

THE UPSIDE OF DOWNSIZING

WORKERS FEAR IT. Firms ponder its benefits. Financial markets celebrate it. Some politicians want government to shield us from it. Media portray it as the scourge of the 1990s. *Downsizing.*

Even in an economic recovery moving through its sixth year, Americans can't escape the reality that some workers are still losing their jobs. The numbers making the headlines are often big enough to provoke anxiety: 74,000 jobs cut at General Motors, 60,000 at IBM, 50,000 at Sears, 40,000 at AT&T.¹ In the 1990s, hundreds of other companies have announced layoffs large enough to command at least a few inches in the *New York Times*, and many more jobs have vanished without fanfare. A recent U.S. Department of Labor survey found that companies dismissed 17.4 million workers from 1990 to 1995.²

Our instinct is to interpret job losses as a sign of failure—something wrong with the system or something wrong with us. To some people, downsizing signifies a breakdown in the loyalty that once held company and worker

together. To others, it signifies personal defeat, a verdict that we, as workers, are no longer valuable human resources. Viewing layoffs as a malfunction, some of capitalism's critics go so far as proposing that government reward "good" companies that don't cut jobs and punish "bad" ones that do with taxes, sanctions and regulations.

Such views are incomplete, if not wholly incorrect and dangerous. Layoffs aren't a sign of failure, not for the economy, not even for most workers. Job losses hurt American workers and their families, no doubt about that, but downsizing cannot be understood apart from a broader view of the economy's health and well-being. More often than not, labor force turnover reflects positive market forces at work. Companies develop new or cheaper products, entrepreneurs pursue opportunities, factories and offices become more productive. In the process, new jobs inevitably replace old ones. This is how the economy grows: through a relentless process of turmoil, a continuous "churn," what economist Joseph Schumpeter called *creative de-*

struction. One of the great ironies of a free enterprise system is that the bad news of job losses is part and parcel of the good news of rising living standards.

Downsizing in Microcosm Smaller but More Productive

A microcosm of recent downsizing will help illustrate what's happening behind the handwringing and headlines. Table 1 presents a sample of 10 large U.S. companies that shed labor in the 1990s, each mentioned time and again in accounts of America's layoffs.³ All told, they jettisoned almost 850,000 workers between 1990 and 1995. Every one of these companies employs fewer workers today than five years ago, so the layoffs appear to be permanent. These companies, and others like them, are the ones critics of downsizing wag their disapproving fingers at and scold as hard-hearted and uncaring.

Beyond the lost jobs, however, another set of facts, typically overlooked,

Table 1
Less Equals More

Downsizing and Productivity Among the Top 10 Corporate Job Cutters

Company	1990			1995			Jobs cut	Productivity gain or loss (-), 1990-95 (Percent)
	Sales*	Employees	Stock price	Sales*	Employees	Stock price		
Sears	\$ 65,263	460,000	\$ 25 ³ / ₈	\$ 35,181	275,000	\$ 39	185,000	-10.3%
IBM	80,475	373,816	113	71,940	252,215	91 ³ / ₈	121,601	28.1
K-mart	37,405	370,000	14 ¹ / ₄	34,654	250,000	7 ¹ / ₈	120,000	31.6
General Electric	68,111	298,000	28 ³ / ₄	70,028	222,000	72	76,000	32.2
General Dynamics	11,872	98,100	12 ⁵ / ₈	3,544	27,700	59 ¹ / ₈	70,400	5.6
Digital Equipment	15,257	124,000	54 ⁷ / ₈	13,813	61,700	64 ¹ / ₈	62,300	59.9
McDonnell Douglas	19,065	121,190	6 ¹ / ₂	14,332	63,612	46	57,578	35.9
Boeing	32,176	161,700	45 ³ / ₈	19,515	105,000	78 ³ / ₈	56,700	-6.8
General Motors	146,936	761,400	34 ³ / ₈	168,829	709,000	52 ⁷ / ₈	52,400	21.0
GTE	21,424	154,000	29 ¹ / ₄	19,957	106,000	43 ⁷ / ₈	48,000	30.3
Total	\$497,984	2,922,206	100**	\$451,792	2,072,227	\$230 ³ / ₄ **	849,979	24.7

NOTES: * Figures are in millions of 1995 dollars.

** Equally weighted index; calculated as $100 \sum_{i=1}^{10} \left(\frac{P_i^t}{P_{1990}^i} \right)$, where P signifies a stock price, i signifies a company and t first equals year-end 1990, then 1995.

SOURCES: Compustat, *Fortune* (various issues), Dow Jones News/Retrieval Service.

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Man acquires wealth in proportion as he puts his labor to better account.

— Frederic Bastiat

The creation of new capital always...releases...labor. Its actual effect [though] is not to make jobs scarce, but to free men's labor for other jobs.

— Frederic Bastiat

Table 2
Dialing for Dollars Pennies

Downsizing and Productivity in Long-Distance Communications

	1970	1994	No progress*
Long distance calls	9.9 billion	83.4 billion	83.4 billion
Switchboard operators	421,000	176,000	3,564,607
Calls per operator per day	64	1,300	64
Operators as a share of the labor force	.51%	.14%	2.85%
Work time required to buy a five-minute, coast-to-coast call	40.3 minutes	7.0 minutes	40.3 minutes

* 1994's volume of calls at 1970's level of productivity.

SOURCES: Federal Communications Commission (1994-95); U.S. Department of Labor, Bureau of Labor Statistics (1996a).

deserves equal attention. After adjusting for inflation, the collective output of all 10 firms was down 9.7 percent. The companies used 34.4 percent fewer workers, however, so output per worker surged nearly 25 percent, or 5 percent a year. Their performance greatly exceeded the economy's average annual productivity gain of roughly 1.5 percent.⁴ Rising productivity plays a vital role in rising living standards, so it's incongruous to celebrate productivity gains yet denigrate downsizing.

That's not all. With the exceptions of Sears and Boeing, the companies in Table 1 emerged from downsizing more competitive, and thus more likely to survive. Those who want to identify "good" firms and "bad" firms should take note: if firms don't survive, *nobody* has a job.

More often than not, the wisdom in the hard-nosed decision to downsize wins approval on Wall Street as companies become more profitable and stock prices rise. Indeed, stock price gains among the companies listed in Table 1 averaged over 130 percent from 1990 to 1995, as compared with only 86 percent for the S&P 500 companies overall.⁵ That's half again as much, a gain that surely pensioners and other investors would celebrate.

And what about the 850,000 employees cut by the 10 companies shown in Table 1? In such a complex economy,

of course, there's no way of tracking what happened to each individual worker, but the vast majority most likely found jobs elsewhere. Clearly, this isn't a heroic assumption: today's unemployment rate of 5.2 percent is below that of 1990, and the economy has added nearly 11 million new jobs, net of those destroyed, in the past five years. Opportunities are out there, and many displaced workers are moving to new jobs in sectors that need labor to expand.

As displaced workers take new jobs, they add to U.S. economic output. A precise calculation of their contribution isn't possible, but a reasonable estimate might come from the average output of an American worker—roughly \$58,000 a year. The 850,000 workers recycled from downsizing just 10 firms could increase the country's GDP by \$49 billion, not a bad bonus hidden in the usually glum assessments of layoffs.

Downsizing in Microcosm Problem or Progress?

"Downsizing" may well be the new buzzword for layoffs. But it's something that's been going on for centuries. In 1800, for example, it took nearly 95 of every 100 Americans to feed the country. In 1900, it required 40. Today, it takes just three. The downsizing of

agriculture, however, hasn't left the country hungry. Quite the contrary, the United States enjoys agricultural abundance—and much more. The workers no longer needed on the farm are available to provide new homes, computers, pharmaceuticals, appliances, medical assistance, movies, financial advice, video games, gourmet meals, and an almost dizzying array of other goods and services. The country today would have much less if farming had not endured one of history's most drastic downsizings.

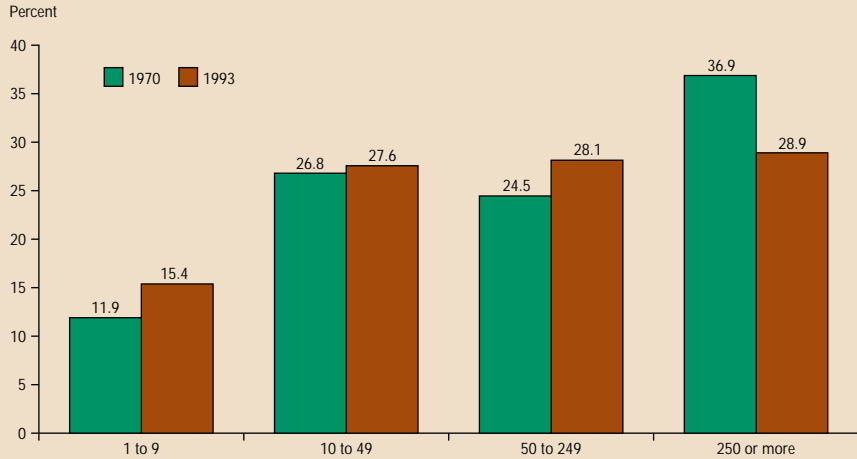
Most of the exodus from farming occurred generations ago, so today's Americans have scant memory of the dislocations it caused. What we have instead is the abundance that comes from allowing the churn to deliver the bounty of higher productivity, wherever and whenever it might occur.

Telephone service provides another rich example of how the economy as a whole benefits as some workers lose their jobs (*Table 2*). In 1970, the industry employed 421,000 switchboard operators, and Americans made 9.9 billion long distance calls. By 1994, Americans rang up 83.4 billion long distance calls. Yet new switching technology allowed telephone companies to downsize this segment of their business to 176,000 operators.⁶

The telecommunications industry could do more with less because a surge in productivity was under way. In 1970, the industry handled only 64 calls a day for every operator. By 1994, the figure had jumped to 1,300—a staggering gain. Without the boost in efficiency, today's volume of long distance traffic would require 3.6 million operators, or 2.9 percent of our labor force, instead of the 0.14 percent it actually takes.⁷ Americans would be worse off in two ways: we would lose the goods and services 3.4 million workers now produce elsewhere in the economy. And we would pay six times as much for our long distance telephone calls.⁸

Chart 1 Small Is In

Percentage of Employees in Establishments by Employee Size



SOURCE: Bureau of the Census, *County Business Patterns*, various issues.

Viewed in macrocosm and with the benefit of hindsight, it is easier to see that downsizing is simply conservation—recycling of the economy's valuable labor resources.

Rightsizing for the '90s

Shedding labor allows companies to adapt to changes in the marketplace. More often than not, downsizing is a matter of sheer survival. Companies with surplus labor will usually have higher production costs and risk losing business to "lean and mean" competitors that can lure away customers with lower prices. Market discipline—in effect, consumers' scrutiny—pushes relentlessly at companies, forcing them to economize on resources, including labor.

Each company must determine its own "right" number of employees, but there's evidence that average firm size has been shrinking in most industries. In effect, the whole economy has been downsizing.

From the early 1960s through the '70s and until 1980, the average size of a company grew—from 13.0 employees

in 1962, to 16.3 in 1970 and 16.5 in 1980. At the peak in 1970, roughly 37 percent of Americans worked in firms of 250 or more employees (*Chart 1*). In that era, bigger was better. In the past decade or so, however, the trend has gone the other way. The average number of employees per firm slipped to 14.8 in 1993, with only 29 percent of workers employed by firms of 250 or more.⁹

Downsizing has suited a broad spectrum of industrial categories—manufacturing; mining; construction; agriculture; wholesale trade; finance, insurance and real estate (FIRE); and transportation, communication and public utilities (TCPU) (*Chart 2*). Average firm size has continued to grow in only two broad sectors. Retail trade went from 12.3 workers in 1980 to 12.7 in 1993. Companies in the catchall category called "other services," which includes health care, entertainment and information industries, expanded from 11.3 to 14.1 employees, on average.

Why are companies getting smaller? One factor might be the computer, an innovation that's touched many industries.¹⁰ These tools, hard to find inside any firm two decades ago, are now

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almost ubiquitous. In fact, half of American workers now use computers on the job. Becoming less expensive and more powerful as they've spread through the economy, computers allow people to work easier and faster than ever before. With a computer, a secretary can quickly revise and print the boss' correspondence (or workers can do their own), reducing the work for a typing pool. Using hand-held devices, salespeople can submit orders with a keystroke or two, cutting the need for personnel to process paperwork. In steel mills, automobile plants and other factories, computers control the production process, so one technician can now do what once took dozens of workers. And with the advent of the Internet, individual workers are becoming more able every day to locate and download information that once might have taken a small staff.

The computer might also help explain why retail trade and many other services aren't showing a decline in average firm size. More than mining or manufacturing, these businesses rely on one-on-one contact with customers, a task ill-suited to the computer. As a result, firms in these sectors don't get

the same benefits from trimming employment.

A Lesson from the EC

No one can guarantee that every displaced worker will readily find a good-paying job, but unemployment in the United States is, for most workers, relatively brief. Job openings average roughly 525,000 per month, more than double the typical monthly growth of the labor force.¹¹ Half of those who lose their jobs find another within six to eight weeks; two-thirds find one within 14 weeks; and seven-eighths within six months. Recent studies show that most workers replace their old job with a new one that pays as well or better.¹²

Even if unemployment is brief, it is unsettling, and society will always be tempted to look for ways to avoid layoffs. Job-saving policies, however, aren't the way to make Americans better off. An economy will remain vibrant and forward-moving *only* if it can redistribute its labor resources in response to changes in demand and advances in technology. Efforts to protect jobs by short-circuiting the churn

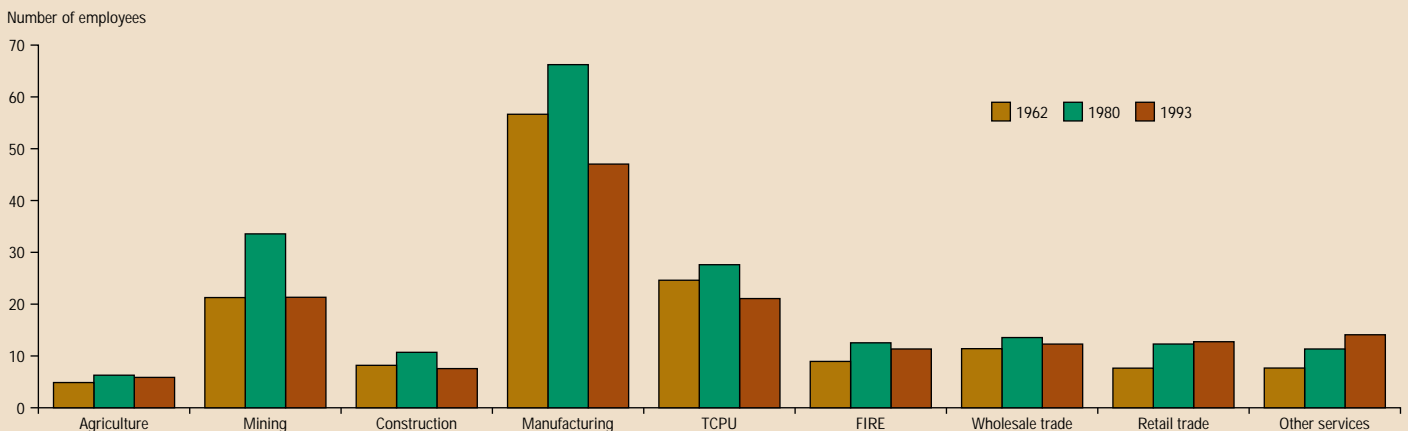
invariably produce higher unemployment, slower job growth and lower productivity growth in the long run.

A comparison between the United States and the European Community bears this out. While America's labor market remains relatively unencumbered, many EC nations, hoping to thwart job losses, have saddled employers with burdensome rules on when and how workers can be dismissed. The red tape and reproach involved in cutting jobs makes firms wary of hiring new workers in the first place. With few new opportunities opening up, workers cling to existing jobs. As a result, too many of Europe's labor resources remain frozen, and companies cannot respond quickly and aggressively to changes in the market.

The EC may have managed to "save" a few existing jobs, but at a high cost in economic performance. Growth is slower. Productivity gains are meager.¹³ Most telling, the effort to preserve jobs has largely hindered prospects for workers. The United States has added 11 million jobs since 1990, a gain of 9 percent, while the EC has created 5 million, or just 3 percent. For most of this decade, unemployment in the EC

Chart 2
Reversal of Trend

Employees per Firm and Industry



SOURCE: Bureau of the Census, *County Business Patterns*, various issues.

There is not a tool, an implement or a machine that has not resulted in a decrease in the contribution of human labor. Labor is not made permanently idle [though]; when replaced in one special category... it turns its attack against other obstacles on the main road to progress.

—Frederic Bastiat

has been at 10 percent or more, almost double the U.S. rate. Worse yet, over 5 percent of the EC's labor force has been out of work for a year or more. In the United States, the figure is less than three-fourths of 1 percent.

Enduring the Churn America's Real Source of Strength

Some may say that downsizing has "gone too far."¹⁴ There's no denying the upheaval caused by letting economic forces work. Yet we cannot ignore the much greater cost that would be imposed by forcing companies to maintain the status quo. To society, the valuable resource clearly is the worker, not an existing job. Efforts to preserve jobs may well succeed, but these policies will rob the economy of its vitality and deprive this generation and future ones of the progress that lifts living standards. Indeed, what makes the American economy so strong is our willingness to endure the churn and let it enrich our economy over and over again.

— W. Michael Cox
Richard Alm

Notes

- ¹ These numbers refer to layoff announcements, not to the total jobs these companies cut from 1990 to 1995, which have been much greater.
- ² Data are from the U.S. Department of Labor (1996b).
- ³ By and large, the companies reviewed here reduced their labor force through layoffs rather than divestitures, although this distinction is not a critical one. Restructuring by any means—downsizing, divestiture, merger, acquisition, leveraged buyout and so forth—will typically have both employment and output effects for the firm, and thus can be investigated in terms of its effect on productivity.
- ⁴ *Productivity* in this study is calculated as output per worker, rather than output per hour, as typically measured.
- ⁵ Moreover, at 3.13 percent, the dividend yield for the 10 stocks listed

in Table 1 averaged more than that (2.88 percent) for the S&P 500 companies over the 1990–95 period. Reinvesting all dividends, a \$100 investment at year-end 1990, spread equally across each of the 10 firms listed in Table 1, would have grown to \$269.16 (an average annual rate of 21.9 percent), as compared with only \$214.95 (16.5 percent annually) for an S&P 500 investment.

- ⁶ At the same time jobs have been pared from this segment of the telecommunications industry, they have been added to others. Employment in the cellular telecommunications segment, for example, increased from 15,927 at the beginning of 1990 to 68,165 by the end of 1995, for a net gain of 52,238 jobs in six years.
- ⁷ Hourly wages of telephone operators also grew at a pace one-third to one-half better than average during the 1990s. From 1990 to 1995, operators' hourly wages increased at an average rate of 4.04 percent annually, as compared with only 2.66 percent for all other clerical workers and 2.91 percent for hourly employees as a whole.
- ⁸ Figures are based on the amount of work time required for a typical manufacturing employee to afford a five-minute daytime residential call from New York to Los Angeles, calculated as the price of the call divided by average hourly manufacturing wages. For 1970, this calculation is $(\$2.25/\$3.35) = 0.67$ hours = 40.3 minutes, and for 1994 the figure is $(\$1.40/\$12.06) = 7.0$ minutes. Based on AT&T's new One Rate Plan (15 cents anytime, anywhere), the 1996 work time figure is 3½ minutes.
- ⁹ Data are the most recent available.
- ¹⁰ One other important factor is the increasing tendency for firms to outsource many of their functions (such as payroll and accounting) to smaller firms that can do them more efficiently.
- ¹¹ Job openings data are monthly averages for 1993–95 and are the most recent available.
- ¹² See Council of Economic Advisers (1996).
- ¹³ GDP and productivity (output per worker) growth averaged 1.5 percent and –0.1 percent in Europe over the 1990–95 period, while in the United States, growth averaged 2.5 and 1.5 percent, respectively.
- ¹⁴ See Reich (1996).

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