Public policy and downsizing decisions

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Introduction

It may be easy to forget now, but in the 1980s, there was an intense fascination in the U.S. with Japanese management systems, especially with employee management. The combination of lifetime employment, internal advancement, and related practices produced a high commitment system in Japan that was the envy of U.S. employers and the topic of endless seminars offering advice to firms in the U.S. A popular joke at the time described how three businessmen, one French, one American, and one Japanese, had been convicted of something especially bad and were being granted their last request before being executed. The French businessman asked to hear the French national anthem. He heard it and was taken out and shot. Then the Japanese businessman was asked what he wanted. "I'd like to hear one more time a lecture about the superiority of the Japanese management system." Then the American jumped up and said, "Wait. Shoot me first."

Since then, so thoroughly has the Japanese system been supplanted as the model by U.S. practices that people now tell the same joke in Japan, this time with the Japanese manager asking to be shot before the American businessman hears his last request of a lecture about the advantages of U.S.-style restructuring. Around the world, the ability to use layoffs to restructure companies is presented as the cutting edge in competitive practices, based in part on testimonials from U.S. employers and especially U.S.-based multinational companies.

Arguably the only exception to the hegemony of U.S.-style restructuring is in Europe, where it is claimed that the flexibility that companies need to respond to changing business demands can be achieved inside the firm. These arguments describe a kind of "functional flexibility" created by cross-functional work systems and related work practices, as well as the use of contingent labor that represents an alternative to "numerical flexibility" achieved by layoffs and hiring. While there is no doubt that functional flexibility can be useful to firms, there is also evidence that they use numerical and functional flexibility as complements, not substitutes.[1] In the U.S., for example, the use of contingent work, especially temporary help and leased employees, has grown along with the incidence of downsizing.

Data from the U.S. Bureau of Labor Statistics' *Displaced Worker Survey* show that many employers now say that their layoffs are driven by something other than what had been the more typical declines in the volume of business.[2] In my experience watching companies, the most common reasons for layoffs now are attempts to meet profitability targets imposed within the corporation or by its owners. One can think of these efforts as an attempt to redraft the firm's production function: achieve lower average costs by using fewer people in an effort to raise residual profits.

The interest in cutting workers as a means of improving productivity has been accelerated and formalized recently through the introduction of what is known as workplace planning software. These are computer-based models that help employers estimate employment needs by job and skill level. Arguably the most sophisticated of these software packages, so-called workplace optimization software, are explicitly designed to ensure that employers know when they can start cutting workers if business falls off and when they need to start hiring them back when business improves. The "optimization" aspect comes from the reduction in excess employees that the firm might otherwise be carrying when business turns down, as well as the missed

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opportunities it might be able to capture if it was fully staffed at the point when business picked up again.

Policy issues associated with greater ease of layoffs

There is no doubt that U.S. employers have pushed for and taken advantage of greater ability to lay off workers when business reasons make it expensive to retain them. The range of business reasons for layoffs spans business cycles, corporate restructurings of all kinds (for example, mergers and acquisitions, changes in organizational structure, disposal of operations), new technologies that alter skill requirements, and assorted factors that raise worker productivity. It seems to be easier in terms of both lack of legal and regulatory constraints and social norms to lay off workers in the U.S. than in any other developed country in the world. States' employment policies seem to be designed to attract companies to their region by making it easier for them to dismiss old workers and hire new ones.[3] But it is still hard to argue with employers that say that greater ability to lay off workers would reduce their operating costs and make it easier for them to restructure and adjust more quickly to changing markets. It is also hard to argue with the notion that greater ease in laying off workers reduces employers' concerns about hiring. Supporters of easing the remaining restrictions on laying off workers sometimes say that doing so would encourage hiring, per se, but of course that is not literally true: Constraints on the ability to dismiss are an additional cost, a variable or per worker cost, that restrains the interest in hiring, and reductions in those costs reduce the disincentives on employers that otherwise have a need to hire.

Holding aside the fact that layoffs impose enormous costs on employees, it would seem to be the case that allowing firms to lay off workers is good for firms and, as a result, possibly good for the economy in the long run.[4] Of course, arguments like these can easily become tautological in that anything that firms say is good for them can be seen a priori as good for business and for the economy as a whole. In the context of layoffs, the picture gets more complicated when one considers general equilibrium issues. More specifically, the fallacy of composition—what is in the interest of a single firm may not be in the interests of all firms considered collectively—may well come into play in the context of layoffs.

Consider, for example, the effects of work force optimization programs that encourage employers to cut jobs sooner in a downturn. Certainly a firm doing so will benefit from cutting unnecessary costs. But will these practices exacerbate downturns in the business cycle by encouraging firms to cut more workers more quickly? The point of these new programs is to do precisely that. Can they, for example, turn what might otherwise be a modest slowdown in the economy into something more severe as workers are tossed out of jobs and consumption begins to fall? At least conceptually, the answer would seem to be yes, although we have no idea what level and speed of layoffs would be required to make that happen.

Rehiring and retention

The fact that firms can more easily cut workers when they are no longer needed creates problems when firms decide to rebuild, expand, or otherwise hire workers back. Before the 1980s, layoffs were virtually always business cycle related and temporary. When business revived, firms would rehire their laid-off employees. Unemployment insurance and supplemental unemployment insurance benefits provided typically through union contracts offered a financial cushion during the period of layoff. Now, layoffs are much more likely to be permanent, because the causes are much less likely to be temporary. Because layoffs are no longer based on seniority and the causes no longer are limited to business cycles, the jobs that are vacated are not just entry-level jobs but likely span the spectrum of skills and experience.

Once the layoffs are completed and firms need to rehire for existing lines of business or move into new ones, they are unlikely to want their old workers back since job requirements may have changed and the laid-off workers by this point have moved on. Because the firms need to hire across the spectrum of skills and experience, it is unlikely that they can meet their skill requirements by hiring inexperienced entry-level workers. Indeed, anecdotal evidence suggests that most employers want applicants with a minimum of three to five years of experience who have been doing roughly similar work to what is required in their new position.

Where can employers find such applicants? Some may have been laid off and be looking for work, but employers have no particular preference for these applicants. Most people who are hired into new jobs leave old ones. The biggest source of these new hires is other employers. When employers hire from competitors, they create retention problems for each other. Voluntary turnover, therefore, seems to be related to layoff-driven, involuntary turnover, albeit with a time lag.[5] Retention is the biggest labor market concern that employers report. Even the difficulty in finding good candidates for jobs could be mitigated if employers did not have so many retention-related vacancies to fill.

If layoffs contribute to retention problems, then a simple solution might seem to be that employers worried about retention should cut back on layoffs to reduce the need to hire later. The problem with this view is that retention problems are in fact driven by externalities created by other employers. The decision by other employers to restructure creates the need to hire from the outside to fill new vacancies, and that outside hiring drives retention problems at the original employer. Another obvious solution is to raise wages to a level that will prevent employees from leaving. To do so, however, may mean raising wages significantly to match the level of the most desperate employer in an increasingly broad and well-informed labor market. When employees are not identical and when knowledge of a competitor's systems is important, it is quite likely that the value of a current employee to an outside competitor may be considerably greater than what the original employer can afford.

Why are retention problems an issue for the economy? They do more than simply add recruiting and hiring costs and contribute to frictional unemployment. They break down internal labor markets and the mutual investments associated with them. Internal labor markets provide a means for employers to screen internal candidates for new positions, as well as a means for recouping investments in employees, both general and firm-specific investments. Voluntary turnover reduces the average tenure over which an employer can recoup those investments. While an employer may have the incentive and ability to offer employees a premium to retain their firm-specific skills, employees may quit before those skills are acquired. And few skills turn out in practice to be truly firm-specific. Indeed, the most highly desirable candidates may be ones with the most detailed knowledge and experience with a competitor's practices, because they provide competitive intelligence as well as the ability to perform the job.

There are no simple ways to calculate the costs associated with these employee retention issues. Estimates of employee turnover, which capture part of the costs of retention, vary widely. Several experts in human resource accounting suggest at least the equivalent of one year of compensation for each employee who has to be replaced. In jobs where firm-specific human capital is involved, the costs can be dramatically higher. Even a modest increase in voluntary turnover can therefore amount to a sizable cost increase for employers.

Employer concern about retention issues has resurfaced now that employers have begun to expand hiring again. My sense is that much of the current concern about "labor shortages" in the face of a reasonably high national rate of unemployment stems from retention problems that are increasing the need to hire. Employers' concerns about retention would be even greater if they could accurately assess the complete costs associated with employee turnover and hiring. The complication for employers is that their own control over employee tenure is severely limited. They do not see a connection between their own decisions to lay off employees and their subsequent retention problems.

When we think about public policy, however, it is important to make those connections clear. Policies that make it easier for employers to dismiss workers also contribute to retention problems through the logical chain of restructure-dismissal-rehire-voluntary quits. Therefore, it remains an empirical question as to whether increasing the ease with which employers can lay off workers is truly in the firms' own interest.

Finally, the greater ability of employers to lay off workers and the subsequent retention problems this generates have affected the balance of power between employers and employees. Employers appear to have gained dramatically more control and influence over their employees during periods when they are restructuring, but especially during downturns in the economy when employees everywhere, not just those at the bottom of the seniority distribution or those in failing companies, fear the pink slip. Karl Marx's notion of the "reserve army of the unemployed" providing a threat to employees who still have jobs seems to be alive and well, because employers in periods of downturns are both able and willing to require increased working hours and work effort among those who remain on the job.

On the other hand, in periods of economic expansion and tighter labor markets, the shoe is on the other foot as employers watch their employees hop to opportunities at other firms, typically for wage increases. In part, employees may move to other firms out of resentment about how they were treated during the economic downturn. It may be as much of a push as it is a pull. Whatever the reason, retention falls as talent walks out the door. In my experience, human resource departments are now more concerned about retention than they are about handling layoffs. Having a booming economy, something one would think would be terrific for firms, is no longer an unmitigated good, and a recession now has much more of a silver lining for them, at least from the perspective of the human resources department. For employees, economic downturns are now much more catastrophic, because more workers are laid off more quickly with less chance of being rehired, while those who remain employed find their employment conditions worsening. But upturns are now much more advantageous, as employers bid not only for entry-level help, as they have in the past, but also for experienced workers.

NOTES

[1]For a description, see Cappelli and Neumark (2004).

[2]Interesting analyses with these data can be found in Farber (2003).

[3]The website of the National Governors' Association, www.nga.org, Social, Economic, and Workforce Division provides information on state-level policies concerning layoffs, training, and other hiring-related subsidies.

[4]The interests of employees obviously run in the opposite direction. Balancing those interests is a question of priorities and values, a political question of considerable importance but one that is beyond the scope of this article to address.

[5]Further, employee layoffs, especially if they are handled poorly, may cause some employees to begin to search for new jobs at other firms for fear that their own jobs may be cut. In this sense, layoff decisions can contribute directly to retention problems at the same firm.

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