Tilburg University

Policy Brief

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Innovation, downsizing and labour flexibility

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http://www.tilburguniversity.edu/dfid-innovation-and-growth/

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Firms increasingly engage in downsizing their labour force with a view to increase their efficiency and to cut costs. However, recent research in developed countries found that downsizing firms do not always enjoy the desired increase but rather frequently experience a decrease in organizational performance, efficiency and profitability: Downsizing is frequently associated with increased feelings of job insecurity among the remaining employees, resulting in lower levels of motivation and commitment and ultimately a decrease in innovative behaviors and performance. Given the frequent use of downsizing, the importance of innovation for firm competitiveness and the negative impact of the former on the latter, researchers and practitioners alike are intrigued by the question how firms can remain innovative despite undergoing downsizing.

Taking the special importance of innovation for developing countries into account, the researchers assess the effect of different forms of labour flexibility on innovation during downsizing in a quantitative study across nine developing countries in South Asia and Africa. As such, the research team broadened the focus from the thus far primarily European and American context to emerging economies. In answering the question whether labour flexibility can be a means to lessen the negative effect of downsizing on innovation, the researchers focus on process innovation. Downsizing poses a special challenge for process innovation given its particular dependence on knowledge exchange and collaboration across firm networks and technology institutions, which suffer immensely during downsizing. Similarly, the focus on the predominant organizational form of small and medium enterprises (SMEs) in developing countries offers an interesting research setting: For reasons associated with proximity, interpersonal links in SMEs are much stronger than in large companies, which can be expected to additionally amplify the negative effect of downsizing on innovation. The original working paper is entitled *‘Success belongs to the Flexible Firm: How Labor Flexibility Can Retain Firm Innovativeness in Times of Downsizing’* (2017) by Daniela Ritter-Hayashi, Joris Knoben and Patrick Vermeulen[1]. ‘

Research findings

The study focuses on process rather than product innovation because downsizing poses particular challenges for the latter given its dependence on knowledge exchange and collaboration across firm networks and technology institutions. The results of the study suggest that downsizing a firm’s workforce negatively impacts process innovation in SMEs in emerging nations. However, the study indicates that labour flexibility can be a way for firms to overcome the innovation challenges associated with downsizing. The researchers find that both numerical flexibility, namely the use of temporary employment, as well as functional flexibility

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[1] The paper is accessible at the project’s website (http://www.tilburguniversity.edu/dfid-innovation-and-growth)

such as employee training, can alleviate the negative impact of downsizing on innovation. Moreover, independent of whether or not a firm is downsizing its workforce, wage and reward flexibity in terms of performance bonuses for managers and employees positively impact innovation regardless of other factors.

Policy implications

Casual work is a common practice in emerging nations, and was regularly observed in the qualitative studies of EIP-LIC, in particular in SMEs with irregular order portfolios. Casual employment in these SMEs involves low-skilled labour as part of the periphery workforce. The fact that casual workers frequently rotate allows them to transport best practices and tacit knowledge from one firm to another. The casual workers usually lack specialised expert knowledge, so the benefit of numerical flexibility does not concern higher level knowledge supporting innovation. SME owners and managers could take both considerations into account in their staffing strategy. Despite the overall lower education and thus knowledge levels in firms, the loss of firm-specific and tacit knowledge associated with downsizing confronts firms with considerable innovation challenges.

Following the research findings, managers of SMEs in developing countries might wish to take functional flexibility into account in their business strategies, because an increasing percentage of employees having received training will positively moderate the relationship between downsizing and innovation. Focusing on the psychological impact downsizing has on the remaining employees, employability as a human resouces management strategy could be a substitute for employment security during downsizing to protect their psychological contract with the firm.

Managers could thus consider functional flexibility as a means to mitigate downsizing's negative effect on innovation. In particular, firms might consider training a core group of staff to distribute existing knowledge among the remaining firm members, to create new knowledge as well as to increase employees' employability.

A final policy or management strategy implication for managers concerns providing performance bonuses. This management practice is highly efficient in the emergent country context. Bonuses also moderate the effects of a high rate of staff turnover, which is considerably higher in emerging compared to developed countries. Wage and reward flexibility can, if designed accordingly, be a means for motivating employees to remain with the firm given the prospect of monetary incentives.

This policy brief is the product of a research project funded by the British Department for International Development (DFID) entitled '*Enabling Innovation and Productivity Growth in Low Income Countries'* (EIP-LIC). The project is implemented by Tilburg University (The Netherlands) and explores SME-level innovation in Low Income Countries (LICs) and factors that contribute to or limit its diffusion. Data collection and research collaborations took place in 10 African and Asian countries (Bangladesh, Ethiopia, Ghana, India, Indonesia, Kenya, Tanzania, South Africa, Uganda and Vietnam). The policy implications of this research are presented in a series of policy briefs, targeted at a broad audience of policy makers within governments, business and development agencies with a view to quantifying research outcomes and promoting evidence-based policy making.