The hidden cost of downsizing: demotivating the remaining employees

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Firms that lay off staff can see a significant reduction in the performance of their remaining workers, according to our experimental study. Our research suggests that firms that decide to ‘downsize’ their workforce should be wary of how the layoff decision is perceived by the remaining (“surviving”) workers. If the surviving staff interpret the decision as a way to boost profits at the cost of the workers, they might react negatively.

Lay-offs are an integral part of dynamic economies. For example, in Germany at least one large firm announces cuts of at least 800 jobs on each third working day of the year. Lay-offs impose massive costs on the displaced workers, the regional economy and social insurances. Hence, it is no surprise that layoffs are often discussed controversially in the general public and the media, and receive a lot of attention by scholars and practitioners.

From the firm’s perspective, the benefits of lay-offs seem to be obvious – in particular, labor costs and organisational slack can be reduced. Firms considering laying off workers have to weigh these benefits with potential costs. Some types of costs (e.g. severance payments) are more or less calculable in advance, while other costs are ex ante hard to estimate. In particular, there may be substantial costs associated with a decrease in the motivation of the workers who stay in firms after lay-offs – a phenomenon called ‘survivor syndrome’.

We set up a lab experiment with 400 students at the Goethe-University Frankfurt to study how non-fired employees respond to an employer’s *decision* to fire a co-worker. In our experiment, employees work for an employer whose payoff depends on the employees’ performance in a real-effort task. Subsequently, the employer is provided with an incentive to layoff one of her/his employees. After her/his decision for or against firing, the remaining employees continue to work for the employer.

To analyse whether the remaining employees’ performance is driven by the employer’s decision to layoff an employee or its implementation, we conduct a control treatment in which it is randomly decided whether an employee is fired or not.

We find that survivors reduce their performance substantially in response to the employer’s decision to lay off a co-worker. The reduction is strongest for survivors who interpret the employer’s decision as a method to increase profits at the cost of the workers; it is weaker if they can comprehend the layoff decision, and it vanishes (in the control treatment) if the employer is forced to fire a co-worker. It seems that the survivors in our experiment perceive an employer’s decision to lay off a co-worker as a signal that she does not expect them to perform well or cares more about her/his own payoff than the well-being of the employees. Our results suggest that this negative signal leads to a decrease in employees’ performance.

Our experimental results imply that firms deciding in favour of layoffs should be wary about how their decision is perceived by their workforce. In firms laying off workers, one can observe a number of business practices that are puzzling at first glance. Our study can provide one potential explanations for these practices.

First, firms often use natural fluctuations to reduce the level of staffing instead of firing workers. The existence of such a policy is quite surprising – firms can more rapidly adjust their labor force by simply firing some workers. One potential explanation for this business practice could be that firms try to mitigate the survivor syndrome.

A second fact is that firms laying off workers often claim that they have “no choice”. A rational for this communication strategy could be that firms try to prevent that employees perceive the employer’s layoff decision as an attempt to increase profits at the cost of the workers. It is, however, an open question whether employees really believe management’s declaration. One way to verify declarations could be a strong cooperation with the works council.

Third, research has shown that top management turnover is higher after downsizing. One explanation for this phenomenon could be that firms try to limit the negative impact of the lay-off decision by separating from the management with the lay-off history. After the separation, the new management can blame the predecessors.

A fourth fact is that firms that are downsizing often provide outplacement services for the leavers, and make financial offers for voluntary leavers (even if these offers are quite expensive and, because of their better outside options, the more able workers who separate). A rational for such business practices could be that firms try to attenuate the negative signal of the lay-off decision by the provision of positive signals.

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Notes:

- *This blog post is based on the authors’ paper The Hidden Costs of Downsizing, The Economic Journal, Volume 126, Issue 598, December 2016*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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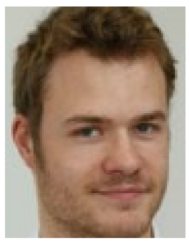

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focus of his research is downsizing. Matthias analyses downsizing from different perspectives; depending on the perspective, and the underlying research questions, he applies different empirical methods and datasets.