Downsizing: Panacea Or Anathema? Essay, Research Paper

Downsizing; Anathema or Panacea

Over the past decade, corporations around the world have been preoccupied with their staff numbers and with implementing strategies to reduce them. The objective has been to create lean organizations, trimmed of bureaucratic fat and bristling with competitive muscle. In the United States alone, some 3.5 million workers have lost their jobs to these programs since 1987. In the first quarter of 1994, there were 192,572 layoffs, averaging over 3,106 jobs a day. (Downs 19). By 1992, more than 85% of the Fortune 500 companies had downsized during the last five years, and 100% of them were planning to do so in the next five years (Cameron, 1994). The ’scorecard’ below illustrates the magnitude of some of the layoffs in the last four years:

Company Jobs Cut % of Work Force

AT&T 128,000 30

IBM 122,000 35

General Motors 99,400 29

Boeing 61,000 37

Sears Roebuck 50,000 16

Digital Equipment 29,800 26

Lockheed Martin 29,100 17

BellSouth 21,200 23

McDonnell Douglas 21,000 20

‘Downsizing’, ‘rightsizing’ and ‘restructuring’ have been the popular buzzwords used to describe the process of shedding staff. These words give a respectable image of strategic foresight to what would otherwise be regarded simply as wholesale layoffs or firings. Some have defended the trend toward layoffs, pointing out that the mission of a corporation is to make a profit and to provide a return for the investors. In this narrow scope of definition, the layoffs seem to be working. With the Dow Jones industrial average above 5500 and corporate profits at a 25 year high, corporate America may have fulfilled Wall Streets highest expectations. But higher profits and productivity have failed to deliver higher wages and job security, and business finds itself accused of putting corporate greed ahead of the nations economic interests. There is, however, a growing body of evidence that perhaps layoffs are not necessarily the quick cure-all for sagging profits that corporations and economists thought they were.

The question now being asked is, did these decisions [to layoff workers] reflect genuine strategic thinking or were they simply knee-jerk reactions to falling market share and profits? A survey by the American Management Association in 1992 of 547 companies that had downsized in the previous six years found that only 43.5% improved their operating profits. In addition to the disappointing financial performance, downsized corporation also experienced higher incidents of absenteeism, resignations, and turnover in their workforces. They also predicted that these companies would downsize again within a few years to try to shore up further market share losses and profit declines (”Unthinking Shrinking” The Economist September 1995). In a recent study, Mitchell and Co., a US consultant firm, found that most firms that restructured (downsized) recognized a short term gains in share price in the first six months, but after three years lagged the rest of the market (”When layoffs alone don’t turn the tide” International Business Week December 1992).

Downsizing is also often a cover for mismanagement. AT&T Chief Executive Officer Robert Allen committed what a Wall Street Journal columnist called “a $7.5 billion boo-boo” when he bought NCR Corp. in 1990. AT&T is also writing off hundreds of millions of dollars it invested in on-line services it is now phasing out. Other stumbles include its $150 million investment in Unitel, a Canadian long-distance network that went bankrupt. The result of all these mistakes? On January 2, CEO Allen announced that AT&T is eliminating 40,000 jobs. Another example of executive mismanagement is William Agee of the Morrison Knudsen Corporation. When he resigned in 1995, the company had recorded losses totaling $114 million during the previous two years. Agee had received $3.5 million in cash and other benefits during that period. On leaving the company, his severance package was estimated to be worth somewhere between $1.5 million and $4.8 million. Citing unprofitability, Morrison Knudsen also laid off 277 workers in early 1995 providing them with no severance pay (Baker, 1996). There is also evidence that corporate CEOs may benefit directly from downsizing.

Senior Corporate Consultant Alan Downs is an expert who served as a key strategist for numerous Fortune 500 companies in methods of cutting payrolls and strengthening bottom line results. Downs points out the direct correlation between CEO pay and downsizings. His recent analysis agrees with many other experts that there is no discernible correlation between executive pay and performance. Downs does, however find a correlation between CEO pay and downsizings. He recently examined 22 companies in a report by Fortune Magazine that announced during 1994 plans to layoff large groups of employees. He found a relatively strong (.31) correlation between the size of the layoffs in the companies and the compensation to the CEOs. In his book, “Corporate Executions: The Ugly Truth About Layoffs” Downs reports how pushing a stock valuation above a specific price for a particular period of time was tied directly to a CEO compensation package and how that led to a massive layoff;

On Feb. 25, 1991, the compensation committee of the board of directors of General Dynamics met to consider revising the compensation package of its CEO, William Anders, and 24 other top executives. Under the plan that they approved, the executives would receive a bonus equal to their yearly salary if General Dynamics stock rose ten points, from $25.56 per share to $35.56 per share, and stayed there for ten days. If the stock went up another ten points to $45.56 per share and stayed there for ten days, they would receive a bonus equal to twice their yearly salary, and so on until the plan expired in 1994…

Now it is no small feat to raise the stock price of a defense contractor in a time of major defense cuts by a few points, much less ten. They needed something monumental… something that would grab the attention of the media and investors on wall street while also sweetening the bottom line by increasing the cash on hand. Somehow General Dynamics would have to look like a good investment for no fewer than ten days. So what do you suppose that Mr. Anders and those executives did?

They announced a massive layoff of more than 12,000 of the company’s 86,000 employees, cut spending in other areas, and froze the salaries of anyone below their ranks. By the end of the year, they had amasses $600 million in cash, which they promised to spread among the shareholders, and earned themselves $18 million in bonuses as the stock price held the $45.56 mark for the tenth day. Anders personally received more than $9 million in salary and bonuses (Downs 224)

These horrific stories become even more insidious when one examines the corollary effects of a layoff.

When examining the effect of a large corporate layoff on the local community, researchers have found that a larger number of people in the surrounding community lose their jobs as a result of the ripple effect. Alan Nevin, managing director of ConAm Research in Old Town, San Diego, California, puts the multiplier rate at 2.5 depending on the industry, meaning that for every job lost in the corporation, 2.5 jobs will also be lost in the community. He says manufacturing jobs may yield a rate of 3.5, due to the support services they require. These numbers become much more severe if an entire industry downsizes (Perry 114). As dramatic as this is; as sobering as these numbers are; can a corporation today afford not to restructure and downsize in order to stay competitive?

Consider the Wyatt survey (Wall Street Journal, June 6, 1991) that found that the majority of organizations that downsized failed to achieve their desired results. Less than half of the firms surveyed were able to reduce expenses. A forthcoming study by the American Management Association (AMA) concludes that fewer than half of the firms that have “downsized” in the past five years earned increased profits. Only a third of those that downsized reported higher productivity. Forty percent of the executives in a Towers-Perrrin study of 300 major companies that had restructured and downsized, fifty percent of the executives were dissatisfied with the outcomes. Many firms try to make good by downsizing again. The study also compared the financial performance of downsized firms over a period extending from three years before the downsizing to two years after found that the firms as a group performed no better after the downsizing that they did before. (”When Slimming is not Enough” The Economist September 1994).

Stephen S. Roach, the chief economist for Morgan Stanley Company used to be a major proponent of downsizing. He now says that it has failed to generate the long-predicted “productivity-led recovery.” In a recent New York Times report (”A Top Economist Switches His View on Productivity,” 5/8/96) he is quoted;

…it is increasingly clear to me that the improvements in operating performance and profits have been built on a steady stream of downsizing and cost cutting that is just not sustainable. If all you do is cut, then you will eventually be left with nothing, with no market share. Technology has not succeeded in significantly increased productivity (22-24).

As mentioned before, another top economist, Alan Downs has also reversed his position on downsizing. In the early 1990s, he began to believe that downsizing was being used principally as a tool for short-term stock manipulation and that in most instances it was seriously damaging the capacity of corporations to compete and maintain profitability in the long term.

There have been other surprises to downsizing corporations. Consider this case taken from the book by Charles F. Hendricks, “The Rightsizing Remedy: How Managers can Respond to the Downsizing Dilemma.”:

The CEO of a parts manufacturer asked the presidents of the firms business units to consider restructuring to maintain competitive pricing. One president moved swiftly on this counsel. He found a consulting group that promised to develop a restructuring plan that would bring dramatic cost reductions within the required time targets. The restructuring plan was complete within five months. The president implemented the plan rapidly and reported his accomplishment at the next meeting with the CEO.

Over the next six months, however, the reorganization and outplacement costs actually increased overall costs, although indicators suggested costs would ultimately decrease. The president heard some complaints that morale had dropped. Some individuals commented that they were now doing three peoples jobs and had trouble keeping up. Several customers reported that quality and delivery specifications had not been met. The president directed managers to resolve them as soon as possible, but considered them minor, considering the overall cost savings.

A month later, the business’s largest customer notified the sales department that they were shifting their business to a competitor. The president immediately called the customer and not only promised that he would correct the quality and delivery problems, but through in a permanent 6% price reduction for all parts. He was shocked when the customer responded that the quality and delivery problems were costing far more than the value of the price reduction he offered. Moreover, the customer’s operating people no longer believed his firm could provide the quality parts and reliable delivery that they needed (78-79).

Observers across the political spectrum have found the behavior of numerous companies unseemly. Many large, successful corporations are permanently downsizing their workforces while earning record profits. Corporate executives are raking in multi-million dollar pay packages while workers pay stagnates or declines. Republicans such as Massachusetts Gov. William Weld and presidential contender Robert Dole have lectured corporations on their responsibilities to their coworkers and communities. Democrats such as Senators Edward Kennedy and Jeff Bingamin, Congressmen Richard Gephardt and David Bonior, and Labor Secretary Robert Reich have gone further and suggested that the government provide incentives that reward good corporate behavior and punish bad. The press has taken up the battle cry. “Corporate Killers,” blared the headline on an attention grabbing Newsweek cover story. The New York Times weighed in with an excruciatingly detailed seven part series that chronicled the plight of workers and communities caught up in what it called “The Downsizing of America.”

Wall Street and the business community have responded by defending their obligation to maximize shareholder value. As former Scott Paper CEO Albert S. Dunlop put it, “The reason to be in the business is to make money for your shareholders. The shareholders own the company. They take all the risks.” Among these shareholders, the argument goes, are pension funds and mutual funds serving a broad swath of American workers and consumers. The bottom line of this argument is that everyone is better off when corporate managers maximize shareholder value. This position is not a new one. Every since the sweat shops of the industrial revolution, there has been a tension between the perceived goals and practices of American industry and the periodic need of the community. Just how much a company should or should not base their policy making decisions on these pressures from the community is beyond the scope of this paper and does not bear more than a precursory mention later in the summation.

Having explored the less than lustrous results of the majority of reorganizations, it is apparent that a large percentage of the companies fail to benefit from their downsizing, Those that do recognize a short term gain in share price may find the benefit to be temporary at best. Those that are fortunate enough to truly recognize an increase in productivity, and increase in operating earnings, and a sustained competitive advantage as the result of a layoff, may find themselves somewhere down the road having a higher rate of employee turnover and a subsequent difficulty attracting and retaining to new talented and ambitious employees necessary to keep the professional ranks fresh and competitive. The conclusion would seem to indicate that downsizing has not been the panacea for ailing profits and sagging stock prices that many thought it would be.

Why such poor results? A fairly clear pattern is beginning to emerge. CSC Index, a consulting firm that focuses on re-engineering surveyed 5,800 organizations in North America and Europe about their experience with reengineering and received 497 responses. The final report has yet to be released, but after reading the preliminary results, the staff of The Economist (July 3, 1994) concluded that “perhaps the most important thing to emerge from the report, which chimes with other smaller studies, is that reengineering is not enough on its own. It needs to be linked to strategy.” In another study of the mixed outcomes of reengineering reported by three McKinsey consultants, their conclusion was also that lasting results were only achieved when the senior management had defined a clear and common vision of the business’ future and invested their time and energy in communicating that vision and working to bring it into being (Hall, Rosenthal, and Wade, Harvard Business Review, November-December, 1993)

A University of Michigan, four year study of 30 organizations undergoing downsizing found that one of the four significant predictors of organizational improvement during downsizing was “systematic analysis in advance of downsizing.” The findings of the study led the author to prescribe that downsizing be associated with a clearly articulated vision of the desired future of the organization (Cameron, 1994). This may sound like a restatement of the obvious, but “structure follows strategy.” That was the major finding of Alfred Chandler’s studies in business history (Chandler, 1962).

The findings of the studies mentioned above give rise to the observation that the choices and trade-offs involved in restructuring a business can only be made after answering the question: Where do we want to go in the future? They require a clear business strategy. Furthermore, when corporations engage in restructuring and downsizing they often wreck havoc in the lives of those directly affected and spread fear and uncertainty among those remaining. They can’t help asking the question, “Why are we doing this?” It is imperative for senior managers to be able to articulate a clear, strategic justification for restructuring to help their people appreciate why these changes are necessary to maintain the viability of the organization.

In the earlier examples given above, restructuring was conducted by large corporations in a kind of knee-jerk response to market pressures, mismanagement of corporate affairs, or through simple greed on the part of the executive board. In all of these examples there is one constant; the downsizing that resulted was the executive strategy for achieving a specific end result. As illustrated so thoroughly by fact and statistics, this approach can only hope to produce the desired result, but will most likely further impair the corporation’s ability to competitively produce in the future. Downsizing, rather than being The Strategy, should be the final outcome in the strategic planning process, if indeed, the strategic planning process leads the executive board to a downsizing decision.

Done properly, the corporation’s vision for the future will be the guiding light for the development of the strategic plan. Before the managers of any organization can determine how to do work better or how to organize to perform work more efficiently, they must first determine what work needs to be done and what processes are critical to perform. Opportunities for increased revenues as well as for reduced costs need to be examined. Choices among those opportunities can only be made on the basis of strategy.

There are several approaches to strategy that may be used to develop the details of the strategy that will most likely achieve the firms vision. A thorough analysis of all holdings and assets, market conditions, the competition, the internal and external social pressures that may arise, as well as the processes used to fabricate the goods must be undertaken. A well kept secret in most organizations is that strategy is seldom formulated, articulated or understood in a way that provides managers with a useful basis for making decisions about restructuring.

Armed with a full understanding of the corporations vision, goals, and the broad level strategic plan, the business unit level manager is then ready to conduct his/her restructuring planning. This information establishes clear strategic priorities for restructuring by identifying the capabilities that do and do not contribute to a firm’s competitive advantage. When restructuring is strategic, it is common for firms to upsize areas in which strategically important work is performed, while downsizing strategically unimportant work. Strategy clarification sets the stage for strategic restructuring by providing a logic for prioritizing organizational work. When the business strategy is clear it is possible to answer the following questions about an organization’s work:

What work should be the object of our most intense improvement efforts?

What work activities need to be improved together and which can be improved separately?

What work should be eliminated?

What work should we outsource?

When is efficiency (i.e., doing things right) and when is effectiveness (i.e., doing the right things) the most useful driver of important efforts?

(Barney, 1991).

The important message here is that although massive layoffs often result in a short-term gain in stock price and sometimes in a moderate gain in productivity, the long-term effects can be disappointing (and perhaps destructive) if the restructuring is not the final step of a business level strategic implementation rather than the first. It is important that strategy be defined and directed from a corporate level, but that the actual strategic plan be developed on the business unit level. Seldom is it the case that the same prescriptive changes directed from the corporate level are effective for each business unit within the company.

With a clearly defined strategic road map, a corporation will often discover the need to fortify or build up one aspect of the business process while trimming or divesting another. By providing the individual business unit with a clear vision of the firm’s goals and plans for the future while allowing them the autonomy to map their own strategic plan, a corporation can insure that the hard decisions and process level reengineering will be accomplished by the expert – those who work within the business process daily. Another benefit to the organization that uses this approach is the opportunity to function as a mentor and a coach to the individual business units while providing a corporate wide network for re-allocation of displaced resources.

There is a storm brewing on the horizon concerning corporate responsibility. The public outcry and political rhetoric witnessed today are but harbingers of the maelstrom of public opinion to come. The evidence is abundant. Presidential candidates noted the early popularity that Buchanan achieved when he began to criticize corporate behavior. Should the economy take a sizable downturn, corporation bashing may become a popular sport. Not that some haven’t deserved it.

A corporation that rewards it’s executives for short term stock valuation while ignoring the company’s real growth in terms of expansion or increased market share will be shortchanging the stakeholders in the company in the long term. This corporation will also face a growing public outcry against perceived disregard for the welfare of its employees and for the communities wherein they reside. These considerations, taken in light of the amassed evidence that huge layoffs most often provide only short-term gain and may do long term damage, should adequately emphasize the need for caution when considering a restructuring.

The seemingly obvious conclusion is that there are times and conditions when a decision to downsize is justified as a means of achieving strategic initiatives. The decision to downsize, although a painful one, is not anathema. If the decision is a part of a larger, broader strategic plan, there is a distinct possibility that displaced individuals may have the option to retrain, relocate, or to integrate into another discipline within the company. Any action that a corporation undertakes; if it is to succeed; if it is to provide material gain; if it is to improve market position, it must be the logical outcome of a strategic plan. Seldom are knee-jerk responses to market pressures the best.

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