The Subcontracted Labor Market

David Weil's book, The Fissured Workplace, *describes a disturbing trend for workers.*

Richard B. Freeman

Harvard economist Richard Freeman on fissuring

- David Weil uses the word "fissuring" to describe the new increasingly subcontracted labor market and how companies disadvantage workers by outsourcing to low-wage subcontractors.
- Fissuring is the new rule, not the exception, in the contemporary labor market.
- We need a better understanding of fissuring in theory and practice. Weil's book, *The Fissured Workplace,* is a good start.

Welcome to the fissured labor market, where whom you work for matters more and more.

The term "fissure" traditionally refers to splits or cracks in objects ranging from parts of the body to the face of a rock or the surface of the earth. Now, thanks to David Weil's *The Fissured Workplace,* the term has entered the labor market lexicon, referring to splits between the wages and working conditions of employees inside a firm and those of the growing network of subcontractors, independent contractors, freelancers, and consultants who work as non-employees outside the firm's legal boundary.

Standard economic analysis posits a unitary labor market that determines the compensation for work, which depends primarily on worker skills. The human capital model relates earnings and productivity to investments in education and experience without reference to the specific employing unit.[1] That is because a well-functioning labor market should produce similar pay for people doing similar work, regardless of whether they work for company A or B or in industry X or Y. If the marginal revenue product (MRP) of workers with given skills exceeds the market wage (W), the firm will increase output/employment to equate the diminishing MRP to W. It will not pay workers the difference between their marginal contribution to revenues and the going wage.[2]

If a business generates excess profits, other firms will enter its market and drive wages up by competing for labor and drive prices down by increasing market output. Subject to costs of mobility, imperfect information, and other frictions, competition will produce more or less equivalent compensation and productivity among firms.[3]

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A fissured labor market is the polar opposite of the ideal competitive model. In a fissured labor market, firms pay workers doing the same work differently, depending on the situation of the employer. When work conditions or benefits are bad, pay may be higher, but it is more likely that the best firms will lead others in all dimensions of compensation. The result is that the firm for which an employee works greatly affects compensation, creating splits or cracks in the labor market.

The United States has experienced an unprecedented divergence of earnings among firms—fissuring of the labor

market—and this divergence accounts for much of the trend of increased wage inequality that is making headlines. In this article, I examine cases of fissuring in the hotel industry in Boston and present evidence that the dispersion of earnings has increased in that sector and nationwide. I conclude with brief comments on the challenge to economic analysis posed by the fissured market.

Case Evidence of Fissuring: Hotel Workers

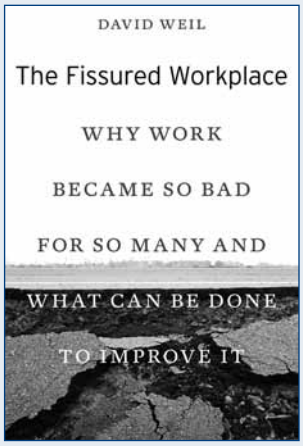
The hospitality industry is big in Boston and adjacent locales. In the 2007 Census of Establishments, the Boston area had 385 hotels, including many famed brand names like Hyatt, Hilton, and Kimpton, that employed about 22,000 workers. Some of the hotels were unionized, but many were not. Most of the brand-name hotels were and remain owned by franchisees. Moreover, many hotels subcontract key services, such as room cleaning, to specialist firms.

Taking the big brand-name hotels as exemplars of firms that subcontract essential work to outside entities, Weil recounts the summer 2009 decision of Boston's Hyatt Hotels to fire its housekeepers, many of whom had cleaned hotel rooms for years, and subcontract housekeeping to Atlanta-based Hospitality Staffing Solutions (Weil, pp. 142–43).

Hyatt replaced its housekeepers with non-employee Hospitality Staffing workers for one reason: wage costs. Hyatt paid its housekeepers about $15 an hour and provided the expensive health insurance and other benefits that one associates with a profitable multinational. By contrast, Hospitality Staffing paid its workers $8 an hour and spent little on benefits.

Had Hyatt tried to lower costs by reducing the pay of its housekeepers to the Hospitality Staffing level, worker morale would almost certainly have plummeted. The low-paid housekeepers would have distorted Hyatt's internal wage structure, and the company's reputation might have taken a long-term hit. Outsourcing to Hospitality Staffing was the easy way to reduce costs and raise profits.

Fast-forward to 2013–2014 and the housekeepers at a different Boston hotel—Hilton's DoubleTree Suites located in a Harvard building near the Harvard Business School. As Table 1 shows, compensation and working conditions differ markedly between DoubleTree and Boston's unionized hotels (including the Marriott Courtyard across the Charles River from DoubleTree and Hilton's own Boston Downtown hotel) and between DoubleTree workers and comparable workers at Harvard, a building or so away. DoubleTree paid less, spent less on worker health insurance, and most striking, required that its housekeepers clean more rooms per shift than competitors, producing worker complaints about injuries and pain from the work.



The Fissured Workplace
Why Work Became So Bad for So Many and What Can Be Done to Improve It

By David Weil

Harvard University Press, 2014. 424 pp.

For much of the twentieth century, large companies employing many workers formed the bedrock of the U.S. economy. Today, on the list of big business's priorities, sustaining the employer–worker relationship ranks far below building a devoted customer base and delivering value to investors.

As David Weil's groundbreaking analysis shows, large corporations have shed their role as direct employers of the people responsible for their products in favor of outsourcing work to small companies that compete fiercely with one another. The result has been declining wages, eroding benefits, inadequate health and safety conditions, and ever-widening income inequality.

David Weil

From the perspectives of CEOs and investors, fissuring—splitting off functions that were once managed internally—has been a phenomenally successful business strategy, allowing companies to become more streamlined and drive down costs. Despite giving up direct control to subcontractors, vendors, and franchises, these large companies have figured out how to maintain quality standards and protect the reputation of the brand. They produce brand-name products and services without the cost of maintaining an expensive workforce.

But from the perspective of workers, this lucrative strategy has meant stagnation in wages and benefits and a lower standard of living—if they are fortunate enough to have a job at all.

Weil proposes ways to modernize regulatory policies and laws so that employers can meet their obligations to workers while allowing companies to keep the beneficial aspects of this innovative business strategy.

For more information on *The Fissured Workplace*, including contents and an excerpt, go to LERAweb.org and access the Members Only section at http://bit.ly/1uRQmQ1.

Table 1. Earnings, benefits, and work activities in Boston establishments, 2013.

	DoubleTree	Boston Union	Harvard Entry-Level Custodian
Hourly earnings	$15.53	$18.51	$18.98
Worker's annual contribution to health care	$3,134	$624	15% of lowest cost plan, ~$972
Yearly gross salary net of health care (2,080 hours per year)	$32,302	$38,500	$38,506
Rooms assigned to room attendant per day	28 rooms plus bathrooms	15 rooms plus bathrooms	Not applicable

Source: UNITE-HERE Local 26, "Are Harvard's DoubleTree and Boston Union Hotels Really That Different?"; Agreement, Harvard University and Local 615 Service Employees International Union, November 16, 2011–November 15, 2016.

The differences between employees of Hilton's DoubleTree and its Boston Downtown facility and comparable Harvard employees reflect the labor policies and collective bargaining agreements of those employers in a labor market that is open to wide variation in pay and working conditions. Compensation at DoubleTree is set by the Boston areawide union hotel agreement, while compensation at the Downtown Hilton is set by Harvard's Service Employees International Union contract for Harvard employees.

Spurred by the intensity of work, limited company contribution to health care, and poor treatment by some supervisors, DoubleTree workers in 2013 sought to unionize to improve their situation—a painful and risky undertaking in twenty-first-century America. To sidestep the acrimony of a contested National Labor Relations Board election, the workers asked Harvard to support a card-check neutrality agreement to decide on unionization.

There was precedent for such action. In 2011, Harvard had brokered a neutrality agreement between the union and the Harvard subcontractor that provided food and beverage services at Harvard Law School. However, Harvard took a different stance toward DoubleTree, declaring that DoubleTree had sole responsibility for its employees. Its labor policies were none of Harvard's business.[4] Parenthetically, as the union drive accelerated in 2014, DoubleTree raised pay and benefits for workers in a classic response to the threat of unionization.[5]

Harvard justified its hands-off policy toward workers on the grounds that DoubleTree is not a Harvard hotel—it is merely a tenant in a Harvard-owned building.[6] However, the DoubleTree website informs Harvard-related customers that, "as a Harvard-owned hotel, we are pleased to offer all Harvard students, staff, and alumni a special discount off our Best Available Rates" and emphasizes the connection by juxtaposing the university's Veritas insignia with the DoubleTree name.[7] In fact, a substantial proportion of DoubleTree business is Harvard connected, and the university earns millions of dollars from its "non-ownership" involvement.

If these examples and those in other industries in Weil's book were one-off cases of management exploiting temporary differences in the wages of similarly skilled workers while market forces were slowly moving them toward comparable levels, the cases would be interesting stories of sluggish market adjustments.

May the next LERA review of this topic be titled "Farewell to the Fissured Labor Market."

However, quantitative evidence on earnings for establishments and workers economy-wide shows that, far from being a temporary aberration, the fissured labor market has become the new normal, producing outcomes different from those in a competitive labor market throughout the United States.

The Quantitative Evidence

While Weil was doing his case research, I and three co-authors were engaged in a seemingly unrelated quantitative analysis of earnings among all U.S. workers.[8] Using a classic analysis of variance model, we sought to estimate the part of the increased earnings inequality that was due to increased inequality of pay *among* the establishments employing the workers and the part attributable to increased earnings inequality *within* those establishments.

From Census files, we calculated the variance of the log of earnings over time for establishments nationwide, controlling for industry and geographic location. Because the average earnings of an establishment change when the composition of its workforce changes and varies over time for idiosyncratic reasons, we sought to identify the "establishment fixed effect" that reflects whether the establishment was high or low paying, regardless of skill mix or time period.

To do that, we compared the earnings of workers with similar skills and characteristics across establishments over time. We also compared the earnings of the same worker when he or she remained at an establishment with the earnings of workers who moved to another establishment.

Our statistical analysis found that a large divergence in earnings for similar workers among establishments in the United States occurred in all industries and areas. We found, moreover, that the increased variance of establishment-level earnings was due almost entirely to establishment fixed effects that were diverging rather than to changes in the composition of establishment workforces.

In our data, 80 percent of the increased earnings inequality among workers who remained with an establishment from one year to the next (which is the majority of the workforce) came from increased earnings inequality *among* establishments as opposed to increased inequality *within* establishments. In addition, we found that the variance of establishment productivity (measured as revenue per worker) also increased greatly—indeed, by more than the variance in establishment earnings.

To link our analysis to the Boston cases, I show in Table 2 the variance of the log of establishment-level earnings per worker in the hotel and accommodation industry in 1977 and 2007 for Boston and the United States. Both variances increase, indicating that the average earnings of hotels and related establishments diverged over time.

The table also shows the variance among all industries in Boston and the United States, which increased even more—in part because the average earnings among industries diverged over time as well. Measuring fissuring as the increased variance of establishment-level earnings, the data confirm that fissuring is indeed a truly big change in the labor market.

Finally, my co-authors and I compared the increase in establishment-level earnings inequality with to the increase in inequality among all workers. Figure 1 shows that the increase in establishment-level inequality accounts for more than one half of the trend rise in inequality from 1992 through 2007,[9] with the exact proportion varying from 56 percent to 65 percent depending on the calculation.

Table 2 .Variance of log of establishment-level earnings and change in variance, 1977–2007.

	1977	2007	Change
Hotel Industry			
Boston	0.114	0.162	0.048
United States	0.168	0.209	0.041
All Industries			
Boston	0.353	0.624	0.271
United States	0.332	0.487	0.155

Source: Calculated from Census of Establishments, 1977 and 2007.

The road to understanding increasing inequality in the United States lies in the divergence of compensation for similar workers among establishments and firms.

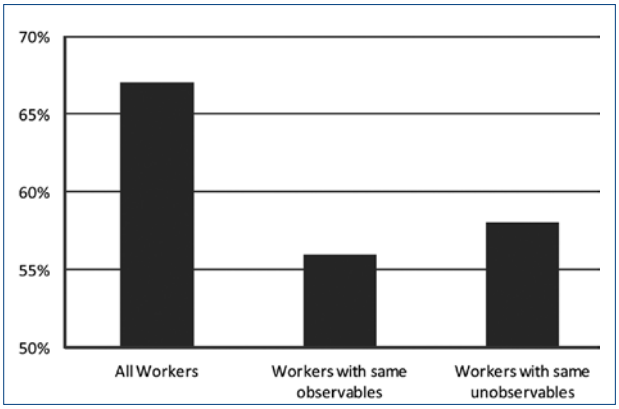


Figure 1. Percentage of increased inequality of earnings among workers attributable to increased inequality of earnings in their employing establishments, 1992–2007.

Source: Erling Barth, Alex Bryson, James Davis, and Richard Freeman. 2014. It's Where You Work: Increases in Earnings Dispersion across Establishments and Individuals in the U.S. *National Bureau of Economic Research Working Paper. All workers, Table 1; with same observables, Table 3; with same unobservables, Table 2.*

Interpreting the Fissured Labor Market

Analysts familiar with research in the 1960s and 1970s on dual labor markets or in the 1950s on the balkanization of labor markets[10] and the variation of earnings by industry[11] may wonder how, beyond being a new term, fissuring differs from the phenomenon in these investigations.

The fissuring phenomenon I discuss in this article differs from the variation of earnings in the same occupation or skill group examined in earlier work by addressing *changes* in the variation of earnings among similar workers rather than the *level* of variation. Analyzing the causes of the change in variation is more complicated than analyzing the factors that cause variation because one must determine why causal factors had larger effects over time.

I suspect that advances in the information technology that monitors goods and services and worker performance have played an important role in the change, but I have no evidence for that. However, changes over time provide an additional (time) dimension of variation that makes it easier to test competing explanations.

With unionization and collective bargaining in rapid decline, the U.S. labor market resembles more closely than before a competitive model in which market forces determine outcomes. That means we must provide explanations for the fissuring of earnings in the working of market forces—no easy task because the basic market model predicts that competition will reduce establishment-based variation of earnings among comparable workers.

> Far from being a temporary aberration, the fissured labor market has become the new normal.

Either our models misrepresent how a relatively unfettered labor market works in reality or we are missing important market forces in applying the model. From either perspective, the evidence of fissuring creates a great puzzle to labor economics and social science more broadly. We need a new "fissured market" model that goes beyond standard analysis, new measures of wage determinants in the existing framework, or some judicious mixture of the two.

I have developed the new model and found the missing factors, but, unfortunately, like Fermat with his Last Theorem, I lack the space to lay it out here. It would also exaggerate what I know. The fissuring process so puzzled me that,

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the last time I was fortunate to see noted economist Gary Becker this year before he died, I put the problem to him in the hope that his unique insight into the workings of the Invisible Hand might yield a critical clue about why market forces have failed thus far to reverse the widening of establishment-level differentials. However, Gary had no easy solution: "It's a hard problem, but keep working on it" were his last words to me.

The economics of fissuring is a difficult problem. My belief is that, as more researchers work on it—via case studies, insider econometrics of labor practices of firms and their subcontractors, and analysis of establishment earnings in countries with different labor institutions—and apply insights from behavioral economics, game theory, and Beckerian price theory, we will advance our understanding enough to find ways to counter its effect on compensation.

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Notes

1. Save for firm-specific human capital, which is intrinsically tied to the worker remaining at the firm over time.
2. Efficiency wage aside.
3. Individuals will sort between companies depending on preferences and match specific relations between them and the firm from which they and/or the firm can earn some infra-marginal surplus.
4. Perhaps the university worried that a labor dispute at campus eating facilities risked student protests, while it saw DoubleTree as a financial investment unconnected to the campus.
5. Ivan B. K. Levingston and Tyler S. Olkowski. 2014 (Jun. 30). "National Union Members Descend on DoubleTree for Protest." *Harvard Crimson*; Sarah Feijo. No date. "Protesters Demand Fair Union Process at Harvard-Owned DoubleTree Hotel." cambridge.wickedlocal.com. (http://bit.ly/1pP3TW2)
6. Marco J.B. Grossi. 2013 (Sep. 10). "Allston Task Force Addresses DoubleTree Hotel." *Harvard Crimson*.
7. http://www.hiltonfamilyboston.com/harvard, accessed July 10, 2014.
8. Erling Barth, Alex Bryson, James Davis, and Richard Freeman. 2014. *It's Where You Work: Increases in Earnings Dispersion across Establishments and Individuals in the U.S.* National Bureau of Economic Research Working Paper.
9. The period over which the longitudinal earnings and household data match workers and establishments.
10. Clark Kerr. 1954. "The Balkanization of Labor Markets." In E. Wight Bakke, ed., *Labor Mobility and Economic Opportunity*. New York: John Wiley & Sons, pp. 92–110.
11. John Dunlop. 1957. "The Task of Contemporary Wage Theory." In George W. Taylor and Frank C. Pierson, eds., *New Concepts in Wage Determination*. New York: McGraw-Hill, pp. 117–39.

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