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Downsizing and Profitability: An Empirical Study of Portuguese Firms in 1993–2005

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Abstract

Although firms may resort to downsizing strategies to improve financial performance, the actual outcome of downsizing is inconclusive. Testing a sample of 1,357 Portuguese firms, we conclude that firms that downsize tend to continue to underperform compared to those that do not downsize.

Key words: downsizing effects; downsizing performance; financial performance; Portugal

JEL classification: G34; M19

1. Introduction

To survive the turbulent, dynamic, and competitive global market and deep structural crises worldwide, companies increasingly often adopt downsizing strategies (Farrell and Mavondo, 2005; Gittell et al., 2006; Coucke et al., 2007; Greenwood et al., 2010). Since the 1980s, firms downsize primarily when they have a distressed financial situation (Greenwood et al., 2010) or face hazardous

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evolutions (Gittell et al., 2006). Multinational companies such as AT&T, Nokia, Caterpillar, Warner Bros, France Telecom, and Deutsche Telekom, among many others, announced several layoffs and drastically reduced their workforces. Cameron (1994) and Farrell et al. (2005) argue that the main reason for companies to downsize is to improve organizational efficiency, productivity, and competitiveness. Over the years, the downsizing strategy has generated a great deal of interest among press, researchers, and managers. The worldwide evidence of the downsizing strategy is paramount. According to the Bureau of Labor Statistics, downsizing activities exceeded two million job cuts in the years 2001 and 2002 in the US alone (De Meuse et al., 2004). The presence of this strategy in the US is undeniable, and several studies have been devoted to the US context (e.g., De Meuse et al., 1994; Espahbodi et al., 2000; Wayhan and Werner, 2000). Although the available evidence for non-US contexts is scarce, several studies confirm that downsizing is spreading all over the world, including Asia (Ahmadjian and Robinson, 2001; Lee, 1997; Kang and Shivdasani, 1997; Yu and Park, 2006), Australia (Farrell and Mavondo, 2005), New Zealand (Carswell, 2005), Eastern Europe (Filatotchev et al., 2000; Love and Nohria, 2005; Kase and Zupan, 2005), and Spain (Magán and Céspedes, 2005; Vicente-Lorente and Suárez-González, 2007).

Despite the popularity of the downsizing strategies, many questions remain concerning their financial effectiveness and organizational success. The common assumption is that downsizing is a managerial response to firms' decreased profitability, possibly in the face of an economic downturn (McKinley et al., 2000) and that firms downsize to improve efficiency and profitability (McKinley et al., 2000; Mentzer, 1996). However, empirical research has found only mixed and ambiguous evidence concerning the positive consequences on firm profitability. Some studies conclude that downsizing increases profitability ratios (Cascio, 1998; Morris et al., 1999) while others find lower financial performance after a downsizing strategy (Carswell, 2005; De Meuse et al., 2004; Suárez-González, 1999).

Most studies assume that downsizing is a managerial response to decreased profitability of the firm if there is an expectation of a relation between downsizing and profitability, although prior studies have concentrated on higher income countries, mostly the US, and have generally ignored European countries. This has lead Littler and Innes (2004) to argue that there is a need to deal with the dynamics of downsizing in relation to other economies, apart from the US context. In this study we contribute to the debate by attempting to examine whether distressed financial situation is a predictor of downsizing and to draw inference about the effectiveness of downsizing in Portuguese firms. Our sample is collected from the Amadeus database and covers the period 1993–2005. Our results suggest that firms that downsized their workforce enjoy a short-term positive effect but that it is not sustained into the following year.

The paper is structured as follows. In the next section we present a literature review on the effects of downsizing on profitability and summarize our hypotheses. In Section 3–5 we present our methodology, data, and variables of interest. In Section 6 we present and discuss results. The paper concludes with a broad

discussion including management implications, study limitations, and avenues for future research.

2. Downsizing: A Reaction to Distressed Finances to Improve Profitability?

Downsizing has several effects when it is implemented. Existing research has examined downsizing consequences on profitability (Carswell, 2005; Morris et al., 1999; Yu and Park, 2006), on the stock market value (Elayan et al., 1998; Wertheim and Robinson, 2000), on organizational reputation (Flanagan and O'Shaughnessy, 2005), and on individuals (Armstrong-Stassen and Schlosser, 2008; Reisel and Banai, 2002; Sahdev, 2003). The "survivor syndrome" is the term given to employees that remain in the firm after the downsizing, which may include reduced motivation, morale, or loyalty (Brockner, 1992; Gandolfi and Neck, 2005; Sahdev, 2003) and higher levels of stress (Devine et al., 2003). A primary focus of downsizing research is to examine the impact on firm profitability through the associated reduction in costs. However, the literature is not conclusive as to the effects of downsizing.

Although several empirical studies tackle the determinants of downsizing, there are notable differences concerning both methods and theory. There is a range of causes probably acting together, though the literature has been largely based on managerial perception of downsizing effectiveness (De Meuse et al., 2004; McKinley et al., 2000).

Most researchers have viewed downsizing as a strategy to respond to economic forces (Cascio, 1993; Freeman and Cameron, 1993). The adoption of this perspective explains managers' attempt to link downsizing to the firms' financial performance. Downsizing is a reactive strategy in several studies where intended workforce reductions were justified by a prior financial crisis (DeWitt, 1998; Lee, 1997). This reactive explanation is supported by the literature on organizational decline and turnover, where firms engage in retrenchment practices such as reduction in workforce size (Barker and Duhaine, 1997; Pearce and Robbins, 1993). Thus, firms are more likely to engage in downsizing strategies when their performance is poor or declining (Love, 2000).

Downsizing is an intentional managerial response to the decreased profitability of companies (McKinley et al., 2000; Mentzer, 1996). Thus it is reasonable to suggest that firms are more likely to engage in downsizing strategies when their performance is poor or declining (Love, 2000). When firms underperform, they tend to engage in retrenchment practices such as a reduction on workforce size (Barker and Duhaine, 1997; Pearce and Robbins, 1993) and reduce personnel costs (Cascio et al., 1997). We formalize this in Hypothesis 1.

Hypothesis 1. Profitability in downsizing companies is significantly lower than in non- downsizing firms in the year prior to downsizing.

Concerning the consequences of downsizing, the literature has treated downsizing effectiveness as an improvement in financial indicators. It is assumed

that downsizing is caused by a search for productivity and efficiency, either in response to organizational decline or, more recently, as a means to enhance corporate profitability under non-declining conditions. The decision makers understand the relationship between downsizing and future financial performance, so that downsizing can be used as a rational and predictable tool for manipulating that performance (McKinley et al., 2000). This manipulation comes with diminishing personnel costs and can be enhanced by reducing the number of employees. The increased profitability emerges either by enhancing lower costs and increasing performance or by achieving competitive capacity due to the consequent reduction of prices (Cascio et al., 1997). Despite researchers' focus on the relationship between downsizing and future performance, the existing empirical evidence is inconclusive of a positive relationship (McKinley et al., 2000), thus raising justifiable doubts on the effectiveness of downsizing. Several studies failed to find significant positive relationship between downsizing and subsequent financial performance (Cascio, 1998; Morris et al., 1999) or found a negative association (Carswell, 2005; De Meuse et al., 2004; Suárez-González, 1999). Notwithstanding the unequivocal empirical findings, there is some evidence that downsizing decisions lead to an improvement in the accounting ratios of firms (Bruton et al., 1996; Chalos and Chen, 2002; Elayan et al., 1998; Kang and Shivdasani, 1997).

Downsizing is often defined in the literature as an intentional effort to permanently reduce personnel to improve organizational efficiency and/or effectiveness (Cameron et al., 1993; Freeman and Cameron, 1993). Theoretical support proposes that downsizing has a positive impact on financial performance (Chalos and Chen, 2002; Elayan et al., 1998) by reducing labor costs. Reducing the number of employees and decreasing labor costs will have a positive impact on profitability, either by enhancing lower costs and increasing production or by achieving competitive capacity due to the consequent reduction of prices (Cascio et al., 1997). In a period of globalization, firms are forced to engage in different strategies to maintain a competitive advantage, and downsizing is a possible solution to improve competitiveness, by reducing their labor costs and all the associated red tape of having a large workforce. Hence, in the years following a reduction in the size of the workforce, profitability measures should increase and lead the firms that implemented these practices to a more attractive financial position. We formalize this in Hypothesis 2.

Hypothesis 2. The profitability of downsizing companies will increase significantly in the years following downsizing as a result of the downsizing.

3. Method

This study analyses the effects of downsizing on the profitability of 1,357 Portuguese firms over the period 1993–2005.

Several authors have studied the effects of downsizing on profitability worldwide (Table 1), however previous empirical studies have employed a wide range of methods concerning the research design to identify firms that implemented layoff programs. Some authors gathered their sample from announcements in the press (Chalos and Chen, 2002; De Meuse et al., 1994; Elayan et al., 1998; Kang and Shivdasani, 1997), others used surveys (Yu and Park, 2006), and still others calculated the decrease in the employment volume (Cascio et al., 1997; Suárez-González, 1999). In this last approach, downsizing is defined as a reduction in the number of employees by more than 2% (Espahbodi et al., 2000), 3% (Cascio et al., 1997), or 5% (Suárez-González, 1999; Suárez-González, 2001; Vicente-Lorente and Suárez-González, 2007). The majority of the studies used accounting data to measure company performance, although the accounting ratios used also vary considerably across studies, involving return on assets (ROA), return on equity (ROE), or return on sales (ROS). Other studies use alternative measures of efficiency and productivity, such as sales per employee (Elayan et al., 1998). Finally, many studies employ different statistical techniques, such as combined regression methodologies (Bruton et al., 1996; Kang and Shivdasani, 1997; Krishnan and Park, 1998; Mentzer, 1996), analysis of mean differences, comparing groups (profitability of the companies that implemented downsizing and those that did not), or comparing different moments of time, such as before and after the implementation of downsizing (Chen et al., 2001; De Meuse et al., 1994; Suárez-González, 1999).

4. Data and Sample

Our sample of Portuguese firms was collected from the European financial electronic database AMADEUS. We compare two groups of firms: those that did downsizing (DOWNSIZER) and those that did not (NON-DOWNSIZER). Prior to 1993, the database did not report variation in the workforce of firms.

The DOWNSIZER firms laid-off 5% or more of their workforce on at least one occasion in a given year, similar to Morris et al., (1999), Suárez-González (1999), and Suárez-González (2001). The 5% ensures that the downsizing decision was significant and permanent, and not a temporary fluctuation in the number of employees (Suárez-González, 1999). The NON-DOWNSIZER firms in contrast never laid-off 5% or more of their employees during this period.

We selected all the firms that had at least 50 employees (Carswell, 2005), thus capturing medium and large firms. An initial sample of 18,359 Portuguese firms was obtained. Firms without any employee data for the 1993–2005 period were eliminated, as well as those that did not have any data on variation. We obtained a final sample of 1,357 firms. Of these, 804 were NON-DOWNSIZER (59%) and 553 were DOWNSIZER (41%) firms that had downsized their workforce by 5% or more at least once in this 13-year period. It is worth noting that the same firm may downsize more than once. In fact, the 553 DOWNSIZER companies downsized 834 times. The year 2003 had the highest number of downsizing occurrences, 122 cases, which follows an economic recession in Portugal, with the GDP falling about 1.1%,

according to the Organization for Economic Cooperation and Development (OECD, 2008).

Table 1. Methodological Characteristics of Profitability Studies

Author(s)	Sample	Data source	Downsizing identification	Accounting dependent variable(s)
De Meuse et al. (1994)	1987–1991/ USA	Secondary	Announced layoffs as a percentage of total employees	Profit margin, ROA, ROE, Asset turnover
Mentzer (1996)	1986–1994/ Canada	Secondary	Percentage change in the number of employees	Percentage change in net income, ROA, Percentage change in sales
Cascio et al. (1997)	1980–1994/ USA	Secondary	Percentage change in the number of employees (5%)	ROA
Kang & Shivdasani (1997)	1986–1990/ Japan and USA	Secondary	Layoffs	ROA, Industry ROA, Total debt/assets, Bank debt/assets
Elayan et al. (1998)	1979–1991/ USA	Secondary	Announcements	ROE, Sales/Employee, Net income/Employee
Krishnan & Park (1998)	1980s/ USA	Secondary	Percentage change in the number of employees in a time period	ROS
Suárez González (1999)	1989–1994/ Spain	Secondary	Percentage change in the number of employees (5%)	ROS, Labor productivity
Espahbodi et al. (2000)	1989–1993/ USA	Secondary	Percentage change in the number of employees (2%)	Pretax operating cash flows, Book value of lagged total assets
Chen et al. (2001)	1990–1995/ USA	Secondary	Announcements	ROA, Operating earnings/sales, Cost of goods sold/sales, Sales and administrative expenses/sales, Sales/employee, Capital expenditure/employee
Chalos & Chen (2002)	1993–1995/ USA	Secondary	Announcements in database	ROA, Sales, Cost of Goods
Morrow et al. (2004)	1980–1995/ USA	Secondary	Cost retrenchment and Asset retrenchment	ROI, Tobin's Q, Market-to-book ratio
De Meuse et al. (2004)	1987–1998/ USA	Secondary	Magnitude of the announced layoff divided by total number of employees in the company	Profit margin, ROA, ROE, Asset efficiency, Market-to-book ratio
Yu & Park (2006)	1997–1999/ Korea	Primary (survey) and secondary	Survey	ROA, Asset turnover, Operating income per employee, Sales per employee, Value added per employee
Carswell (2005)	1997–1999/ New Zealand	Primary (survey)	Survey	Profit margin, ROA, ROE, Sales per employee
Farrell & Mavondo (2005)	Australia	Primary (survey)	Survey	Customer retention, New product success, Sales growth, ROI, Overall performance

Downsizing firms were mainly found in services (297 firms) whereas the non-downsizing counterparts were found mainly in manufacturing (403). Downsizing firms were mainly medium-sized (380), similar to the non-downsizing firms (615).

5. Variables

Downsizing. There are two major groups of studies using two types of downsizing measures. Several studies employ "announced layoffs" (De Meuse et al., 1994; De Meuse et al., 2004; Wertheim and Robinson, 2000). They assume that it is an intentional action taken by managers, and that it will be undertaken according to what was previously announced. Other studies use the percentage of reduction in employment level (Suárez-González, 1999; Vicente-Lorente and Suárez-González, 2007). Given that not all announced downsizings are subsequently implemented following the announcement characteristics, and sometimes (perhaps due to legal interventions) they do not take place at all, we measured downsizing as the percent reduction in the employment level: $(\text{employees}_n - \text{employees}_{n-1})/\text{employees}_{n-1}$. If the reduction was 5% or more, we label the firm as a DOWNSIZER.

Profitability/financial performance. We used two common measures of profitability. The ROA looks at profitability in relation to the dollars invested in a firm:

$$ROA = \frac{\text{Profit or loss before taxation}}{\text{Total assets}} \times 100 .$$

This measure has been used in several previous studies (Carswell, 2005; Cascio et al., 1997; Chalos and Chen, 2002; Chen et al., 2001; De Meuse et al., 1994; De Meuse et al., 2004; Mentzer, 1996; Yu and Park, 2006).

We also consider the profit margin (PM), which directly reflects the cost of producing each dollar of sales:

$$PM = \frac{\text{Profit or loss before taxation}}{\text{Operating revenue}} \times 100 .$$

Several authors also use both measures simultaneously (Carswell, 2005; De Meuse et al., 1994; De Meuse et al., 2004).

6. Results

We conducted a multivariate analysis of variance to analyze the downsizing predictors and effects on profitability measures (ROA and PM) for the final sample. Two main analyses were performed. First, we analyzed the cross-sectional effects, comparing the DOWNSIZERS with the NON-DOWNSIZERS in a given year with respect to their mean profitability measures, in the year before the downsizing event ($t-1$), and up to two years following the downsizing event ($t+1$ and $t+2$).

Second, we also analyzed the longitudinal effects for the DOWNSIZERS, comparing their mean profitability measures from the year prior to downsizing ($t-1$) with the year of the occurrence (t) and the two following years ($t+1$ and $t+2$).

Table 2 reports the results. There are significant differences in the profitability ratios of DOWNSIZERS and NON-DOWNSIZERS in the year prior to downsizing. We may conclude that these differences in ROA and PM have a pattern: DOWNSIZERS have lower financial ratios than NON-DOWNSIZERS, and these poorer performing firms are probably more prone to downsize their workforce in the future as a possible strategy to overcome financial hazards. These results rationalize the downsizing made in year t, supporting Hypothesis 1. Thus, examining the ROA of DOWNSIZERS compared to NON-DOWNSIZERS in year t, we conclude that downsizing may be a reaction to lower performance.

DOWNSIZERS always have lower performance ratios than their counterparts (except for PM in 1994), although these differences are not always significant. Thus, DOWNSIZERS maintain their underperformance with respect to NON-DOWNSIZERS in the downsizing year. In a post hoc test we compared DOWNSIZERS and NON-DOWNSIZERS for the two years after the downsizing. The sign is in the expected direction but it is not generally significant (Table 2).

Table 2. Cross Effects on ROA and PM for Downsizers and Non-downsizers

Year t	Variable	$t-1$	t	$t+1$	$t+2$	Year t	Variable	$t-1$	t	$t+1$	$t+2$
1994	ROA	–	–	–	–	1994	PM	+	+	–	–
1995	ROA	–	–	+	–	1995	PM	–	–	+	+
1996	ROA	–*	–*	–*	–	1996	PM	–*	–*	–	–
1997	ROA	–*	–	–	–	1997	PM	–*	–	–	+
1998	ROA	–	–*	–*	–	1998	PM	–	–*	–	–
1999	ROA	–*	–*	–*	–*	1999	PM	–*	–	–*	–
2000	ROA	–*	–*	–	–	2000	PM	–*	–*	–*	–
2001	ROA	–*	–*	–	–	2001	PM	–*	–*	–	–
2002	ROA	–*	–*	–	–	2002	PM	–*	–*	–	–
2003	ROA	–*	–*	–	–	2003	PM	–*	–*	–	–
2004	ROA	–*	–*	–	NA	2004	PM	–*	–*	–	NA
2005	ROA	–	–	NA	NA	2005	PM	–	–	NA	NA

Notes: + (–) denotes higher (lower) mean value of downsizers with respect to non-downsizers. * denotes significance at the 5% level. NA indicates that no data are available.

Hypothesis 2 proposes improved financial performance after downsizing. We test this hypothesis in the two years following downsizing. For this test, we contrasted only the performance of DOWNSIZERS to check whether there was any significant improvement in the two years after the downsizing.

The results (Table 3) do not support Hypothesis 2. Although results were generally in consistent direction, the tests were non-significant (except for PM_{t-1} compared with PM_{t+1}). Hence, we may conclude that PM may have a short-term positive effect but that is not permanent.

Table 3. Longitudinal Effects on ROA and PM for Downsizers

Year	Variable	t	$t+1$	$t+2$
$t-1$	ROA	–	+	+
	PM	+	$+^{*}$	+

Notes: + (–) denotes higher (lower) mean value with respect to year $t-1$. * denotes significance at the 5% level.

7. Discussion

Over the past two decades many firms worldwide have resorted to downsizing despite the absence of conclusive evidence concerning its impact on performance. However, most studies are US-based, and the available evidence for non-US contexts is scarce and warrants additional research. Indeed, to the best of our knowledge, this is the first study examining predictors and effects of downsizing among Portuguese firms.

Over the period 1995–2006, almost 107,000 Portuguese workers have been laid-off from 941 companies according to the Portuguese State Office for Employment and Labor Relations. Layoffs have been frequent even in high-technology firms, such as subsidiaries of the North American Alcoa Fujikura in the automotive cable industry, which laid-off 480 employees in February 2007, and Delphi, which laid-off 500 employees also in 2007. Yazaki Saltano announced the layoffs of 533 employees in 2006, and Lear International announced layoffs of 3,000 employees all over the world, including the Portugal plant, in 2008. These are strong indicators that the Portuguese situation regarding downsizing is indeed topical.

In this study, we review evidence from the literature and empirically examine a sample of 1,357 Portuguese firms. With this research we are able to present a pioneer investigation into the Portuguese context, which has been highly affected by the downsizing trend. We find that the realities of downsizing strategies, possibly in response to market shocks, is ill-understood and warrants additional research. It is worth pointing out that downsizing strategies may be deployed in diverse forms (Greenwood et al., 2010), and its impact on performance may depend on the form adopted. In this regard it would be informative to learn what downsizing strategies actually mean in the context of Portuguese firms and whether and how these strategies go beyond layoffs. Moreover, it is important to assess the long-term consequences of the downsizing strategies deployed, i.e., through a longitudinal study following the performance of firms. In this study we are unable to find significant post-downsizing positive effects.

We find strong support that reactive downsizing is still a common motivation. There are noticeable differences in ROA and PM measures: DOWNSIZERS have lower financial ratios than NON-DOWNSIZERS, and these poorer firms probably are more prone to downsize their workforce in the future. These results support the downsizing made in the base year, supporting Hypothesis 1. Our profitability variables, ROA and PM are consistency lower prior to and in the years of downsizing.

We do not find conclusive evidence of improving performance after downsizing using ROA and PM measures. Our results suggest that the improvement in financial performance sought by downsizers probably did not unfold as expected. Firms that laid off employees do not show significant financial improvements when compared with those firms that did not reduce their workforce. Rather, the results suggest that firms that laid off employees still underperform when compared to other firms, although in some cases statistical significance is not reached.

With respect to the longitudinal effects for downsizers, the results do not completely support Hypothesis 2 due to non-significant differences. We may conclude that PM has some positive effect but it may not be permanent, given that in the second year after downsizing the coefficients are not significant. This result is consistent with that of Wayhan and Werner (2000), where workforce reductions significantly improved subsequent financial performance, particularly in the short term, but inhibited long-term adaptability (see also Cameron, 1994).

This study contributes to the debate on the effects of downsizing as an actual strategy to restructure and turnaround poorly performing firms. In addition, we diminish the European gap in empirical research on the rationale for deploying a downsizing strategy. Our results suggest that financial distress before downsizing led companies to downsize. However, according to our results, the Portuguese firms that implemented layoffs did not completely reach their main goal of improving profitability measures. It seems that economic reasons, by themselves alone, cannot support these practices.

For managers we recommend a clear understanding of what is expected of the downsizing strategies. If downsizing-related paths are undertaken in conditions of severe financial distress, it is likely that firms will not have the resources to redesign and reengineer their operations beyond indiscriminate cost-cutting actions. Perhaps the non-significant findings on the long-term performance is due to a lack of a coherent set of measures that may permit a more profound restructuring. For managers it is also important to understand that downsizing is not a remedy for all evils and indeed the potential cost savings may be easily offset by demotivation of the labor force, the exit of key employees, degraded reputation, lower scale operations, and so forth.

Managers should be cautious when engaging in downsizing as a response to environmental pressures. In fact, it is essential to figure out whether downsizing may solve the existing hardships. In many instances the environmental changes may actually reflect a declining industry or long-lasting market changes. In these instances a strategic response may entail deploying other strategies. Following

Coucke et al. (2007), it may be that different modes of restructuring may be more appropriate under different conditions. Future research may delve into how different modes of restructuring may be best employed and have a greater impact in improving firm performance.

The managerial implications from this study may be extended to the need to use downsizing and other restructuring practices in firms' global plan that not only affects workforce size but also that can be combined with other practices. Downsizing is not an underexplored terrain for Portuguese managers, and layoffs appear to be a common management practice to reduce costs, but the real consequences of these practices is poorly understood. Our results indicate that downsizers do not improve their profitability measures; hence, it is crucial to explore the actual modes under which they have been deployed.

A more thorough view of downsizing and its impact warrants additional research in a number of paths. While we used a limited set of performance measures, future research may use different, non-accounting-based performance measures, such as productivity, while taking into account the long-term effects. Downsizing also has implications on human resources that should not be neglected. Using measures derived from strategic management research that evaluate human capital outcomes may be desirable. The effect of downsizing on stock market values also remains unclear and may be taken up in future research. It would be interesting, for instance, to complement the institutional and economic arguments with a socio-cognitive perspective. The contemporary environmental turmoil faced by many firms around the world arguably points to a likely trend in the deployment of downsizing practices. For managers and researchers, an accurate assessment of what it means to downsize and its true effects will require a deeper look inside the organizations to capture the internal dynamics and the interfaces with other firms and agents in the external milieu.

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