Faced with excess capacity, innovative firms retain staff, train and even hire

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When firms experience unwanted drops in capacity utilisation, one of the many challenges they are confronted with is how they should respond in terms of their employees. This happened to firms across a wide range of industries in the wake of the financial crisis in 2008-09, and it is happening to firms in the oil and gas sector – and those linked to this sector – right at this very moment.

Since excess capacity is costly, an obvious response is to get rid of the excess capacity through layoffs. Certainly, many firms do exactly this. Yet, some firms hold on to parts of the excess capacity, or possibly all of it, and invest in training instead. Some even hire during such episodes, and some combine both hiring, firing and training. But who does what, and why?

In a recent study, we examine how firms responded to the burst of excess capacity following the financial crisis that began in 2008-09. As it turns out, the strategy a firm pursued before the recession was an important determinant of its responses. When comparing firms that emphasise innovation with firms that emphasise cost efficiency in their pre-recession strategies, we find that those emphasising innovation were more likely to invest in training, to hire, and interestingly, to combine training with both hiring and firing – simultaneously. The opposite is true for firms with a cost focus. So what can explain these findings?

Let us start with investments in training. Periods of excess capacity are periods where the cost of training is unusually low. This is because time spent in training does not replace time spent producing output, or selling, or whatever an employee normally does, when capacity utilisation is low. Put differently, the opportunity costs of training are lower when capacity utilisation falls, making training cheaper, and thus more attractive.

An alternative to training is to lay off the employee and get rid of the excess capacity instead. So increased investment in training is only attractive when a firm has strong incentives to hoard an underutilised employee, instead of laying him/her off. One of the factors that affect firms' incentives to hoard employees is the adjustment costs associated with finding and training a replacement should demand pick up again later. The more an employee has firm-specific knowledge that would take a long time to develop in a replacement, the higher the adjustment costs, and the stronger the incentives to hoard that employee. Innovative firms are more likely to do things differently from their peers, which translates into a higher likelihood of relying on firm-specific knowledge. It follows that such firms have more employees that are attractive to keep, despite reduced capacity utilization. And again, if a firm has incentives to hoard labour in a downturn, training suddenly becomes very cheap.

What about hiring? Why would innovative firms also be more likely to hire in a downturn? One reason is that labour markets are very different in a recession than in a boom, meaning that talent is much cheaper in a recession. To the extent that this "discount" matters more to innovative firms than to cost-focused firms, it will make the former more prone to hire. But it is also cheaper to provide training for new employees if a firm is already hoarding some of their more experienced ones, since they don't have to take the veterans out of their ordinary work to train the rookies. The logic parallels the logic above: Innovative firms have stronger incentives to hoard labour, and therefore have access to cheap trainers. Cost-oriented firms, on the other hand, are more likely to shed the excess capacity.

Lastly, we also find that innovative firms are more likely to combine investments in training and hiring with layoffs. The likely explanation for this is that the employees that are being laid off are different from those that are being retained and recruited. Most firms will have some employees that have predominantly general knowledge and some employees that have more firm-specific knowledge. For the former category, the adjustment costs of layoffs and hiring a replacement later is low. Innovative firms will therefore often lay off the former category to finance retaining, recruiting and training employees of the latter category. Put differently, the strain of hoarding specific employees makes innovative firms more prone to lay off nonspecific employees, and more so the more financially constrained the firm was going into the recession.

To sum up, a firms' strategy will affect what type of human capital it relies upon, which will affect its incentives to hoard labor, and thus its propensity to invest in training, to hire or to fire different employees when being hit by an economic downturn.

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Notes:

- *This post is based on the authors' paper Hire, Fire, or Train: Innovation and Human Capital Responses to Recessions, in Strategic Entrepreneurship Journal, Volume 9, Issue 4, 2015.*
- *This post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
- *Featured image credit: Yinan Chen Public Domain*

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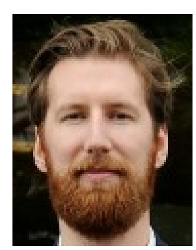

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