices than peers—either immediately or over time. A study of 141 layoff announcements between 1979 and 1997 found negative stock returns to companies announcing layoffs, with larger and permanent layoffs leading to greater negative effects. An examination of 1,445 downsizing announcements between 1990 and 1998 also reported that downsizing had a negative effect on stock-market returns, and the negative effects were larger the greater the extent of the downsizing. Yet another study comparing 300 layoff announcements in the United States and 73 in Japan found that in both countries, there were negative abnormal shareholder returns following the announcement.

Layoffs don't increase individual company productivity, either. A study of productivity changes between 1977 and 1987 in more than 140,000 U.S. companies using Census of Manufacturers data found that companies that enjoyed the greatest increases in productivity were just as likely to have added workers as they were to have downsized. The study concluded that the growth in productivity during the 1980s could not be attributed to firms becoming "lean and mean." Wharton professor Peter Cappelli found that labor costs per employee decreased under downsizing, but sales per employee fell, too.

Another myth: layoffs increase profits. Even after statistically controlling for prior profitability, a study of 122 companies found that downsizing reduced subsequent profitability and that the negative consequences of downsizing were particularly evident in R&D-intensive industries and in companies that experienced growth in sales. Cascio's study of firms in the S&P 500 found that companies that downsized remained less profitable than those that did not. An American Management Association survey that assessed companies' own perceptions of layoff effects found that only about half reported that downsizing increased operating profits, while just a third reported a positive effect on worker productivity.

Layoffs don't even reliably cut costs. That's because when a layoff is announced, several things happen. First, people head for the door—and it is often the best people (who haven't been laid off) who are the most capable of finding alternative work. Second, companies often lose people they didn't want to lose. I had a friend who worked in senior management for a large insurance company. When the company decided to downsize in the face of growing competition in financial services, he took the package—only to be told by the CEO that the company really didn't want to lose him. So, he was "rehired" even as he retained his severance. A few years later, the same thing happened again. One survey by the American Management Association (AMA) revealed that about one third of the companies that had laid people off subsequently rehired some of them as contractors because they still needed their skills.

Managers also underestimate the extent to which layoffs reduce morale and increase fear in the workplace. The AMA survey found that 88 percent of the companies that had downsized said that morale had declined. That carries costs, now and in the future. When the current recession ends, the first thing lots of employees are going to do is to look for another job. In the face of management actions that signal that companies don't value employees, virtually every human-resource consulting firm reports high levels of employee disengagement and distrust of management. The Gallup organization finds that active disengagement—which Gallup defines as working to sabotage the performance of your employer—ranges from 16 percent to 19 percent. Employees who are unhappy and stressed out are more likely to steal from their employers—an especially large problem for retailers, where employee theft typically exceeds shoplifting losses.

Some managers compare layoffs to amputation: that sometimes you have to cut off a body part to save the whole. As metaphors go, this one is particularly misplaced. Layoffs are more like bloodletting, weakening the entire organism. That's because of the vicious cycle that typically unfolds. A company cuts people. Customer service, innovation, and productivity fall in the face of a smaller and demoralized workforce. The company loses more ground, does more layoffs, and the cycle continues. That's part of the story of now-defunct Circuit City, the electronics retailer that decided it needed to get rid of its 3,400 highest-paid (and almost certainly most effective) sales associates to cut its costs. Fewer people with fewer skills in the Circuit City stores permitted competitors such as Best Buy to gain ground, and once the death spiral started, it was hard to stop. Circuit City filed for bankruptcy in 2008 and closed its doors last March.

Beyond the companies where layoffs take place, widespread downsizing can have a big impact on the economy—a phenomenon that John Maynard Keynes taught us about decades ago, but one that's almost certainly going on now. The people who lose jobs also lose incomes, so they spend less. Even workers who don't lose their jobs but are simply fearful of layoffs are likely to cut back on spending too. With less aggregate demand in the economy, sales fall. With smaller sales, companies lay off more people, and the cycle continues. That's why places where it is harder to shed workers—such as (can I dare say it?) France—have held up comparatively better during the global economic meltdown. Workers there are confident that they'll remain employed, so they needn't pull back on spending so dramatically.

The airline industry provides a case study of the downside of retrenchment. After the layoffs following 9/11, airline service deteriorated and flying became a truly unpleasant experience. That carried predictable consequences: the number of "premium" passenger trips, defined as full-fare coach, first-, or business-class fares (where airlines make their biggest margins), declined by 47 percent between 2000 and 2007. According

to an industry survey published in 2008, in the preceding 12 months airlines had lost \$9.6 billion in revenue as people voluntarily flew less because they found the experience so noxious. In a fixed-cost industry like airlines, that was the difference between an industrywide loss and profitability.

There are ways that companies can try to minimize the damage when they eliminate jobs. For instance, don't announce that you're cutting jobs without identifying who'll be affected; that makes every employee (including your best performers) anxious and exacerbates the damage. Companies that behave humanely—by providing generous severance packages and allowing displaced employees to say goodbye to colleagues rather than marching them out the door—are likely to see a smaller hit to morale. Well-run companies also communicate clearly about why they're eliminating jobs, and share the pain by cutting senior executives, not just front-line workers.

Still, there's only so much companies can do to mitigate the long-term effects of downsizing—and businesses that avoid layoffs altogether can experience a virtuous cycle instead of a vicious one. On a flight from Madrid to Barcelona, I asked one of the leaders of executive education at Spanish business school IESE how its programs were doing during the global economic crisis. "Down about 5 percent," he said. When I commented that this was much lower than the decreases at other business schools, he noted that because IESE had not downsized, it had been able to maintain its marketing and the number of its programs. As A. G. Lafley, chairman and former CEO of Procter & Gamble, commented, the best time to gain ground on competitors is when they are retreating.

As bad as the effects of layoffs are on companies and the economy, perhaps the biggest damage is done to the people themselves. Here the consequences are, not surprisingly, devastating. Layoffs literally kill people. In the United States, when you lose your job, you lose your health insurance, unless you can afford to temporarily maintain it under the pricey COBRA provisions. Studies consistently show a connection between not having health insurance and individual mortality rates. Other data demonstrate that even fairly brief interruptions in health-care coverage lead people to skip diagnostic screening tests such as mammograms and colonoscopies.

When people lose their jobs, they get angry and depressed—not a big surprise. Angry and depressed people who believe they have been treated unfairly can lose psychological control and exact vengeance on those they deem responsible. We have all seen too-frequent cable-news coverage of the fired employee who returns to the workplace with a gun and wounds or kills people. It's not just the occasional anecdote. Research shows that people who had no history of violent behavior were six times more likely to exhibit violent behavior after a layoff than similar people who remained employed.

And some research has looked directly at the health consequences of losing one's job or being unemployed on mortality. A study in New Zealand found that for people 25 to 64 years old, being unemployed increased the likelihood of committing suicide by 2.5 times. When two meat-processing plants closed in New Zealand, epidemiologists followed what happened to their employees over an eight-year period. The odds of self-harm and the rate of admission to hospitals for mental-health problems increased significantly compared with people who remained employed. A recent National Bureau of Economic Research working paper reported that in the United States, job displacement led to a 15 to 20 percent increase in death rates during the following 20 years, implying a loss in life expectancy of 1.5 years for an employee who loses his job at the age of 40. Even in societies with strong social-welfare provisions, job loss is traumatic. A study of plant closures in Sweden reported a 44 percent increase in the mortality risk among men during the first four years following the loss of work.

Anyone who's suffered a layoff or watched a loved one lose a job can understand why downsized exhibit increased rates of alcoholism, smoking, drug abuse, and depression. In economic terms, we should think of these as "externalities," just like air and water pollution, since many of the costs of these behaviors and ailments are borne by the larger society.

Despite all the research suggesting downsizing hurts companies, managers everywhere continue to do it. That raises an obvious question: why? Part of the answer lies in the immense pressure corporate leaders feel—from the media, from analysts, from peers—to follow the crowd no matter what. When SAS Institute, the \$2 billion software company, considered going public about a decade ago, its potential underwriter told the company to do things that would make it look more like other software companies: pay sales people on commission, offer stock options, and cut back on the lavish benefits that landed SAS at No. 1 on *Fortune's* annual Best Places to Work list. (SAS stayed private.) It's an example of how managerial behavior can be contagious, spreading like the flu across companies. One study of downsizing over a 15-year period found a strong "adoption effect"—companies copied the behavior of other firms to which they had social ties.

The facts seem clear. Layoffs are mostly bad for companies, harmful for the economy, and devastating for employees. This is not news, or should not be. There is substantial research literature in fields from epidemiology to organizational behavior documenting these effects. The damage from overzealous downsizing will linger even as the economy recovers—and as it does, perhaps managers will learn from their mistakes.