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Domestic Outsourcing Reduces Wages and Contributes to Rising Inequality

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growth is weak, labor force participation is historically low, and deep concerns remain, particularly about the low-wage workforce. Temporary help agencies, which hire a disproportionate share of low-wage workers, are often touted as providing a pathway to permanent, better jobs for these workers, yet we see strikingly low hire rates in our data, even among those in temp-to-hire contracts. Low conversion rates to permanent jobs with clients reflect the fact that employers are highly selective in making job offers to temporary help workers, but they also reflect skills deficits among the workers. Performance problems or quits prior to assignment completion drive a significant share of temporary help assignment terminations, with "soft skill" problems such as tardiness and unexcused absences notably high among the lower-paid temporary workers. In sum, our data indicate that the pathway to better jobs via temporary help employment currently is limited for low-wage workers.

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Domestic Outsourcing Reduces Wages and Contributes to Rising Inequality

This article highlights findings from "The Rise of Domestic Outsourcing and the Evolution of the German Wage Structure," Upjohn Institute Working Paper No. 15-244. To read the paper, please visit research.upjohn.org/up_workingpapers/244/.

The last three decades have seen a thorough transformation of the nature of the labor market, with large firms increasingly relying on nontraditional employment arrangements such as outsourcing, temporary or contingent work, offshoring, and subcontracting. Across a wide range of industries, firms have been focusing on their "core competencies" and hiring outside companies to provide services that were once performed by their own employees, such as cleaning, security, logistics, human resources, or information technology.

Outsourcing to business service providers potentially allows for reductions in wages for the contracted-out jobs. The outsourcing firms are often traditional lead companies in sectors such as manufacturing or finance, and they typically offer the most attractive jobs, with higher wages, increased job security, strong worker representation, and union coverage. Large employers may thus find it beneficial to reduce the number of direct employees who benefit from such wage premia by outsourcing jobs to subcontractors. These business service firms compete fiercely with each other for service contracts from large companies on price, and since labor costs are a large share of business service firms' total costs, this creates intense pressure to lower wages and reduce benefits.

We analyze domestic labor service outsourcing in Germany using detailed administrative data on workers and firms. We use the term *domestic outsourcing* rather than offshoring, as it refers to a form of outsourcing where the service provider is located in the same country. We document for the first time in detail the increase in outsourced labor services over the last three decades in Germany, focusing in particular on cleaning, security, logistics, and food services.

Figure 1 shows the share of all full-time workers in business service firms that provide cleaning, security, and logistics services, as well as temporary help agencies. In 1975 only 2 percent of the German labor force worked for such companies, but that number almost quadrupled by 2008 to around 7 percent. A substantial share of this rise is due to the growth in both temp agency work and business service firms. Since employment in cleaning, security, and logistics occupations has remained relatively constant, this suggests that a much larger share of these occupations are now working for contractors.

In order to obtain credible effects of outsourcing on wages, we develop a new method of identifying a particular type of outsourcing—*on-site outsourcing*—which refers to situations where a large employer spins out a group of workers providing a particular service, such as cafeteria workers, to a legally separate business unit, such as a subsidiary or an existing business service provider. In these situations the outsourced workers still work together and do essentially the same job at the same physical location but for a different employer. Such outsourcing events can be identified in administrative data sets using worker flows between establishments.

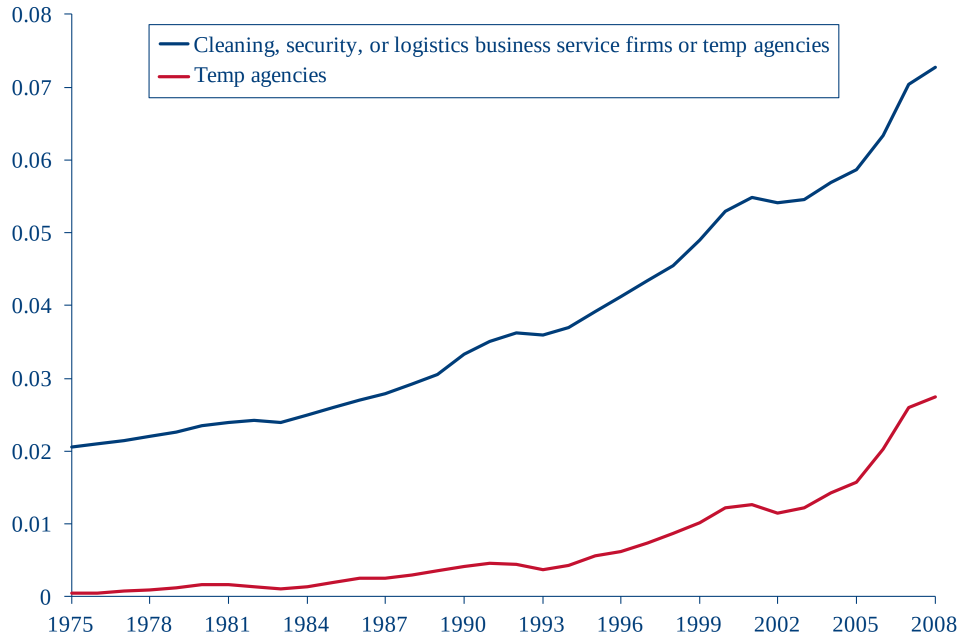
The basic intuition is that if a group of workers is contracted out at the same time, this can be observed by following the establishment identifiers as well as occupation and industry codes. For example, if a group of workers splits off from a large bank in year $t - 1$ and forms a new establishment identifier in year t with an industry code of "cafeteria," this likely indicates that the bank is outsourcing its cafeteria staff. We compare workers who are outsourced in these on-site outsourcing events to workers in the same occupation and industry who are not outsourced and estimate how their wages change over time.

Figure 2 shows the main estimates of outsourcing's effect on wages. While wages of both groups of workers move in parallel up to the year of outsourcing (year 0 in the figure), they drop for the outsourced workers as soon as outsourcing occurs by about 2.5 percent. The wage differential then keeps growing until it reaches about 10 percent, approximately 5–10 years after outsourcing. This suggests large and long-lasting wage differentials between outsourced and in-house jobs. Since these differences also imply that outsourcing may lead to substantial cost savings to employers, we investigate whether firms that pay higher wages relative to the market have a higher likelihood of outsourcing any of their labor services, and we do indeed find that firms are significantly more likely to do so the more they pay above market-level wages.

Finally, we consider the relationship between the documented impacts of outsourcing in Germany and the broad changes in the country's wage structure over the last three decades. Dustmann et al. (2014) document a dramatic decline of real wages at the lower end of the wage distribution since the early 2000s. After a decade of stagnation from 1990 to 2000, real wages at the 15th percentile fell by around 10 percent between 2000 and 2008.

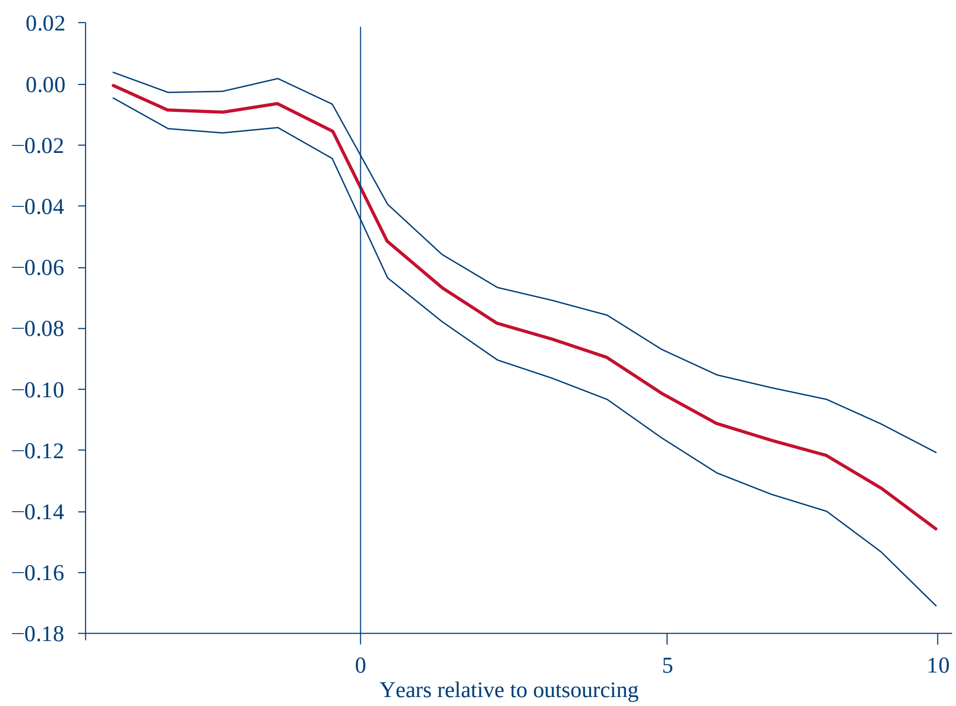
Furthermore, Card, Heining, and Kline (2013) observe that low-skill workers are increasingly working at low-paying establishments and are increasingly concentrated in establishments with homogenous workforces where most workers have similar occupations. Outsourcing provides a natural explanation for this, since it typically involves outsourcing low-skill

Figure 1 Fraction of Full-Time Workers in Germany in Cleaning, Security, or Logistics Business Service Firms or Temp Agencies, by Year



SOURCE: Authors' calculations.

Figure 2 The Effect of Outsourcing on Log Wages of Outsourced Workers in Germany



NOTE: The blue lines represent 95 percent confidence intervals. The figure shows the evolution of wages for outsourced workers in food, cleaning, security, and logistics occupations relative to the wages of workers in the same occupations and industries who are not outsourced. Year 0 is the first year of outsourcing. The y-axis is measured in fraction of relative wage losses to obtain the wage loss in percent multiply by 100.
SOURCE: Authors' calculations.

workers to very competitive low-paying establishments. In addition, outsourcing provides a natural explanation for the increase in occupational sorting: since business service firms are much more homogenous (for example, in the typical cleaning firm, about 60 percent of the employees are cleaners), moving workers from heterogeneous lead employers to business service firms that employ largely the same occupations as the outsourced worker will increase the overall occupational assortativeness.

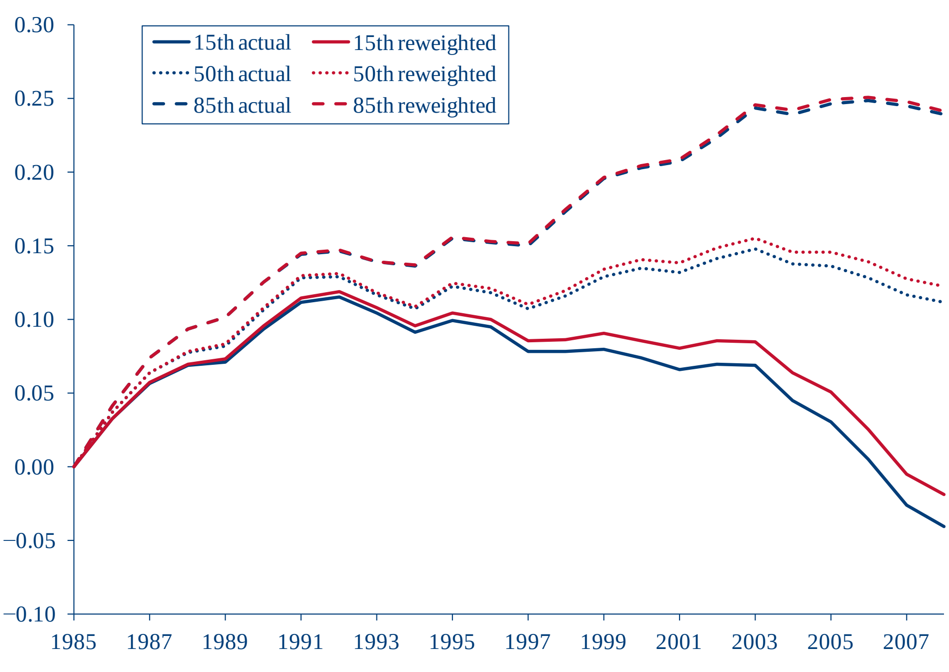
We quantify the contribution of outsourcing to the rise in wage inequality in Germany using a reweighting method, which allows us to calculate a counterfactual distribution of wages in Germany under the scenario that outsourcing did not increase since the 1980s. Figure 3 shows the evolution of different percentiles of the wage distribution relative to 1985. Especially for low wages, outsourcing contributed substantially to the increase in inequality. Overall we show that about 9 percent of the increase in inequality can be accounted for by the increase in outsourcing of just these four occupations. Since many other tasks experienced an increase in outsourcing, this should be viewed as a lower bound with the overall contribution of all forms of outsourcing to wage inequality possibly being much larger. The labor market has seen a fundamental restructuring in recent decades, with lead employers increasingly contracting out parts of their noncore labor force.

This reorganization of the production structure changes the employment relationship for a large share of the workforce. As more workers become employed by specialized business service firms, they find themselves working for companies that provide narrow products and compete fiercely with similar firms for contracts with lead companies. This creates pressure to reduce costs and lower wages, which likely makes up a large share of input costs among these types of business service providers.

This restructuring also drastically changes the bargaining environment, as the price competition among business service firms makes it difficult for outsourced workers to bargain for a share of the firm rents at the lead company. In this article, we provide careful estimates of how this translates into lower wages for outsourced workers, and we find that across a wide range of measures, outsourcing reduces wages by around 10 percent. Our method implies that this is not due to selection of different types of workers in outsourced employment relationships or to differences in the types of jobs that outsourced workers do. Instead, it appears that outsourced workers receive lower pay because they are excluded from firm rents that are being paid to workers at the lead companies.

It is difficult to know why firms decide to outsource parts of their workforces, but our evidence indicates that firms that pay wage premia to their workers are more likely to outsource. This suggests that saving on labor costs is part of the motivation, but other reasons include comparative advantage of business service firms in their specialty, cost savings through economies of scale, and gains in efficiency through market pressures in the competitive environment of bidding for service contracts. It is even more difficult to know what is driving the long-term increase in outsourcing. Changes in management philosophy (e.g., a move toward emphasis on shareholder value in the 1980s and 1990s) may be of similar importance as the development of new technologies makes it easier to rely on contractors. Understanding this is beyond the scope of this project but a fruitful area for future research.

Figure 3 The Contribution of Oursourcing of Cleaning, Security, and Logistics Occupations to the Rise in Wage Inequality in Germany



NOTE: The figure shows the percentage change in wages relative to 1985 at the 15th, 50th, and 85th percentiles of the wage distribution for full-time men. The blue lines show the evolution of the actual wage distribution, while the red lines show how the wage distribution would have evolved if outsourcing for cleaning, security, and logistics workers had not increased relative to 1985.
SOURCE: Authors' calculations.

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