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Temporary Services and
Contracting Out



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Temporary Services and Contracting Out

Effects on Low-Skilled Workers

Temporary help employment grew dramatically over the last decade, accounting for 10 percent of net employment growth in the United States during the 1990s. Evidence from case studies and business surveys suggests dramatic growth in the outsourcing of functions to contract companies as well (Abraham and Taylor 1996; Houseman 2001). Through case studies in a representative manufacturing, service, and public sector industry, we examined why employers are increasing the use of these nonstandard employment arrangements and the implications of this increased use for wages, benefits, and working conditions in low-skilled labor markets.

Temporary help and contract company workers perform work for a client, usually at the client's work site, but they are the legal employees of an agency or contract company. Because workers in these arrangements often receive lower compensation than they would if they were employees of the client organization, the growth of temporary help and contracting out generally is viewed as inimical to workers' interests. We find, however, that the story is not that simple. Our case study evidence points to circumstances in which workers *are* likely to be adversely affected by the

outsourcing of jobs to agencies or contractors. In other situations, however, the effects on low-skilled workers appear to be minimal, and in some situations they may even be beneficial.

Incidence of Temporary Help and Contracting Out

We studied the use of temporary services and contracting out in five Midwest automotive supply establishments, six hospitals in Michigan and North Carolina, and seven Michigan public school districts.¹ Low-skilled jobs comprise a large share of employment in all three of the industries studied. The majority of auto supply workers are in low- or semi-skilled production positions. Hospitals have shifted work away from high-skilled, high-paid registered nurses to low-skilled, low-paid nurse assistants. Moreover, hospitals utilize a large number of workers in low-skilled clerical, food service, and housekeeping positions. Typically, 15 to 20 percent of a public school's staff is in low- and semi-skilled noninstructional positions in such areas as food service, cleaning, and transportation.

The use of temporary agency help in low-skilled functional areas was common in our auto supply and hospital case studies. Contracting out low-skilled

functions was prevalent in hospitals and public schools. Four out of the five auto supply plants utilized temporary agency help in production positions during the period of our interviews. Among the two unionized plants in our study, the use of agency temporaries was strictly limited at one and prohibited at the other. In two nonunion plants, temporary employment accounted for over 20 percent of production employment.

Although most hospitals in our study kept poor records of their use of agency temporary help in support functions, they reported using agency temps in many low-skilled clinical, clerical, housekeeping, and food service positions. Data from the hospitals that did keep good records suggest a moderately high level of temporary employment. For instance, in one hospital, agency temps worked 11 percent of hours in food services, 5 percent of hours in housekeeping, and 14 percent of hours in clerical functions.

We observed several cases in public schools where noninstructional support services, including custodial, transportation, and food services operations, were entirely contracted out. Interestingly, however, it is quite common for hospitals and public schools to contract out only management functions and to keep workers on their payroll. Whereas all of the hospitals we studied contracted out the management of food services or housekeeping services, none contracted out the entire operation. Among public schools, two districts contracted out their entire food services operation, but three contracted out only the management function.

Implications for Workers

In several instances, management decisions to use agency temporaries or to contract out functions appeared to have a direct, adverse effect on the wages, benefits, or other working conditions of low-skilled workers.² These cases involved the substitution of agency or contract company staff for regular employees on a long-term basis. Sometimes, contracting out entailed loss of union status and benefits, for affected workers, such as due process in grievance

procedures. The contracting out of an entire low-skilled function in public schools was always associated with lower benefits and sometimes lower wages for workers in these occupations. By law, public school employees received pension and other benefits, which were considerably more generous than those typically offered in the private sector to low-skilled workers. In addition, wage levels of contracted workers tended to be lower than those paid to school employees, who were often unionized. A 1994 Michigan law precluding union bargaining over the contracting out of noninstructional services, coupled with financial pressures on public schools, have led to a recent surge of contracting out of these services.

In only one case—that of an auto supplier—did an employer use temporary agency workers on a long-term basis. This auto supplier screened all new hires

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through a temporary help agency and offered them permanent positions after six months to a year or more—far longer than other auto suppliers using temporary agencies for screening purposes. This nonunion supplier paid its regular workers wages and benefits comparable to unionized plants in the area, a strategy designed to improve the quality of its employees and to avoid unionization. However, in prolonging the probationary period in its hiring through a temporary agency, the company acknowledged substantial savings in wage and benefits costs.

Interestingly, the human resources directors at the unionized auto supplier plants also indicated that they would like

to be able to use temporary agency workers more to save on labor costs. However, unlike the situation in public schools, unions in this sector were able to prohibit or greatly restrict the use of temporary agencies through collective bargaining. These examples underscore the importance that laws governing collective bargaining have on the incidence of outsourcing and ultimately on compensation and other working conditions in an industry.

Although outsourcing is often associated with the substitution of agency or contract company workers for higher-paid regular workers, evidence from our case studies suggests that outsourcing typically did not involve such substitution on a permanent basis. Agency temporaries usually were hired on a short-term basis to fill in for an absent employee, to staff a temporary project, or to screen workers for permanent positions. Particularly in hospitals, agency temporaries' compensation was similar to that of regular staff in comparable positions; in a few cases, they even earned more.

Only the management function was contracted out in almost all of the instances of contracting out in hospitals and in about half of the instances in public schools, so the wages and benefits of low-skilled workers in these functional areas were unaffected. In these cases, schools and hospitals believed any wage and benefits cost savings from contracting out the entire function were non-existent or relatively small: the motivation for contracting out the management function was to achieve product or productivity improvements and cost savings in other areas.

The simple but important point is that unless an organization's low-skilled employees are earning above market compensation, management will have little to lose—and workers will have little to lose—in terms of wage and benefits cost savings from the use of agency temporaries and contractors. Where we observe such use, the organization's motivation is something else.

A caveat to this conclusion is that compensation among regular employees

likely depends on the existence of competition from staffing agencies and contractors. It will be difficult for low-skilled workers and their union representatives to raise compensation if employers have the option of using low-cost third parties. We observed this sort of dynamic in one of our public school case studies. The previously mentioned state law, which precluded collective bargaining over the contracting out of noninstructional services, paved the way for this school district to contract out the custodial services in some of its buildings. The union was able to continue operating in half of the buildings, but only because it agreed to steep pay cuts for its higher-paid custodians and to the disciplining of poor performers.

Potential Benefit: The Case of Temporary Agencies and “Risky” Workers

When can workers actually benefit from a temporary agency or contract arrangement? Some workers, of course, prefer temporary positions. Workers may benefit from superior management skills provided by a contractor. More interesting is the use of temporary help agencies for screening purposes. Here, we argue, agency temporaries may benefit from the arrangement, even when they desire permanent positions and receive lower wages than direct hires.

The use of agency temporaries for screening purposes increased during the late 1990s among employers in our case studies as labor markets tightened and the average quality of job applicants dropped. Some of these employers began hiring workers for certain low-skilled positions exclusively through temporary agencies. Others used a mixed hiring strategy. For instance, one auto supplier directly hired applicants with good work histories while hiring others through a temporary agency at lower wages and lower cost to the company.

By lowering compensation and firing costs, temporary help agencies made it more attractive for companies to try out workers with criminal records, poor work histories, or otherwise “risky” characteristics. Because many of these workers might not otherwise have had the

opportunity to audition for a permanent position, they potentially benefited from the temporary employment arrangement.

At the same time, by lowering the companies’ costs of trying out riskier workers, temporary help agencies effectively expand the supply of potential labor to a company. In this way, companies may avoid raising wages in order to attract more qualified candidates. Furthermore, because increases in wages for new workers are almost always accompanied by increases in wages for existing workers, the more general use of agency temporaries may relieve upward wage pressure in tight labor markets.³

Conclusion

Sometimes an organization’s motivation for outsourcing low-skilled jobs is to substitute lower-paid temporary agency or contract company workers for regular employees. Often, however, an organization’s motivation for outsourcing is unrelated to wage and benefits cost savings. Workers in low-skilled positions may already receive relatively low pay, and outsourcing involves no permanent substitution of temporary or contract company workers for regular employees. Except to the extent that the existence of an outsourcing option inhibits compensation gains among low-skilled workers, contracting out and the use of agency temporaries has little apparent effect on low-skilled workers.

The growing use of temporary agencies to screen workers for permanent positions illustrates the complexity of assessing the impacts of temporary agency work on low-skilled workers. Our case study evidence suggests that often workers hired through agencies are deemed riskier than those hired directly, rendering simple wage comparisons between these two groups invalid. Moreover, the fact that temporary agencies sometimes lower compensation costs and facilitate dismissal may be the very reason some employers are willing to try out certain workers. The potentially more important impacts of temporary employment are on workers’ subsequent employment and earnings. The extent to which temporary agencies help open doors to good jobs for low-skilled, risky

workers or instead channel them into low-paying, dead-end assignments is an important topic for future study.

Notes

1. We conducted extensive interviews with each organization’s managers, temporary agency or contract company representatives, and workers. We also collected data on employment, wages, and benefits by occupation for regular, temporary agency, and contract workers from each organization.

2. An obvious caveat to the conclusion that lower wages and benefits adversely affect workers is that lower compensation may increase employment and reduce unemployment in the long run. While these long-term impacts are hotly debated in the economics profession, we do not consider such macroeconomic effects here.

3. We develop these arguments, including why employers may need a third party to lower the costs of trying out risky workers, in Houseman, Kalleberg, and Erickcek (2001).

Suggestions for Further Reading

Abraham, Katharine G., and Susan K. Taylor. 1996. “Firms’ Use of Outside Contractors: Theory and Evidence.” *Journal of Labor Economics* 14(3): 394–424.

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Erickcek, George A., Susan N. Houseman, and Arne L. Kalleberg. 2002. “The Effects of Temporary Services and Contracting Out on Low-Skilled Workers: Evidence from Hospitals, Automotive Supply, and Public Schools.” Working paper, W.E. Upjohn Institute, Kalamazoo, Michigan. Available on the Web at www.upjohninstitute.org.

Susan Houseman is a senior economist and George Erickcek is a senior regional analyst at the Upjohn Institute. This study was funded by the Russell Sage and Rockefeller Foundations. More extensive discussions of the study and its findings are provided in Houseman, Kalleberg, and Erickcek (2001), and Erickcek, Houseman, and Kalleberg (2002).