Downsize this? Cutbacks 1, Innovation 0

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When profits slip, lay off employees. It's typical, if nothing else. In the auto industry, for example, DaimlerChrysler lost US$1.48 billion in 2006 and is now laying off 13,000 workers in North America — 2,000 at the Ontario plants in Windsor and Brampton. The employee downsizing mirrors similar cuts made at Ford and GM over the last two years, and both continue to struggle. Meanwhile, Japan-based Toyota and Honda are expanding and building new plants in southern Ontario. How come they're doing relatively well and the Big Three are failing?

The answer is innovation, or lack thereof. The Big Three have for too long focused on "luxury" gas-guzzlers, whereas Toyota and Honda, sensing a market change, have more quickly shifted gears toward fuel efficiency, hybrid technology and longer life spans. But the automakers aren't the only guilty ones.

Steven H. Appelbaum, a professor of management at the John Molson School of Business in Montreal, says downsizing wasn't always the No. 1 cure-all for CEOs. "Downsizing has become a knee-jerk reaction," he says. "It's short-term thinking and the eventual loser is the company itself, because the surviving employees never reinvest in the company."

And without employee investment, innovation dies. Companies where employees are secure retain loyalty, or what Appelbaum terms "organizational citizenship behaviour," and so the company never faces a break in innovation. "Downsizing kills loyalty because, the Monday morning after the layoffs, everyone wonders when it's going to happen to them," says Appelbaum. "Panic spreads throughout the office. The whole culture switches over to protection mode, and that's the end of creativity and generally the end of the organization."

That's not to say downsizing is always a bad decision; sometimes cuts are necessary. However, before making any decision, especially to lay off employees, you must examine your infrastructure, says Ajar Chadha, an analyst with PricewaterhouseCoopers. He describes infrastructure as being composed of four areas: people, processes, technology and facilities. When that's done, plan a strategy. "The key is to demonstrate decisiveness, that you're in control, and that you're being fair to those people leaving. This is how you get buy-in and, eventually, innovation."

Open communication can also breed solutions, such as employees who want to retire early, job share or work part time. "These are people who are self-selecting themselves out of the company, which means there's no lingering bad taste or rapid depletion of infrastructure," says Appelbaum. "Here downsizing doesn't have a negative connotation

and innovation isn't affected. The problem is most executives aren't smart enough to ask because they don't care. This is bad management that will bite you in the end, because it's your employees who ultimately call the shots when it comes to innovation and profitability."

Downsizing is dirty work, but some companies get it right, returning as more efficient, more focused companies. Take IBM: Back in 1991, it laid off 63,000 employees. At the time, the company was your classic large corporation: dozens of managers coordinating isolated teams. All direction came from the top. Productivity suffered, and layoffs ensued. But rather than repeat the same error, IBM altered its structure. "IBM changed from an hierarchical organization to cross-functional teams," says Appelbaum. These teams can anticipate change and make decisions without having to ask upper management. They're more innovative because the company trusts them and invests in them. "And the more cross-functional teams, the less people you have making decisions to chop people."

Closer to home, Algoma Steel(TSX: AGA)is a company that once flirted with bankruptcy, weathered several downsizings and in 2005 emerged the most efficient integrated steel manufacturer in North America, earning US$131 on every ton sold — nearly twice as much as the No. 2 steelmaker, U.S. Steel.

Algoma CEO and president Denis Turcotte eliminated two layers of management between executives and the shop floor. This meant 600 layoffs, but Turcotte's plan went deeper than just job cuts. Shareholders, including employees, receive cash distributions when things go well, so there's incentive to remain innovative, and all employees — not just execs — are encouraged to share money-saving ideas.

"These are companies that made real changes instead of staying locked in an existing paradigm," says Bill Greenhalgh, CEO of Human Resources Professionals Association of Ontario. Greenhalgh also points to 3M and GE as companies that never face mass layoffs and — no surprise — remain innovative.(GE spends about US$14 billion each year on marketing and R&D, which translates into consistent profits because it's anticipating where the market is moving.)

"They focus entirely on innovation, so there's never a moment when someone wakes up and says, 'Oops, we need to take a hit.' GE is like management graduate school."