The Hidden Costs of Layoffs

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Think downsizing will solve your company's financial woes? Before getting out the ax, take a look at what experts and researchers have discovered about the unexpected consequences of layoffs. These harsh realities may make you think twice:

1. Significant indirect costs often wipe out the direct savings of layoffs.

While layoffs may seem like a good way to cut costs in the short-term, the direct and indirect costs of downsizing can paralyze your company's long-term revenue-generating streams. "The books look great for two or three quarters, and then things don't get done," says Jonathan Phillips, managing director of Houston-based executive search firm Magellan International.

The direct costs of layoffs from outplacement services and severance pay can add up initially, but indirect costs — like losing experienced sales and marketing employees who have strong relationships with clients — can cause lasting damage to a business. Phillips saw this phenomenon first-hand when he worked in various management roles at Shell in the late 1980s. "They let a lot of senior executives go, mostly out of sales and marketing, which they thought was a marginal activity until their clients didn't want to buy from them anymore."

Additionally, the direct costs of layoffs negate any financial benefit if new employees are hired within six to twelve months, according to a Bain & Company study. This type of "binge-and-purge" tactic, common during recessionary periods, can place an organization in an unfavorable position when the recession comes to a close.

2. Your best employees might bolt after a round of cuts.

The top performers who survive a layoff won't necessarily feel obligated to soldier on. A 2000 study by Roderick Iverson and Jacqueline Pullman from the University of Melbourne, and a 2003 study by Sarah Moore, Leon Grunberg, and Edward Greenberg from the University of Colorado at Boulder, both confirmed that employees were far more likely to quit jobs in environments of repeated downsizing. The likelihood that an employee will quit actually increases the more layoffs he or she "survives," the CU-Boulder study found.

Both studies partially attribute this occurrence to the general malaise associated with working at a company after a series of layoffs, a feeling businesses rarely do anything to counteract. "We tend to think people leave because of poor morale, but the real reason is businesses fail to spell out for people why things will get better," says Wayne Cascio, a professor of business at the University of Colorado at Denver and author of the book "Responsible Restructuring: Creative and Profitable Alternatives to Layoffs." "What is it that will make things better? Where's the new vision? If people don't see that, and if there are other opportunities, they'll tend to walk."

See also: How to Manage Your Team in a Downturn (and Come Out on Top).

3. The best types of workplaces often suffer the most.

If your company touts itself as receptive to the needs and personal development of its workers, layoffs can be even more troublesome. A recent report by researchers Christopher Zatzick and Roderick Iverson of Simon Fraser University found that layoffs at "high-involvement workplaces" — those with management strategies that give employees the skills, information, and motivation to be competitive — can be markedly more detrimental to the organization than layoffs at an average company.

"Layoffs can be perceived as a violation of the psychological contract between an organization and its employees, resulting in decreased trust and greater stress in the workplace," the authors write. The negative effects on the survivors of a layoff — decreased commitment and productivity — are "more costly for high-involvement workplaces, as these workplaces rely expressly on employee involvement and motivation." Not only are top-performing employees more likely to leave, but the employees that remain may exhibit less effort and involvement.

Fortunately, these workplaces can mitigate the negative aftereffects of downsizing, the study found, by continuing their employee-friendly practices. Phillips of Magellan says Johnson & Johnson is a good example. "Johnson & Johnson has huge family involvement with the firm," Phillips says. "They try desperately to place everybody, even if they know [they] can't do it. The attitude in HR is, 'What can we do to help?'" Companies that cut back on this management strategy as part of a layoff to minimize costs fared worse, the study found, as employee productivity suffered.

4. Layoffs don't improve organizational performance.

Since some of your best and most experienced employees will jump ship after a layoff, workplace productivity is bound to suffer, and the psychological effects of a layoff on those who remain can be even more detrimental to your company's continued performance. New York Times reporter Louis Uchitelle examined these effects in "The Disposable American: Layoffs and their Consequences," finding that company performance suffered significantly in a post-layoff atmosphere. Uchitelle cites an example of a group of productive software engineers at Xerox who shifted their focus from inventing to flaunting their talent with needless meetings and crisis sessions after a layoff made them question their job security.

Researcher and author Cascio compared cost-cutting strategies with several companies' performance on the S&P 500 during an 18-year period. His findings showed that the most successful companies didn't rely on layoffs to improve performance. "Over time, the only firms that really outperformed their industries were those that found ways to grow revenues," Cascio says. "You can't just shrink your way into prosperity."

5. Employee retention is linked with customer retention.

Negative public perception of a layoff can be another unexpected cost. "If you're buying from a company that treats its people badly, you're going to try and buy from someone else, even if it's not overt," Phillips says. "This is the only reason Whole Foods survives — because people want to do what's right — and so they buy more expensive food that doesn't taste as good from Whole Foods." Convincing customers that layoffs are absolutely necessary is probably impossible, since most companies that lay off employees aren't actually in dire straits. "In any given year, we tend to think the firms that do downsizing are in rather desperate situations and are battling to survive," says Cascio. "The data just doesn't confirm that." According to research by Bain & Company fellow Fred Reichheld, employee loyalty and customer loyalty have a direct correlation. So companies that hold on to their employees and eschew a policy of frequent downsizing are far more likely to keep customers — and thus keep revenue flowing.