

Since the mid-1990s the number of people being made redundant in the UK at any time has remained at a low and fairly stable level. But with the economy experiencing what is at best expected to be the sharpest economic downturn since the recession of the early 1990s, redundancy is again on the rise.

# The cost to employers of redundancy

To remain viable and maintain profitability in tough times, businesses are looking to increase productivity and cut costs. This can be achieved in a variety of ways but inevitably some businesses will resort to making staff redundant. However, redundancy is itself a significant cost to most organisations and can thus prove to be a false economy. This is particularly true if redundancies are an employer's first resort in difficult times and have to be quickly reversed by renewed hiring when economic conditions improve.

As recession starts to bite, therefore, this Work Audit looks at the latest redundancy indicators and counts the cost of redundancy to employers.

## Redundancies on the rise

Official figures published by the Office for National Statistics (ONS) show the number of people made redundant and the redundancy rate (that is, the number of redundancies per 1,000 employees). Unfortunately, statistically comparable redundancy data are available only back to the mid-1990s, so we can't directly compare what's happening in the emerging recession with previous recessions. What we do know is that at the worst point in the early 1990s recession as many as 400,000 people were being made

redundant each quarter. This number fell as the economy recovered and for a decade to the mid-2000s fluctuated between 150,000 and 200,000 each quarter. From 2004 to early 2008 the number dropped further, fluctuating between 100,000 and 150,000 per quarter.

At the beginning of 2008 the redundancy rate had fallen to 4.4 redundancies per 1,000 employees but is now starting to rise, reaching 6.1 in the three months to September 2008 (the latest period for which data are available at the time of writing, see Table 1). And the rate looks set to rise further in 2009.

The autumn 2008 CIPD/KPMG *Labour Market Outlook* (LMO) survey, conducted by Ipsos MORI in mid to late September 2008, found that one in four employers had contingency plans in place to make new or further redundancies in the following 12 months. A sudden increase in redundancy announcements in the final weeks of 2008 began to indicate that such plans are now being implemented.

## Counting the cost of redundancy

Redundancy is one of the most traumatic events a person will ever experience. Unfortunately, the financial and psychological pain to the individuals affected is not always

**Table 1: Redundancies, level and rates, UK 2006–08 (seasonally adjusted)**

	Level (000s)	Rate
Jul–Sep 2006	137	5.5
Jul–Sep 2007	129	5.1
Oct–Dec 2007	111	4.4
Jan–Mar 2008	111	4.4
Apr–Jun 2008	127	5.0
Jul–Sep 2008	156	6.1

Source: ONS

# Work audit

**Table 2: Formula for counting the cost of redundancy**

$$CR = nR + xH + xT + ny(H+T) + Wz(P-n)$$

where:

**CR** = total cost of redundancy  
**n** = number of people made redundant  
**R** = redundancy payments  
**x** = number of people subsequently hired  
**H** = hiring costs  
**T** = induction/training cost  
**y** = percentage quitting post-redundancy  
**W** = average monthly staff salary  
**z** = percentage reduction in output per worker caused by lower morale  
**P** = number of people employed prior to redundancies

avoidable or indeed sensible to avoid. Organisations often need to restructure to remain competitive or improve their performance – which is why one always observes some level of redundancies, even in overall good times for the economy.

Such redundancies, while painful to those made redundant, may ultimately be good for jobs in the organisation involved and/or the economy at large. In other circumstances, particularly during periods of recession, organisations may need to make people redundant simply to avoid going out of business, or indeed because they do go out of business.

However, while accepting that redundancy is a fact of economic life,

there is a strong business case for doing everything to always make redundancy a last resort. Employers tempted to make people redundant on the assumption that this is the most straightforward way to cut costs are being short-sighted.

There are a number of direct and indirect costs associated with redundancy. These can be incorporated in a formula such as that shown in Table 2.

The elements of the formula include a number of direct financial costs and a number of indirect effects experienced in the form of higher labour turnover and lost output resulting from the impact of redundancy on the morale and engagement of 'survivor' employees.

## **Direct financial costs of redundancy Redundancy payments (R)**

An employee made redundant after at least two years with an employer is entitled to a minimum statutory redundancy payment. The level of payment is based on the employee's length of service, age and weekly pay. R represents the minimum financial cost of redundancy. However, the CIPD/KPMG autumn 2008 LMO survey finds that half of organisations surveyed offer redundancy payments above the statutory minimum. The average redundancy payment is found to be £10,575, though a quarter of employers pay less than £5,000. The average payment ranges from £7,629 in the voluntary/not-for-profit sector to

£8,891 in the private sector and £17,926 in the public sector.

## **Hiring costs (H) and training/ induction costs (T)**

Employers always run the risk of overstating the number of redundancies they need to make. This will occur, for example, where an organisation exaggerates the length or severity of an economic downturn, the risk increasing the earlier into a downturn an employer resorts to redundancy as a cost-cutting measure. In such circumstances the employer will eventually have to rehire workers to restore staffing levels, incurring higher than necessary recruitment costs (H).

The CIPD's 2008 annual *Recruitment, Retention and Turnover* survey report finds that staff recruitment on average incurs a cost of £4,667 per recruit. This figure includes advertising costs and agency or search fees. The cost of recruitment ranges from an average of £553 per recruit for manual workers to £6,000 for managers and professional staff, rising to £10,000 for senior managers and directors.

Employers who find that they have to rehire staff may also discover that they have lost valuable skilled or experienced staff to competitors and thus have to induct and train recruits. This will result in additional initial induction and training costs (T) – which the CIPD's 2008 annual *Recruitment, Retention and Turnover* survey report indicates will amount on average to around £1,133 per recruit.

### Indirect labour turnover and lost output effects

There is a large body of psychological research evidence that suggests that redundancies can cause a decline in morale, motivation, engagement and performance among staff who keep their jobs. The impact of redundancy may also show up in increased levels of employee stress and higher rates of sickness absence.

It is commonly asserted that so-called 'survivor syndrome' has a negative effect on workplace productivity and thus increases the cost to employers of redundancy. A reduction in employee engagement might also result in a higher rate of voluntary labour turnover (the 'quit rate'). And it is possible that an organisation with a reputation for making people redundant may also find it harder to attract the most talented recruits, which might damage longer-term performance.

If redundancy increases the voluntary quit rate, an organisation will incur additional hiring and training costs. The actual cost – shown in the formula by  $ny(H+T)$  – will depend on the percentage of people who quit as a result of other people in their organisation being made redundant.

The value of any lost output resulting from negative psychological effects on survivor employees is shown in the formula by multiplying the reduction in the output of survivors ( $z$ ) by the average earnings of survivors ( $W$ , which is a proxy for the average value of employee output).

It should be stressed, however, that there is a dearth of quantitative economic evidence that clearly and unequivocally translates such negative psychological effects into bottom-line financial impacts. Indeed, some of the psychological evidence is itself equivocal on the impact of redundancy on productivity.

For example, some employees may react to redundancies by working longer hours or working more intensely per hour in an effort to impress their employer and thereby try to reduce their personal risk of being made redundant. By the same token the effect of redundancy on the quit rate may be different if redundancies are made during periods of economic growth (when there are plenty of alternative jobs on offer) rather than during periods of recession. The effect may also differ by category of survivor (the more talented being better placed to quit for alternative employment, whatever the overall state of the economy).

Similarly, any potential impact of survivor syndrome may be fully or partly influenced by the effectiveness with which an organisation manages the redundancy process. Negative impacts can be mitigated by extensive prior consultation, the demonstration of fairness in selecting staff for redundancy, and the provision of support for those made redundant. As

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an illustration of the likely incidence of effective management, the CIPD/KPMG autumn 2008 LMO survey finds that more than two in five employers have a redundancy strategy in place, with around three-quarters offering counselling support or advice to people facing redundancy.

### Applying the cost-of-redundancy formula

The precise costs of redundancy for an individual organisation will of course depend on the specific circumstances of that organisation. Applying figures drawn from CIPD surveys, the average direct financial cost to employers of redundancy per worker being made redundant in 2008–09 is estimated as ranging from £10,575 (measured in the formula as  $R$  where redundant workers are not subsequently replaced) to £15,242 (measured in the formula as  $R+H$  where redundant workers are replaced by new-hires). If replacement hires need to be inducted and provided with initial training, the cost rises to £16,375 (measured in the formula as  $R+H+T$ ).

To this might be added indirect costs resulting from the effect of redundancy on survivor employees, such as higher labour turnover ( $y$  in the formula) and a fall in employee productivity caused by reduced morale ( $z$  in the formula), as discussed above.

As an illustrative example, if for every redundancy 1 in 20 survivor employees were to decide to quit as soon as an opportunity came their way, this would at some point increase their employer's labour turnover rate by 0.05% (other things being equal). Setting  $y$  in the formula at 0.05, the cost of redundancy in terms of higher labour turnover is calculated at £290 per person made redundant. This increase would be in addition to the employer's

normal labour turnover rate (which, according to CIPD survey evidence, was 17.3% for the average employer in 2007) and normal labour turnover cost.

Similarly if  $z$  equals a 5% net reduction in the output of survivor employees and  $W$  equals average monthly employee earnings of £2,000 (roughly average earnings in the economy as a whole), the value of lost output would be £100 per survivor employee per month.

However, while the formula allows for the calculation of these costs there is to date insufficient evidence to enable a precise estimate of either  $y$  or  $z$  to be imputed. Moreover, not only is the size of the impact of redundancy on quit rates and lost output difficult to estimate, but so is the duration of such effects, which are likely to dissipate over time.

We are therefore unable to here provide a reliable estimate of the indirect cost of redundancy but simply conclude that the direct financial cost is likely to be an underestimate of the total cost. In addition, it is possible that organisations making redundancies might also suffer a 'loss of reputation' cost in product markets if consumers shy away from them as a result. This is unlikely to be a widespread phenomenon but might occur where an employer is both a significant employer in a locality and a supplier of goods or services to that locality. Again, however, we are not aware of any evidence on which to estimate the size of any such effect.

### **Making the business case for minimising redundancies**

In the very mild economic downturns experienced since the 1990s recession, UK employers have generally preferred to hoard labour and accept a temporary cyclical reduction in productivity rather than resort to large-scale redundancies as a first resort. Even given the recent prospect of recession, three in ten organisations

informed the CIPD/KPMG autumn 2008 LMO survey that they have taken measures to minimise the number of redundancies they make. The two most commonly chosen alternatives are reducing staff levels through natural wastage and freezing recruitment.

Such behaviour – which is generally preferable from the perspective of long-run business performance, macroeconomic stability and social and personal happiness – is likely to be partly explained by the fact that most organisations, especially in the private sector, are nowadays leaner and have less 'spare' staff to shed and partly because the use of agency temps and self-employed contract staff enables organisations to adjust headcount with less need for formal redundancies. But some employers will also be mindful of the substantial cost of redundancy. The intention of the calculation made in this Work Audit has been to draw the full extent of this cost to the attention of as many employers as possible to try to mitigate the number of redundancies suffered during the course of the current recession.

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