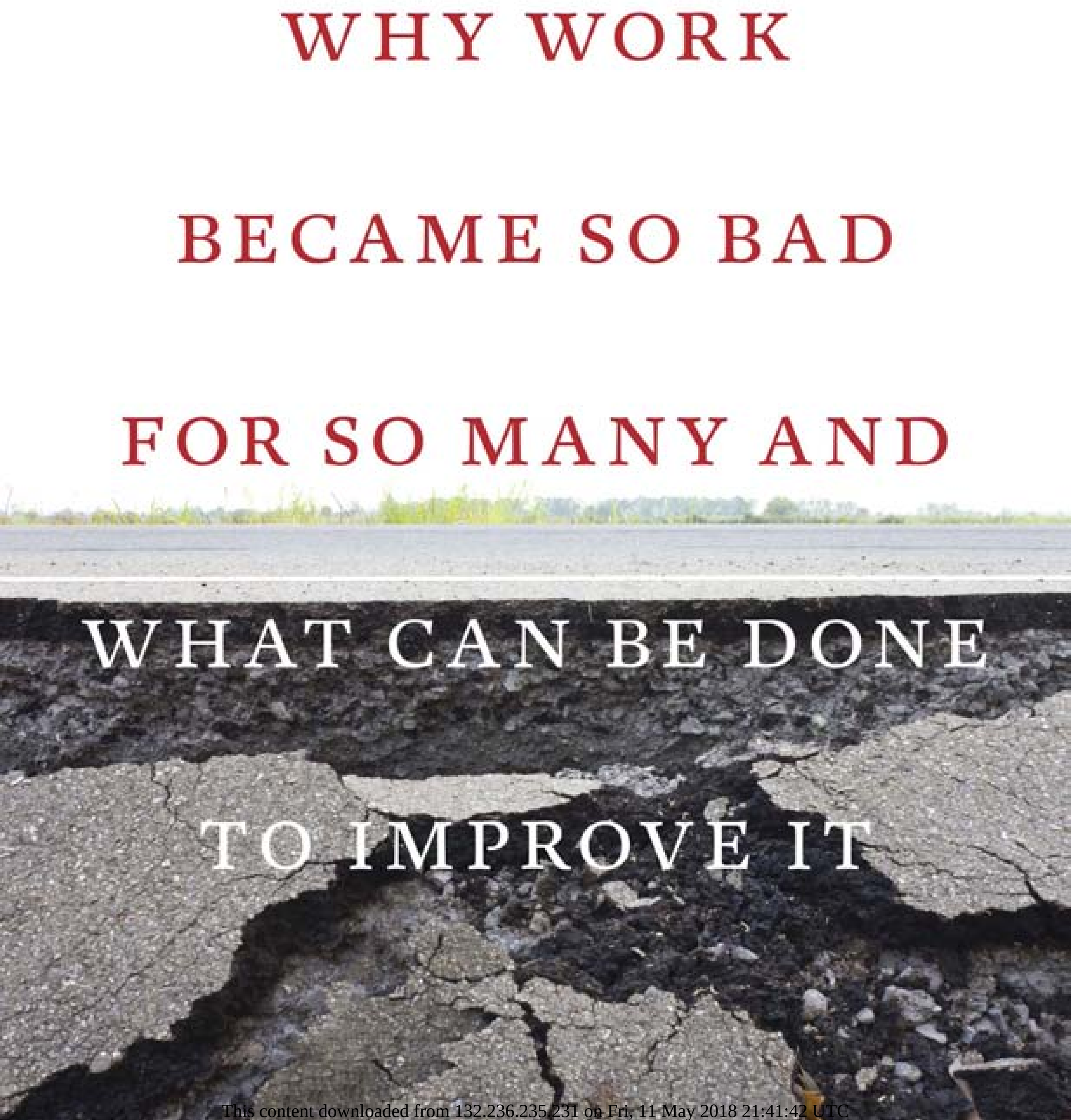
DAVID WEIL

The Fissured Workplace

WHY WORK BECAME SO BAD FOR SO MANY AND WHAT CAN BE DONE TO IMPROVE IT



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DAVID WEIL

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To my family—past, present, and future

Contents

The Fissured Workplace

PART I

Vignettes from the Modern Workplace

A maid works at the San Francisco Marriott on Fisherman's Wharf. The hotel property is owned by Host Hotels and Resorts Inc., a lodging real estate company. The maid, however, is evaluated and supervised daily and her hours and payroll managed by Crestline Hotels and Resorts Inc., a national third-party hotel management company. Yet she follows daily procedures (and risks losing her job for failure to accomplish them) regarding cleaning, room set-up, overall pace, and quality standards established by Marriott, whose name the property bears.

A cable installer in Dayton, Ohio, works as an independent contractor (in essence a self-employed business provider), paid on a job-by-job basis by Cascom Inc., a cable installation company. Cascom's primary client is the international media giant Time Warner, which owns cable systems across the United States. The cable installer is paid solely on the basis of the job completed and is entitled to no protections normally afforded employees. Yet all installation contracts are supplied solely by Cascom, which also sets the price for jobs and collects payment for them. The installer must wear a shirt with the Cascom logo and can be removed as a contractor at will for not meeting minimum quotas or quality standards, or at the will of the company.

A recent immigrant to the United States and an aspiring entrepreneur in Boston starts a commercial janitorial service by purchasing a franchise from Coverall, one of the largest U.S. companies in this business. He is owner of the Coverall franchise and works long hours, cleaning clients' businesses, including a Bank of America branch. He receives his clients from Coverall, which sets the price and quality standards, defines the geographic boundaries of his franchise, and loaned him capital to purchase the franchise. The prevailing market rate for janitorial services set by Coverall barely covers the royalties, loan repayment, and other expenses to the franchisor, the gas and car costs for traveling between clients, and compensation for himself and the people who work with him.

A member of a loading dock crew working in Southern California is paid by Premier Warehousing Ventures LLC (PWV)—a company providing temporary workers to other businesses—based on the total time it takes him and members of his crew to load a truck. PWV, in turn, is compensated for the number of trucks loaded by Schneider Logistics, a national logistics and trucking company that manages distribution centers for Walmart. Walmart sets the price, time requirements, and performance standards that are followed by Schneider. Schneider, in turn, structures its contracts with PWV and other labor brokers it uses to provide workers based on those prices and standards and its own profit objectives.

A young Moldovan exchange student works in a Palmyra, Pennsylvania, shipping facility packing chocolates exclusively for the Hershey Company. The job was arranged via the J-1 visa program overseen by the State Department to provide international students with cultural opportunities in the United States via a nonprofit organization, the Council for Educational Travel, USA (CETUSA). CETUSA, in turn, set up summer employment for the student and four hundred others with Exel, a company contracted by Hershey to manage its packing facility. Exel in turn hires a labor contractor, SHS OnSite Solutions, to provide workers, including students holding J-1 visas. Students who paid $6,000 to participate in the exchange program are assigned the 10:00 p.m. to 6:00 a.m. shift in the refrigerated facility and are paid a wage of $8.00 an hour, from which rent and other expenses are deducted, leaving little extra for the "exchange" portion of their experience.

In an earlier era, Marriott, Time Warner, Bank of America, Walmart, and Hershey, as well as other large employers that produced well-known products and services, would likely have directly employed the workers in the above vignettes. Not so now. As major companies have consciously invested in building brands and devoted customers as the cornerstone of their business strategy, they have also shed their role as the direct employer of the people responsible for providing those products and services.

In all of the above cases, the jobs shifted away to be done by separate employers pay low wages; provide limited or often no health care, pension, or other benefits; and offer tenuous job security. Moreover, workers in each case received pay or faced workplace conditions that violated one or more workplace laws. Tudor Ureche, a Moldovan student working in the Hershey packing facility, sent an email to the State Department seeking "help [from] the miserable situation in which I've found myself cought [*sic*]," which included lifting 50–60-pound boxes in a refrigerated facility on the night shift. Pius Awuah, a resident of Lowell, Massachusetts, put his life savings into a Coverall franchise contract that in many respects was simply paying to be an employee (who was then compensated in violation of minimum wages and overtime standards). And Everardo Carrillo and coworkers at a facility operated by Schneider Logistics were paid in violation of the Fair Labor Standards Act and then fired for stepping forward to complain about those working conditions.

The cases are not exceptional, but rather indicative of practices found in the varied industries depicted above as well as in a growing number of other sectors and occupations. Yet these working conditions are not an inevitable result of the nature of those jobs or of amorphous forces like globalization. They result from a fundamental restructuring of employment in many parts of the economy.

The vignettes reveal a transformation in how business organizes work in ways that are invisible to most of us as consumers. We walk into a Marriott and assume that the people who greet us at the front desk or who clean our rooms each day are employees of that venerable brand (as their uniforms imply). We greet the technicians sent to our home to fix our cable, not even questioning whether they work for the media company to whom we pay our bills. In short, we assume that the companies who invest millions of dollars to convince us of the benefits of buying products under their retail nameplate or to purchase the unique services they offer also undertake the operations needed to produce them—including acting as the employer of all the interconnected people who make their businesses possible.

Those assumptions are increasingly wrong. In the late 1980s and early 1990s, many companies, facing increasingly restive capital markets, shed activities deemed peripheral to their core business models: out went janitors, security guards, payroll administrators, and information technology specialists. But then came activities many of us would assume were more central to these well-known businesses: the front desk staff at hotel check-in; the drivers for the package delivery companies who come to our homes or offices; the tower workers who help assure uninterrupted cell phone service promoted in the commercials (and for which we pay a premium). Even the lawyers who handle our business transactions and the consultants who work for well-known accounting companies may now have an arm's-length relationship with those by whom we think they are employed.

By shedding direct employment, lead business enterprises select from among multiple providers of those activities and services formerly done inside the organization, thereby substantially reducing costs and dispatching the many responsibilities connected to being the employer of record. Information and communication technologies have enabled this hidden transformation of work, since they allow lead companies to promulgate and enforce product and quality standards key to their business strategies, thereby maintaining the carefully created reputation of their goods and services and reaping price premiums from their loyal customer base.

The new organization of the workplace also undermines the mechanisms that once led to the workforce sharing part of the value created by their large corporate employers. By shedding employment to other parties, lead companies change a wage-setting problem into a contracting decision. The result is stagnation of real wages for many of the jobs formerly done inside.

Laws originally intended to ensure basic labor standards and to protect workers from health and safety risks now enable these changes by focusing regulatory attention on the wrong parties. Core federal and state laws that regulate employment, often dating back to the first half of the twentieth century, often assume simple and direct employee/employer relationships. They make presumptions about responsibility and liability similar to those we make as customers, presumptions that ignore the transformation that has occurred under the hood of many business enterprises. Traditional approaches to enforcing those laws similarly ignore the myriad new relationships that lie below the surface of the workplace. As a result, the laws crafted to safeguard basic standards, to reduce health and safety risks, and to cushion displacement from injury or economic downturn often fail to do so.

In essence, private strategies and public policies allow major companies to simultaneously profit from the core activities that create value in the eyes of customers and the capital markets and shed the actual production of goods and services. In so doing, they have their cake and eat it too.

How did the workplace fissure? What are the wider impacts? Is continued shedding of employment the inevitable outcome of a modern, flexible economy? Are there ways to assure that workers are treated fairly and responsibly given the continued pressure to fissure employment? These are the central questions explored in this book.

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The Fissured Workplace and Its Consequences

The modern workplace has been profoundly transformed. Employment is no longer the clear relationship between a well-defined employer and a worker. The basic terms of employment—hiring, evaluation, pay, supervision, training, coordination—are now the result of multiple organizations. Responsibility for conditions has become blurred. Like a rock with a fracture that deepens and spreads with time, the workplace over the past three decades has fissured. And fissuring has serious consequences for the bedrock that people depend upon from employment: the share of the economic pie available to workers and their families; their exposure to health and safety and other risks each day at work; and the likelihood that their workplaces comply with the standards set out by law.

The stories opening Part I are not unusual. In 1960 most hotel employees worked for the brand that appeared over the hotel entrance. Today, more than 80% of staff are employed by hotel franchisees and supervised by separate management companies that bear no relation to the brand name of the property where they work. Twenty years ago, workers in the distribution center of a major manufacturer or retailer would be hired, supervised, evaluated, and paid by that company. Today, workers might receive a paycheck from a labor supplier or be managed by the personnel of a logistics company, while their work is governed by the detailed operating standards of the nationally known retailer or consumer brand serviced by the facility. And whereas IBM in its ascendency directly employed workers from designers and engineers to the people on the factory floor producing its computers, Apple can be our economy's most highly valued company while directly employing only 63,000 of the more than 750,000 workers globally responsible for designing, selling, manufacturing, and assembling its products.

A Seismic Shift in the Focus of Employment

During much of the twentieth century, the critical employment relationship was between large businesses and workers. Large businesses with national and international reputations operating at the top of their industries (which will be referred to as "lead businesses" throughout the book) continue to focus on delivering value to their customers and investors. However, most no longer directly employ legions of workers to make products or deliver services. Employment has been actively shed by these market leaders and transferred to a complicated network of smaller business units. Lower-level businesses operate in more highly competitive markets than those of the firms that shifted employment to them.

This creates downward pressure on wages and benefits, murkiness about who bears responsibility for work conditions, and increased likelihood that basic labor standards will be violated. In many cases, fissuring leads simultaneously to a rise in profitability for the lead companies who operate at the top of industries and increasingly precarious working conditions for workers at lower levels.

But the fissured workplace is not simply the result of employers seeking to reduce wages and cut benefits. It represents the intersection of three business strategies, one focused on revenues, one on costs, and one on providing the "glue" to make the overall strategy operate effectively. Its components begin not with employment, but with the demands by capital markets that lead companies focus on core competencies that produce value for investors and consumers. This means building brands, creating innovative products and services, capitalizing on true economies of scale and scope, or coordinating complex supply chains. But focusing on the core also has come to mean shifting activities once considered central to operations to other organizations in order to convert employer-employee relationships into arm's-length market transactions. Finally, fissuring weds these potentially contradictory activities through the glue of the creation, monitoring, and enforcement of standards on product and service delivery, made available through new information and communication technologies and enabled by organizational models like franchising, labor brokers, and third-party management.

The result is businesses and industries wired in fundamentally new ways. Wage setting and supervision shift from core businesses to a myriad of organizations, each operating under the rigorous standards of lead businesses but facing fierce competitive pressures. Although lead businesses set demanding goals and standards, and often detailed work practice requirements for subsidiary companies, the actual liability, oversight, and supervision of the workforce become the problem of one or more other organizations. And by replacing a direct employment relationship with a fissured workplace, employment itself becomes more precarious, with risk shifted onto smaller employers and individual workers, who are often cast in the role of independent businesses in their own right.

Consequences

As the fissured workplace has deepened and spread across the economy, work that once provided middle-class wages and benefits has declined. Jobs that once resided inside lead businesses providing decent earnings and stability now reside with employers who set wages under far more competitive conditions. Where lead companies once shared gains with their internal workforce, fissuring leads to growing inequality in how the value created in the economy is distributed.

Laws that protect workers have not kept pace with the new boundaries of the fissured workplace. Americans' commitment to providing safety and health and decent conditions at the workplace has not changed. But relentless subcontracting can blur responsibility for safety and put workers in harm's way. Outsourcing management to third parties can lead to violation of minimum wage laws. And franchising, an often unrecognized form of fissured employment, can create incentives that simultaneously demand adherence to product quality and create incentives for franchisees to violate laws.

Even the business cycle may be affected by the spread of fissuring. Historically, hiring by large businesses led economic recoveries: as aggregate demand recovered, large firms directly increased employment. Now, employment decisions in many industries are mediated by fissured structures. Not only does this mean that the timing of recoveries may be slowed, since they must flow through multiple layers of fissured relationships; but the composition of jobs added also will reflect those relationships. Seen in this light, it is not surprising that the first jobs to be added following the Great Recession were predominantly at the low end of the wage distribution.

Why Fissure?

Multiple motivations underlie fissuring. In some cases, shedding employment by a lead company to other parties represents what is regarded as a short-term measure to deal with sudden increases in demand.[1] In other cases, fissuring reflects a desire to shift labor costs and liabilities to smaller business entities or to third-party labor intermediaries, such as temporary employment agencies or labor brokers. Employers have incentives to do so for obvious reasons: shifting employment to other parties allows an employer to avoid mandatory social payments (such as unemployment and workers' compensation insurance or payroll taxes) or to shed liability for workplace injuries by deliberately misclassifying workers as independent contractors.[2] Misclassification of this sort is a major problem, particularly in industries like construction and janitorial services.

The fissured workplace does not arise only from pernicious motivations, however. Technologic developments increasingly allow businesses to focus on core competencies while shedding activities not central to the firm's operation. With the falling cost of coordination resulting from new information and communication technologies, productive reconfiguring of the boundaries of companies and entire industries naturally occurs. This is a well-known phenomenon in industries that create intellectual capital, like software, Internet and information technology development, and the creative arts. Decentralized software engineers and game developers need not work in one physical location or even for the same company to develop new apps. In these areas, the fissured workplace reflects the transformation of the production and delivery of intellectual content and in many respects represents a positive development.

More fundamentally, however, the fissured workplace represents a response to pressures from capital markets and is enabled by the falling cost of coordinating business transactions through information and communication technologies. It characterizes the rippling of these forces across industries over time that express themselves in different ways but have common impacts on the situation faced by workers affected by those changes.

Workplace fissuring arises as a consequence of the integration of three distinct strategic elements, the first one focused on revenues (a laser-like focus on core competency), the second focused on costs (shedding employment), and the final one providing the glue to make the overall strategy operate effectively (creating and enforcing standards).

Focusing on Core Competencies

The first element leading to the fissured workplace arises from a broad movement traceable to the late 1970s that urged companies to focus on what mattered most to the business—that is, the company's core competency. Changes in capital markets dramatically increased the pressure brought to bear by investors, lenders, and the capital markets in general on senior management in lead companies to focus their attention on those activities that added greatest value (such as product design, product innovation, cost or quality efficiencies, or other unique strengths) while farming out work to other organizations not central to their core mission. This strategy led companies to focus their key strategies and attention on the development of brands and strong customer identification with the company's goods or services; on building the capacity to introduce new products or designs; or on implementing true economies of scale or scope in production and operation. Activities outside of this core were shifted away. As a result, companies outsourced customer relations to third-party call centers; manufacturers shifted production to networks of subcontractors for subassemblies; and private, public, and nonprofit organizations contracted out everything from cleaning and janitorial services to payroll and human resource functions.

Shedding Employment

By focusing on core competencies, lead businesses in the economy have shed the employment relationship for many activities, and all that comes with it. Shedding the tasks and production activities to other businesses allows lead companies to lower their costs, since externalizing activities to other firms (particularly those operating in more competitive markets) eliminates the need to pay the higher wages and benefits that large enterprises typically provided. It also does away with the need to establish consistency in those human resource policies, since they no longer reside inside the firm. This aspect of fissuring pushes liability for adherence to a range of workplace statutes (and other public policies) outward to other businesses.

Creating and Enforcing Standards

There is an inherent tension between the first two elements of fissured strategies: by shifting the provision of services to other businesses, companies that have created brands may jeopardize them if quality standards are not adhered to closely. Similarly, coordination economies will not persist if the suppliers that one depends on fail to live up to them or to provide the services required in a timely manner. The third element of fissured organizations is, therefore, developing clear, explicit, and detailed standards that provide the blueprint that the enterprises at lower levels must follow. But detailed standards are not enough: the lead organization must also create contracts or develop organizational structures that allow it to monitor such standards and impose real costs if the affiliated companies fail to live up to them.

It is not coincidental, then, that the expansion of the fissured workplace has been accompanied by the creation of many different forms of standard setting and monitoring, among them the promulgation of bar codes, electronic data interchange protocols, product identification, shipment and delivery standards, GPS, and other methods of tracking products through supply chains and monitoring provision of services to customers. At the same time, organizational forms like franchising that were once restricted to a few industries (such as fast-food restaurants) have become omnipresent, spanning sectors from janitorial and landscaping services to home health care.

Having It Both Ways

The fissured workplace gives rise to a basic contradiction in many industries and in the policies of major businesses. In focusing on core competencies, businesses seek to expand their margins and their markets, thereby improving the profitability of their operations. At the same time, by shedding nonessential activities, they seek to push out activities that would be more costly if maintained within the boundaries of the firm (in a variety of apparent and nonapparent ways, as I shall discuss in later chapters). To do the latter while protecting the integrity of the central business model (that is, protecting the brand or the other sources of core competencies), businesses rely on the promulgation and enforcement of myriad standards through a variety of organizational and technological methods. This final piece of the fissured workplace model is fundamental: it explains why many of the forms of fissured work are possible and prevalent now but not in the past, and represents an intrinsic but underacknowledged element of many business models. Consider the following examples taken from standards promulgated in three very different industries:

- *Fast food—Dunkin' Donuts standards for franchisees:* "All Dunkin' Donuts Stores must be developed and operated to our specifications and standards. Uniformity of products sold in Dunkin' Donuts Stores is important, and you have no discretion in the products you sell."[3]
- *Hotel and motel—Microtel brand standards for affiliated properties:* "You operate the Microtel Hotel under the Hotel System . . . We designed the Hotel System for the operation of "super budget" and "hard budget" hotels, and we expect [that] each Microtel Hotel will comply with Hotel System standards to achieve a relatively uniform and standardized package of services and amenities that are offered to guests consistent with the economy budget sector of the hotel industry."[4]
- *Retailing—Saks Fifth Avenue standards for vendors:* "Now that supply chain efficiencies are the key to remaining competitive and satisfying our customers, it has become critical that we develop collaborative partnerships with vendors who have a similar commitment to these technologies. We expect our vendors to support us by shipping their merchandise "floor ready," trading with our required EDI transactions, and following our Transportation, Packing, and Invoicing guidelines."[5]

Each of these examples illustrates both the specificity and the breadth that characterize standards in many modern business systems across major segments of the economy. Competitive strategies that are central to a wide range of industries—including computers, finance, retailing, and service to traditional manufacturing—simply would not be possible to execute without the promulgation and enforcement of stringent standards.

Yet many of the businesses that rely on the close enforcement of such standards create an artificial distance from subordinate organizations when it comes to employment obligations. While a major restaurant brand may set out standards and guidelines that dictate to a minute degree the way that food is prepared, presented, and served, and specify cleaning routines, schedules, and even the products to be used, it would recoil from being held responsible for franchisees' failure to provide overtime pay for workers, for curbing sexual harassment of workers by supervisors, or for reducing exposure to dangerous cleaning materials. Similarly, a lead electronics company in a supply chain may specify all aspects of product quality and production, set a price, and specify delivery standards but blanch at the notion of responsibility for the consequences of those parameters on the ability to pay people the legally required minimum wage.

The failure of public policy makers to fully appreciate the implications of how major sectors of the society organize the production and delivery of services and products means that lead businesses are allowed to have it both ways. Companies can embrace and institute standards and exert enormous control over the activities of subsidiary bodies. But they can also eschew any responsibility for the consequences of that control.

In light of all these factors, the spread of the fissured workplace creates an economy that is wired differently than the traditional model it has gradually replaced. The economic system for much of the twentieth century was dominated by large corporations where economic value creation, power, and employment were concentrated. The fissured economy still is powerfully affected by large businesses with their concentration of value creation and economic power. But employment now has been split off, shifted to a range of secondary players that function in more competitive markets and are separated from the locus of value creation. The consequences for employment and working conditions and the functioning of the economy as a whole are enormous.

Twin-Edged Sword

Lead companies, enabled by changing technology in the economy, have embraced fissured employment in response to market forces. The central cases in this book examine different organizational forms—subcontracting, franchising, third-party management, outsourcing—that bring together the three elements of focusing on the core, shedding employment, and enforcing standards. Those organizational forms have rippled across industries and the economy.

The widespread adoption of new forms of organization in markets is often a sign of a superior method of allocating resources. It signals that a set of outputs (goods and services) can be produced at a lower cost through a new way of organizing production. Economists would be quick to point out that this makes society overall better off: if fewer resources can be used to produce the same bundle of goodies, more resources are released for use elsewhere. The drivers behind the fissured workplace must improve outcomes for someone—why else would they become so pervasive?

There are indeed positive aspects of the reorganization of production for companies, investors, and consumers, and finding new ways to organize production can enhance social welfare. Focusing on core competencies and the benefits of specialization, facilitated by flexible organizational forms, can lead to the development of new and better products available at lower prices. But reorganization can also have real social consequences if the businesses undertaking it do not fully weigh the costs and consequences of their actions.

Fissured Work, Vulnerable Employment

Although the fissured workplace plays out in different ways across industries, its consequences for workplace conditions are similar. By shifting the provision of service or parts of production to other employers, lead businesses create markets for services that are usually very competitive, thereby creating downward pressure on the marginal price for them. This means that the employers competing for that work face significant pressures on the wages and conditions they can offer their workforce, particularly in industries where there is an elastic supply of labor, skill requirements are relatively low, and labor costs represent a significant part of overall costs.

There is abundant evidence that the majority of workers in the United States face an increasingly difficult workplace—and did so even before the Great Recession of 2007–2009. Falling real wages, declining benefits, reduced employment security, and a stifled ability to complain about problems describe a growing part of the employment landscape. Trends in the labor market (particularly in the low-wage segment), studies of workplace compliance, and the findings of government regulators paint a picture of a worsening workplace and more vulnerable workers in recent decades.[6] Consider:

- Real wages for median workers (those at the 50th percentile of the wage distribution) grew by only 0.5% between 2000 and 2012. Median hourly compensation (wages plus benefits) grew by only 4%. Yet productivity (measured as output of goods and services per hour worked) rose by 23% over the same period.
- Fewer and fewer workers have pensions: the proportion of private sector workers with some form of pension fell from 51% in 1979 to 43% in 2009. Of those workers who have them, the vast majority now have defined contribution plans that shift the risk of retirement income onto the worker.[7]
- Among low-wage workers, the U.S. Bureau of Labor Statistics in its 2007 National Compensation Survey reported that only 24% in the bottom quintile of the wage distribution had employer-provided health coverage, compared to 62% of workers in the middle-wage quintile.[8]
- In 2012 the U.S. Department of Labor recovered a record level of back wages from employers—representing the difference between wages workers received and what the law says their employers are responsible for paying.

Many of the industries where researchers in recent years have found high rates of violations of basic labor standards and worsening employment conditions coincide with industries where fissuring is most advanced. These include restaurant and hospitality sectors, janitorial services, many segments of manufacturing, residential construction, and home health care. But fissuring also is present in retailing, telecommunication and IT sectors, hospitals, public schools, auto supply, transportation, and logistics/distribution services. Accounts of fissuring of paralegal and legal jobs, accounting, journalism, and professional services are also increasingly common. In fact, employment fissuring represents an organizational format that has been adopted across many sectors of the economy, assuming many different forms.

There are three reasons we should worry about the social consequences of the fissured workplace. First, it often undermines compliance with basic labor standards. Second, chopping employment into pieces makes production coordination harder and results in a problem economists call externalities that can result in accidents, injuries, and fatalities. Third, there are distributional consequences of the fissured workplace, shifting surplus generated by businesses away from the workforce and to investors.

Obeying the Law

Workplace regulation in the twentieth century saw a progression of legislation beginning with basic protections for children and women from long hours of work in state legislation at the turn of the last century through a long sequence of state and federal legislation, including compensation for workplace accidents and loss of employment; minimum standards for wages and overtime; provision of the right to organize unions and to bargain collectively; protection against discrimination on the basis of race, gender, and age; provision of a safe and healthful work environment; and granting workers leave to care for family medical needs.

Historically, although business groups resisted (often fiercely) passage of these laws, once they were enacted, lead companies in the economy adjusted by creating systems to assure compliance and making those standards and requirements a part of operations and daily practice. Sometimes large employers did so because they were already exceeding the demands of legislation in their internal practices. Large companies, for example, often paid wages to even unskilled workers in excess of the minimum wage or provided pensions or medical leave because of a desire to keep valued workers or to maintain morale and meet standards of fairness inside the firm (which I discuss in Chapter 4). Other times, large businesses complied because they perceived that their scale made them particularly vulnerable to inspections, penalties, or public scrutiny.[9]

By shedding employment to other subordinate businesses, fissured employment altered those incentives. Lead businesses that, for example, shed janitorial and security work to contractors or franchised service providers no longer faced the responsibility for compliance with minimum wage or overtime standards, or even ensuring that payroll, unemployment, or workers' compensation insurance taxes were being paid for those workers. Activities that are shed by lead organizations are often taken up by smaller businesses. Given the competitive markets in which they operate, smaller employers face intense pressure to reduce costs. Noncompliance with a gamut of workplace standards is often the end result.

Some of the highest rates of violations of basic labor standards occur in industries where fissuring is common. In a landmark survey of low-wage work in three major U.S. cities— New York City, Chicago, and Los Angeles— Bernhardt et al. documented high rates of violations of labor standards in a number of low-wage industries. Figure 1.1 presents estimates of the high rates of violation of standards regarding off-the-clock work, overtime pay, and minimum wage requirements in many of the industries discussed above.

Overall, 26% of workers in the three-city sample were paid less than the required minimum wage; 76% of those who worked more than forty hours in the previous week had not been paid the legally required overtime rate; 70% of workers who were asked to come in early or stay after their shift were not paid for that time and were subjected to retaliation by their employers for complaining in some way about work conditions.[10]

Creating External Costs

To understand the second social problem associated with the fissured workplace—externalities—take the classic case of a manufacturer that makes, say, plastic containers. When it does so, it considers all the labor, material, and capital costs it faces in setting its production goals, weighed against the price it thinks it can charge for the containers. If it also creates air and water pollution in the process of making containers but does not face a cost for that

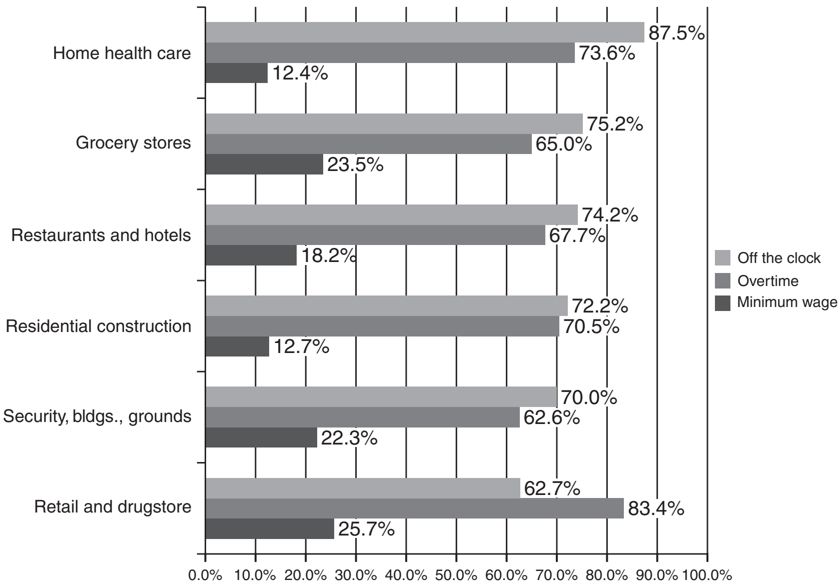

FIGURE 1.1. Labor standards violation rates (percentage in violation) in selected industries. *Source:* Bernhardt, Milkman, et al. 2009.

pollution, it will act as if that cost is zero—in other words, it will ignore the costs of pollution it imposes on society. As a result, its prices will not reflect the total social costs of production, and its market price will be too low. That will lead consumers, responding to the lower price, to consume too many containers, resulting in too much pollution. The pollution externality will leave society worse off than if the container manufacturer, as well as consumers, were forced to include the cost of pollution in their decisions.

Significant externalities arise from fissuring. By fragmenting the employment relationship, certain important decisions that do not directly affect the costs of any of the employers involved fall through the cracks. Complex systems that underlie production require coordination. By carving up employment among many parties, the problem of coordination increases. And when coordination fails, accidents happen. The BP Deepwater Horizon disaster of 2009 is a prime example of this: the U.S. Chemical Safety Board investigative team concluded in the summer of 2012 that a principal cause of that workplace and environmental disaster arose from coordination failure among the three organizations responsible for the drilling. The Chemical Safety Board noted a number of such deficiencies, including those related to the linkages between the hazard assessment systems of BP and its subordinate organization on the Deepwater Horizon, Transocean:

> BP and Transocean hazard assessment systems were inadequate. For example, the bridging document that sought to harmonize safety controls between BP and Transocean was a minimal document that focused only on six personal safety issues such as minimum heights for employing fall protection equipment. The document did not address major accident hazards like the potential for loss of well control.[11]

As a result of this failure of coordination, eleven men died on the rig and billions of dollars of environmental damage were inflicted on Gulf Coast economies and fragile ecosystems. Fissured employment has led to similar outcomes in other industries, from cell tower construction to the logistics industries I examine in detail in Part II.

Dividing the Pie

Finally, the fissured workplace also affects how the economic pie created by companies is divided. A superior form of organization can lower the costs of making goods or delivering services. That potentially can have an impact on three groups: consumers, in the form of prices; investors, in the form of better returns; and workers, in the form of wages and employment.

Large firms employing a wide spectrum of workers—from highly trained engineers and professional managers, to semiskilled production workers, to janitors and groundskeepers—characterized the workplace of the mid-twentieth century. An important consequence of having people with diverse skills and occupations working under one roof was that companies shared the gains received from their market position with the workforce. They did so through how wages were set—in both union and nonunion workplaces. While some businesses shared gains out of corporate beneficence, many did so because of what might be called enlightened self-interest. Because feelings about fairness affect employee morale, fairness considerations have an impact on human resource policies, including wage determination. In particular, perceptions about what one is paid depend in part on what others are paid. If a large company employed executives, secretaries, engineers, mechanics, and janitors, it therefore needed to be cognizant of how the structure of wages was perceived among all those working underneath the common corporate umbrella. As a result, janitors' wages were pulled up because of the wages lead employers paid their factory workers.

Fissured employment fundamentally changes the boundaries of firms—whether through subcontracting, third-party management, or franchising. By shifting work from the lead company outward—imagine the outsourcing of janitorial or security workers—the company transforms wage setting into a pricing problem. As will be seen, this pushes wages down for workers in the businesses now providing services to the lead firm, while lowering the lead business's direct costs. Fissuring results in redistribution away from workers and toward investors. It therefore contributes to the widening income distribution gap.

Mending the Fissured Workplace

An examination of fissured employment puts the question of the boundaries of employment responsibility center stage. Most employment laws in the United States at the state and federal level define "employee" according to stated objectives of the individual statute. This has led to varied—and highly contested—debates on who is or is not an employee. Common law defines an employer as a party who has the right to "direct and control" the performance of an employee as he or she undertakes a set of compensated activities. Courts apply a long list of factors used to determine if such control exists in a given situation, such as control of the work product, determination of the time and place of work, and the provision of tools and materials.[12]

Federal workplace laws define employees and employers. The problem is that each law does so differently. Take two examples. The Fair Labor Standards Act, which sets minimum wage and overtime standards and regulates child labor, defines an employee as "any individual who is employed by an employer" and states that "employ includes to suffer or permit to work." To help clarify this vague definition, courts apply an economic realities test to evaluate the particular employment situation surrounding a worker and an employer. This potentially gives the agency responsible for enforcement the latitude to adjust to changing employment conditions on the ground.[13]

The National Labor Relations Act, the federal statute governing union organizing and collective bargaining, also uses an economic reality test for defining employment. However, a Supreme Court decision in 1944 holding that boys who sold newspapers on the street on commission were in fact Hearst employees despite the company's contention that they were independent contractors led enraged conservatives in Congress to amend the National Labor Relations Act in 1947 to specifically exempt independent contractors.[14] This has led historically to very narrow readings of coverage and application of the act.

The definition of "employee" has become a hotly contested issue in recent years, particularly in regard to the reclassification of employees as independent contractors. Since independent contractors are viewed under law as business entities in their own right, they are exempted from minimum wage and overtime requirements of the Fair Labor Standards Act, workers' compensation, unemployment insurance, Occupational Safety and Health Administration (OSHA) regulations, the National Labor Relations Act, and Social Security.[15]

But as the vignettes opening Part I also make clear, fissured employment further muddies these already murky waters. Although most laws look to the owner of the enterprise as the party ultimately responsible, in many cases the owners are only nominally involved in the setting of employment policies or their implementation. In hotels, for example, the pace and nuances of work are set by the brand (for example, Hilton); day-to-day human resource functions and oversight of the workforce are handled by an independent hotel operating company (for example, Tharaldson Lodging); and the employee may receive her paycheck from a staffing company hired by the hotel operator, rendering the owners of the property little more than the ultimate wallet from which pay is dispensed.[16] Employment therefore bears little resemblance to the dyadic relationship often assumed in how we think about and administer our core workplace regulations.

Efforts to address conditions in the workplace arising from fissured employment structures cannot ignore the relationship between organizations at the top and bottom of those industries. It has long been the case that state and federal agencies that enforce labor standards face an uphill battle. In the labor standards area, approximately 8.5 million workplaces are covered by applicable federal legislation or similar requirements at the state level. There are a total of 1,000 federal labor standards investigators and an estimated 660 inspectors at the state level to oversee these workplaces. Consequently, the annual probability of a workplace receiving an investigation is well below 1 in 100, and in industries with deep fissuring as tiny as 1 in 1,000.[17]

The emergence of fissuring further heightens the need to think differently about how government agencies, as well as labor unions and other worker advocates, address the problems of precarious employment. An economy dominated by large business organizations with concentrations of employees operating within their boundaries is difficult to police. An economy where much of that employment—particularly for workers with lower skills and market leverage—has been shifted outside of the boundaries of those companies poses even graver questions about the efficacy of the traditional approach to workplace regulation.

The implications of fissuring go even beyond workplace conditions to more macro-level outcomes. The productivity of U.S. workers has grown steadily since 1973, increasing particularly rapidly from the mid-1990s until 2010. Over the same time period, median hourly compensation stagnated. Yet some people were indeed doing quite well. While wages stagnated over the past quarter century, the pay received by top business executives soared. In 1979 the ratio of the pay received by the average CEO in total direct compensation to that of the average production worker was 37.2:1. By 2007 (the year before the recession) it had grown to 277:1.[18]

As a result of these trends and the fact that the highest-earning households received a large percentage of their income from returns on capital and other nonwage and salary sources, U.S. income distribution has become unequal to an extent not seen since the 1920s. In 2007 the share of national income that went to the top 1% of families hit 23.5%. More strikingly, while the real income of the top 1% grew by 58% between 1993 and 2010, that of the rest of the 99% of families rose by a paltry 6.4%.[19] Although these shifts arise from a complex set of factors, the changing shape of employment and the outward shift of jobs from large companies to smaller ones play a role.

Even our models of the business cycle may be affected by the presence of fissuring. Historically, large businesses led recoveries: as demand returned, large firms directly increased employment. Now, employment decisions in many industries are mediated by fissured structures. Not only does this means that the timing of recoveries may be slowed, since they must "flow through" the fissured relationships; but the composition of jobs added also will reflect those relationships. Seen in this light, it is not surprising that the first jobs to be added following the Great Recession of 2007–2009 were predominantly at the low-wage end of the spectrum, nor that 93% of total income growth during the recovery from 2009 to 2010 went to the top 1% of the income distribution.[20]

Addressing the problems of working conditions, wages, and employment over the next decades will require wrestling with the consequences of the fissured organization and the public's willingness to balance its benefits to some consumers and shareholders against its consequences to those whose workplaces have been fundamentally altered by it. Although the fissured organization raises a raft of new questions and challenges, an understanding of its origins, operation, and implications opens a range of opportunities to address its consequences.

Why Is This Account Different from All Other Accounts?

Contingent work, subcontracting, misclassification, offshoring, and the problems of low-wage work are well-known and abundantly documented phenomena of the past two decades.[21] Coming out of the recession of 1980–1981, many companies in the private sector that had in the post–World War II era provided their workforces with increasing real wages, generous benefit packages, and reasonably secure employment began to introduce practices that broke with these traditions.[22] Many companies began to experiment with contracting out certain services, and, later in that decade, seeking alternative workforces outside of the United States. Through outsourcing, companies seek to minimize labor costs by moving activities formerly undertaken inside the boundaries of an organization to labor markets located outside of the organization.

At the same time, employers replaced jobs that were once full time and permanent with a different type of employment contract with a less clear commitment to longevity or even stable hours. Part-time work, temporary positions, and other "contingent" forms of employment began to pop up in the human resource portfolio of Fortune 500 employers. Independent contracting—where workers left the traditional employment relationship entirely to become (or be classified as) entrepreneurs providing services to former employers—also became increasingly prevalent. Long a practice in industries where individuals possess specialized skills of value to multiple employers, independent contracting popped up in places that previously would have been regarded as traditional employment situations.

Analysts examining these trends associate them with a familiar list of causes: globalization of industries; falling rates of unionization; new technologies and work processes; changing composition of industries; and declining enforcement of workplace policies at the state and federal levels. Together, these changes created pressures for firms to find ways to reduce labor costs and gain flexibility at the workplace. Markets and competition beget contingent work and contracting out.

The concept of fissured employment includes, but is not limited to, these well-known practices. It is also linked to some of the aforementioned environmental changes. But the usual accounts of employment change often do not fully paint the picture of *why* organizations have restructured, and therefore give an incomplete assessment of the implications of these changes for the workplace and the economy. Fissured employment is rooted in part in cost control, but lowering labor costs is only part of the story (and it is motivated by broader aims than many of the above explanations suggest).[23] The fissured workplace reflects a more integrated and comprehensive strategy that businesses have increasingly chosen to take, rooted in considerations of both the revenue and the cost side of the income statement. Facing ever greater pressures from public and private capital markets to improve returns, companies who adopt fissured employment strategies aim to improve profitability by focusing attention and controlling the most profitable aspects of firm value while shedding the actual production of goods or provision of services.

This account of the fissured workplace also examines a wider range of organizational forms than do many accounts of contingent work. Notable among these is franchising—an organizational form once largely restricted to a few industry segments that has now diffused to many other sectors of the economy. Franchising provides a mechanism for a lead company to create a model of business organization that can then be replicated by others, but controlled by a lead company. It creates a mutually advantageous means of sharing the gains of a brand, as well as an ingenious mechanism to push out the difficult task of providing the good or service to other entities with greater incentive to control costs while still selling the product of the lead company. It works, however, because of the franchise agreement, which allows the lead company to create and enforce its definition of the product and limits subordinate units' ability to alter it. The use of franchising as an organizational form has spread from familiar sectors (fast food and hotels) to surprising ones (among them janitorial services and home health care).

The various forms of third-party management used in industries as diverse as hotels, logistics, education, and manufacturing also allow lead companies to shift out the problem of ensuring adherence to core standards while giving the third party manager the incentive to undertake day-to-day operations more vigorously than might a sprawling, geographically dispersed organization. In some cases, third-party managers are brought in to oversee functions that the lead company views as outside its areas of core competency (for example, food service inside a major hospital, or transportation for a school district). In other cases, such as hotels, outside managers are hired to oversee even core functions for the enterprise. In these instances, the model requires that the lead business create and maintain rigorous standards that the third-party manager/operator undertakes and against whose performance it is judged.

Supply chain systems represent an additional organizational form that allows lead firms to implement the fissured model. The increasing scope, depth, and global reach of supply chains that provide products to major manufacturers and retailers create efficiencies for companies like Walmart while reducing their exposure to inventory risk and demand fluctuations (the bane of the retail business). Retail or manufacturing supply chains rely on lead companies promulgating detailed technology, shipping, delivery, and product standards that are adhered to by their supply base. The degree of specificity of those standards and the high stakes attached to their fulfillment are fundamental to the operation of modern supply chain logistics.

Seen in this light, the forces leading to the vulnerable work conditions described at the outset of this chapter are not an inevitable result of the nature of those jobs or industries. *They arise from how those sectors have come to be organized.*

Organization of the Book

This book has three major parts. Chapters 2 and 3 discuss the origins of the modern corporation and how fissuring came to change that stalwart institution of the U.S. economy (Chapter 2). Economists (and other skeptics) often ask, "If something is so advantageous now, why didn't businesses adopt it before?" Chapter 3 answers this question by examining the changes that brought pressure to bear on major businesses to shed employment as well as the technology and standards revolution that enabled them to fissure the workplace. Chapter 4 then examines the crucial issue of how wage setting has changed as a result of the organizational evolution discussed in Part I.

The basic architecture underlying the fissured workplace plays out in distinctive ways in different sectors, with important implications for policies seeking to redress them. Part II therefore explores the major organizational forms resulting in fissured workplaces: subcontracting (Chapter 5), franchising (Chapter 6), and supply chains (Chapter 7). Each chapter examines in depth cases that portray the different mechanisms that underlie each organizational type and their consequences for employers and workers.

Part III takes up the question of how to mend the fissured workplace. Chapter 8 discusses why current workplace laws are poorly suited to dealing with how the employment world actually functions and suggests the kind of legal reforms that could redress this problem. However, mindful of the limitations of legislative solutions to workplace and employment problems, Chapter 9 turns to how government policies under existing laws might—and are—being adapted to deal with fissured employment. Chapter 10 looks at how other workplace institutions—including unions, worker advocates, employer associations, and international monitors—can address the "broken windows" problem arising in fissured workplaces. The book concludes by considering the broader consequences of an economy characterized in major sectors by fissured employment and workplaces and speculates on the future path forward.

2

Employment in a Pre-fissured World

During much of the twentieth century, the critical employment relationship was between large businesses and workers in major sectors of the economy. Large employers—General Motors, U.S. Steel, and Alcoa—dominated much of the manufacturing economy. Emerging industries also spawned huge companies: Kodak, IBM, and Xerox grew to be giants in their product markets and in the labor markets from which they drew their workforces. While the service sector operated at a more local level, the national players that did emerge—Hilton and Marriott in hotels, Macy's and Sears in retail—similarly employed thousands.[1]

To understand fissured workplaces, we must go back first to their origins in the modern corporation of the twentieth century. Fissured employment implies that something about the structure of large enterprises is no longer advantageous, leading firms to shift out to other businesses activities that were once regarded as core to the enterprise. This evolution requires an understanding of how large businesses came to dominate industry landscapes in the first place.

Growing Companies, Changing Boundaries

Shifting Retail Boundaries

The emergence of the large corporation of the twentieth century is captured in the business history of the fastest-growing retailer in the United States of its time, one that came to dominate national markets, gained enormous power over its supply network, and created deep concern among the public about its growing clout: A&P. Like a retailer of far greater contemporary repute, A&P grew in scale and scope by internalizing a core set of activities that lowered key costs of providing food to its customers, thereby allowing it to cut its prices and gain market share.[2]

For decades, getting food from farmers and food processors to consumers was handled through a complicated chain of intermediate businesses—wholesalers who would buy products from producers, aggregate them, and move them to other distributors and ultimately to the small stores that would sell them to consumers. Distribution therefore required multiple market transactions (and costs associated with each step).

In the first two decades of the 1900s, consumers relied on local grocery stores. Typically, these stores purchased their supplies from jobbers, small wholesalers who dealt in small quantities of goods. Jobbers, in turn, purchased from larger-scale wholesalers, occasionally directly from manufacturers, or from central produce markets. With an order placed by phone, the jobber saved the local grocer the task of making trips to purchase food or having to hold an inventory of it. A grocery store would draw on many jobbers, since each one carried a relatively narrow line of goods. Because neither the jobber nor the grocer had much shelf or storage space, jobbers delivered their goods multiple times a week.[3]

A&P's key organizational innovation was using scale to dramatically lower the costs of providing food to its customers, largely by internalizing tasks that were traditionally undertaken by jobbers and wholesalers—that is, buying goods from food providers and getting them to small retail groceries. Rather than depending on the warehousing and delivery services of many other intermediate businesses, A&P brought this function inside the walls of the corporation, removing one layer of middlemen (and the costs associated with them), enhancing the opportunity for scale economies, and in particular improving its ability to manage inventory of goods.[4] The fickle nature of consumer demand—even at the turn of the last century—represented a central problem for retailers. As Walmart later would show once again, effective management of inventory costs and risks confers great advantages on a retailer.

A&P's strategy gave the company substantial cost advantages over the small retail stores with which it competed, allowing the company to sell groceries at prices far below those of its competitors. Growth in its market gave it greater clout to negotiate lower prices with food suppliers, further expanding its cost advantages, allowing A&P to grow and capture substantial market share across the country.[5] In so doing, A&P changed the nature of the food retailing industry and the way companies needed to organize themselves to compete. As a result, the boundary of firms in the industry came to incorporate many of the functions that, before A&P's ascendency, would have been undertaken through market transactions.

Defining Enterprise Boundaries

Ronald Coase argued in "The Nature of the Firm" (one of the most famous essays in the history of economics) that the boundaries of a business enterprise could not be understood without thinking about the decision of when work should be done inside versus outside of the organization. Many of the activities of corporations involve the allocation of resources across different activities. This is precisely what markets do. Coase asked, If this is the case, why are organizations superior? His answer was that under certain circumstances, organizations provide a more efficient solution to handling transactions where coordination through a market would be more costly. In a world where the costs of transactions between parties may be significant, many activities become located within the walls of a firm.[6] A&P's model of getting food from producers to a consumer's kitchen lowered costs relative to a long chain of market transactions from producers to wholesale distributors to retail stores.

Oliver Williamson built on the Coasian framework to develop a formal theory of transaction cost economics, viewing the primary purpose and impact of organizations as economizing on transaction costs in the course of producing complicated products and services. In the transaction cost framework pioneered by Williamson, business organizations that make up an industry are neither simply production processes combining capital, labor, and material to produce goods for the market (as traditional economics would lead one to believe) nor organizations untethered from economic forces and able to configure themselves as they wish (as often implied by popular business gurus or some management academics). Over time, competitive forces acting on individual decision makers within organizations pursuing their own objectives lead some functions to end up being done internally, others through various types of relationships (partnerships, franchise agreements, other forms of contracting), and still others through market transactions.[7]

Property rights (or efficient contracts) theorists in the 1980s pushed Coase's and Williamson's questions on the drivers of firm boundaries by asking why parties could not undertake more activities via market relationships by writing contracts that would solve the types of problems that created high transaction costs.[8] Market transactions would be sufficient if two parties could write a "complete contract" that captured the private benefits and costs of two parties (whether business/business, buyer/supplier, or employer/employee) covering all exigencies. But that is often not possible for a variety of reasons. The vagaries and uncertainties of life mean that writing a contract that covers all possible outcomes is simply not possible. Even if it were, many outcomes are not directly observable by one party or the other, making contract terms difficult to enforce. Where one party invests heavily as part of the transaction, making it expensive for it to leave, problematic incentives may arise in relationships, allowing one party to "hold up" the other. And the bigger those problems loom, the higher the incentives need to be in the contract itself to move the contracted party in the right direction. As a result, many forms of contracts are incomplete, making organizational solutions to certain coordination problems necessary. Once again, this means that some activities need to be done inside rather than outside firm boundaries.

Visible Hands and the Origins of the Modern Corporation

Railroads, steamships, and the telegraph transformed the scale of markets in the years following the Civil War. The combination of rapid communication and the slashing of transportation costs meant that potential markets could become national or global. Manufacturers, formerly constrained to filling demand primarily in local markets, now had incentives to dramatically scale up their enterprises.[9]

At the same time, a pre-A&P wave of consolidation had restructured distribution chains, replacing large numbers of unconsolidated wholesalers, which distributed manufactured products through a complicated commission system, with large wholesale channels, which more effectively consolidated demand (a system A&P would displace by further expanding efficiency at the retail end). By consolidating demand more effectively, national markets for goods replaced localized markets, thereby providing a basis for increasing the scale of production.

Technologic innovations created methods of producing existing and new products through more mechanized processes that dramatically reduced their costs and increased the potential size of production runs. Mass production of synthetic dyes and, later, synthetic fibers, plastics, and myriad other chemical products in the 1880s led to dramatic falls in costs per unit and the emergence of huge chemical manufacturers in the United States as well as in Germany and the United Kingdom. The invention of the Bonsack machine in the early 1880s transformed the production of cigarettes, as did new production technologies in the food industry allowing large-scale production of vegetable oils, refining of sugar, and production of food for people and livestock. Manufacturers could harness these new production technologies and more efficient forms of energy to create greater scale advantages, allowing them to benefit from a virtuous circle of growing markets, falling costs arising from scale, greater market share, and further incentives to ratchet down costs through scale.[10]

The melding of technologic innovation with production geared to expanding national and international markets produced astonishing reductions in costs. Adoption of the Bessemer process as the technologic fulcrum of steel production, for example, led the cost of rails produced by Andrew Carnegie's steel mills to fall from about $100 per ton in the early 1870s to a mere $12 per ton in the late 1890s.[11] Similarly, Henry Ford's installation of the assembly line in 1913, coupled with standardization of components and creation of a work organization that broke jobs down to discrete, repeatable, and simple steps, drove the time to assemble a Model T chassis from 12.5 hours to just 1 hour, 33 minutes.[12]

Although economies of scale technically arise from the relation of unit costs to volume, they can only be achieved through the building of organizational capacities. Firms needed to create systems by which to oversee, supervise, and create incentives adequate to the complex task of modern production. The development of modern management was the final innovation to put the above into effect and allow the parts to fit together through organizational and management structures. In particular, the need to coordinate a vast and growing network of railroads or telegraph systems or to assure a stable and consistent flow of materials to achieve high levels of capital utilization in industries such as chemicals required multiple levels of professional managers, supervisors, and specialists in running operations.

Managerial hierarchies first emerged in the railroad industry to coordinate the complex network of trains and telegraphy. They next were adopted in companies like Sears, Roebuck, which took advantage of modern communication and transportation systems to transform the archaic forms of distribution that had long characterized balkanized, small markets.[13] Managerial hierarchies then emerged in those industries where the technology of production created scale economies and competitive advantages, such as in chemicals, petroleum refining, steel production, and machinery manufacturing.

Gaining competitive advantage through scale also provided the basis for firms to expand their product offerings and capitalize on their ability to provide related goods and services to customers. Economies of scope emerge where an enterprise gains a competitive advantage in introducing new products in part because of its dominance in other product areas and its reputation and relationships in distribution. The cost of introducing a new product is therefore far lower for the established firm than it would be for a smaller competitor. Firms like General Foods in food retailing, DuPont in the production of synthetic products, and of course General Motors in the auto industry gained further dominance through broadening product offerings. The result was the basis for a new method of organizing production and distributing goods.[14]

The businesses that became dominant did so through a recipe of (1) investing in production facilities sufficient to capture economies of scale and scope (as determined by technological constraints); (2) investing in national and international marketing and distribution networks; and (3) investing in managerial systems sufficient to coordinate production and distribution as well as by taking advantage of their integration. Those able to do so quickly came to dominate the smaller and less-sophisticated competitors and emerged as the oligopolies and monopolies of the early 1900s. They also grew by employing large numbers of skilled, semiskilled, and unskilled workers to take on the varying tasks of production, distribution, and management under one corporate roof.

Finally, emerging modern corporations like General Motors and DuPont developed a managerial structure that evolved as an apparatus to coordinate the increasingly complex set of operations required of multiproduct, multilocation enterprises with respect to both production and distribution: the multidivisional organization. Some very large businesses had emerged in earlier periods. But with ownership usually concentrated in a single family or at most among several partners, the organization typically looked like a federation of loosely tied businesses (that is, a holding company) with different family members or partners overseeing their piece of the enterprise (usually with considerable autonomy).

The demands of the modern corporation required a level of coordination and integration incompatible with a federation structure. The multidivisional firm still allowed for separate divisions, representing different functional areas (for example, production, inventory, shipment, marketing) or geographic regions. However, a centralized management structure sat on top of these functions, exercising control and final decision authority as well as using streams of data to monitor the activities of subordinate units. Managerial hierarchies reinforced the ultimate control of the top level of the organization, while human resource policies, accounting systems, and performance management provided sufficient incentives to allow delegated authority paired with centralized accountability.[15]

Changing Structures of Business Ownership

The emergence of large-scale enterprises and modern management was accompanied by a second, related development in terms of ownership. The scale of production and the investment capital necessary to underwrite the expansion of the modern enterprise made it impossible for individuals to be the sole source of finance.

New financial markets emerged in response to the need to raise capital on an unparalleled scale. Innovations in financial markets (trusts, dramatically expanded equity markets, and new forms of borrowing through bond markets) moved companies away from a reliance on a small group of family members or an inner set of investors toward new sources of funding and capital structures. This made available capital for investment in machinery well beyond what had previously been the case.[16]

The modern corporation, with its ability to raise capital through issuing equity or taking on debt at a scale impossible for individual owners, created a solution to capital limitations. At the same time, markets developed new mechanisms and instruments to raise capital from investors and move money between different industries with increasing efficiency (as well as creating new opportunities for skullduggery on a much grander scale).

Corporate forms of organization diffused in parallel to the transformation of production and management, reflecting both the capital intensity of industries and the development of managerial sophistication that often accompanied it. Although the original corporate model in the United States goes back to Lowell, Massachusetts, at the turn of the nineteenth century, it spread later in that century from public utilities to railroads, to sectors of manufacturing, and then to banks and insurance sectors.[17]

The fact that more and more large-scale enterprises on the production and distribution sides of the economy drew upon the modern corporation as a source for both accumulating capital and managing enterprises meant a growing divide between those who owned an enterprise and those who operated it. Rather than a single family (or a small number of partners) owning and operating a business, ownership came to be held by a growing number of shareholders, while the complicated task of running the organization became the province of professional managers.

Breaking apart ownership and management created the capacity to vastly increase the scale of operations of corporations by tapping capital from large numbers of investors, accessed through public stock or private capital markets. At the same time, the separation of ownership and control created a variety of puzzles in how to obtain information, create adequate incentives, monitor performance, and make sure that the activities of the hundreds or thousands of people working in multiunit enterprises were aligned with the interests of the owners. Adolph Berle and Gardiner Means, two of the first scholars to carefully document the separation, noted with alarm:

> The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use. It consequently challenges the fundamental economic principle of individual initiative in industry enterprise. It raises for reexamination the question of the motive force back of industry, and the ends for which the modern corporation can be or will be run.[18]

The concentration of economic surplus and power in the modern company, steered by managers operating under weak oversight by dispersed owners, led Berle and Means to forecast that corporations would soon exert an influence over the economic landscape rivaling that of the political power of the state: "The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of organization."[19]

Large corporations indeed came to dominate manufacturing, communications, food production, and retailing in the first half of the twentieth century. Production and distribution scale and the evolution of sophisticated organizational structures helped propel that growth, focused on building and expanding particular product lines, brands, and areas of competitive strength. Alfred P. Sloan, the CEO who built General Motors, is best known for transforming it from a loose confederation of automobile companies acquired during the period of industry consolidation into an integrated, multiproduct automotive giant. But Sloan also believed in staying focused on automobiles. When the opportunity arose for GM to produce ethyl gasoline, a higher-performance fuel, he and other executives rejected the idea, since it was a "chemical product rather than a mechanical one" and required an entirely different distribution mechanism.[20]

But as the century continued, some companies chose to radically expand their scope along with their size and to move far beyond their original area of competitive strength. By the 1960s executives operating with less restrictive attitudes about business scope than Sloan's acquired or engaged in mergers with companies often from businesses far afield of their own. A bevy of sprawling conglomerate corporations resulted, including companies like Beatrice (which then owned such diverse entities as Playtex, a manufacturer of bras, and Avis, a car rental company); Litton Industries (which, along with being a major defense manufacturer and shipbuilder, diversified into manufacturing office equipment and microwave ovens, operating restaurants, and distributing packaged foods); and ITT Corporation (which began in 1920 as a telegraph and telephone company but ballooned in the 1960s into a conglomerate by purchasing over three hundred companies, including the Sheraton Hotel chain and Continental Bread). Eleven of the top twenty-five acquiring companies at the height of this "go-go" era were classified as conglomerates, and that group acquired more than five hundred companies between 1961 and 1968.[21]

Defenders of conglomerate merger and acquisition activity argued that diversification allowed large companies to create their own internal capital markets where corporate resources could be efficiently allocated to a wide range of business sectors.[22] Other business analysts, however, viewed the trend with alarm, citing conglomerate acquisitions as a prime example of the consequences of the gulf between ownership and management. Conglomerates reflected senior executive decisions to grow simply for the sake of growing and perpetuating the organization.

Whether through a strategy of growth focused on established product lines or through a conglomerate strategy, major companies in the postwar era pursued stability over risk taking, as reflected in follow-the-leader pricing policies (stabilized through the dominance of U.S. corporations in many industries), long-term pricing and contract agreements for key inputs with suppliers, and ever-more-refined demand management through advertising and marketing. This conception of the self-perpetuating, planned, and ever-growing corporate entity was best (and most mordantly) described by John Kenneth Galbraith:

> The firm must be large enough to carry large capital commitments to modern technology. It must also be large enough to control its markets. But the present view also explains what the older explanations don't explain . . . The size of General Motors is in the service not of monopoly or the economies of scale but of planning. And for the planning—control of supply, control of demand, provision of capital, minimization of risk—there is no clear upper limit to the desirable size. It could be that the bigger the better. The corporate form accommodates to this need. Quite clearly it allows the firm to be very, very large.[23]

The Development of Internal Labor Markets

An important piece of the management task facing corporations in the first half of the 1900s was hiring, training, evaluating, and compensating the thousands of people working within them. Just as ad hoc methods for managing resource flow were no longer possible given the scale of operations, finding systematic means to handle complex human resource functions became essential for the functioning of the organization. Collective bargaining and the development of sophisticated industrial relations functions in corporations became one track of development given the emergence of labor unions in the manufacturing sector in the 1930s and expansion of unions in other areas. Large nonunion corporations developed their own sophisticated policies to handle these functions along different lines.

These parallel developments in union and nonunion workplaces led to what Peter Doeringer and Michael Piore deemed internal labor markets: the system created inside major businesses that set policies for wages, employment practices, and other features of the workplace. Although their framework originally described internal labor market features common in large, union enterprises, Doeringer and Piore—and the many who followed their work—drew attention to the fact that workplaces in the enterprises dominating the economy were governed by administrative rules and procedures responsible for wage determination systems not affected directly by supply and demand conditions in local labor markets, but rather by the institutional practices that emerged within the firm.[24]

A key characteristic of those rules was their rigidity with respect to "external" labor markets surrounding (and in some cases connected to) them. Thus, while internal labor markets included ports of entry into the external labor market that were susceptible to fluctuations in supply and demand, the internal structures, and movement within them, were less connected to those external conditions, and movement into and out of them was governed by organizational rules.

The conditions that created significant advantages for the growth of large-scale enterprises, modern management practices, and divisional organizational structures also were well served by internal labor markets governed by rules that increased skill acquisition, stable methods of advancement, and employee loyalty. For employees, once on the inside of an internal labor market—whether entering as a production worker in a steel plant, a maintenance worker at a large food manufacturer, or a junior executive at a chemical company—one could look forward to certainty in employment, an established profile of wage or salary increases over time, and fairly clear expectations of what was required to retain employment and advance in the organization (again, whether that meant on the factory floor or in the corporate hierarchy).

For employers, internal labor markets meant stability in the supply of a labor force with the requisite skills to undertake the various activities necessary to produce steel, chemicals, or hotel services. By creating limited ports of entry, employers achieved some degree of market power in setting wages and salaries for their workforce, given the benefits created by maintaining a long-term attachment to the firm (a form of "velvet handcuffs").[25] Incentives within the system were well aligned: employee loyalty was rewarded with continuing employment and a rising profile of compensation. Employers secured a workforce capable of producing the output and services for stable but growing markets.[26]

The growth of broad and deep internal labor markets occurred in both unionized and nonunionized sectors in the post–World War II era. In the union sector, labor agreements in the automobile, steel, and rubber industries built these arrangements into elaborate job classification systems that were negotiated and administered through the collective bargaining process. These core collective agreements set the bargaining standards that were then adopted in other industries (in some cases where such detailed job classifications were less well suited, but still readily adopted).[27]

Complex internal labor markets developed among large corporations in the nonunion sector as well. In companies like Kodak, IBM, and Aetna, formal systems for promotion, job posting, evaluation, and compensation developed to handle the same problem facing union employers managing a large workforce and providing incentives to align their interests with those of the company. Rapid growth in existing and new markets, expanding product lines, and the increasing complexity created by coordinating a large organization raised the need to find methods of promoting from within a company, finding mechanisms for resolving disputes, and making sure that compensation, review, and disciplinary policies led to the retention of good employees.[28]

Departments related to administering the human resource policies for the workforce also grew during this period. In 1955 a little fewer than 30% of a representative sample of large firms had personnel / human resource management offices. By 1965 about 35% had such offices. Bolstered by the need to comply with new workplace laws governing pensions, occupational health and safety (including the Occupational Health and Safety Act), discrimination, and affirmative action passed in the later 1960s and the first half of the 1970s, the number of firms with human resource offices grew quickly: by 1975 the proportion with such departments reached just under 50%, and by 1985 it hit 70%.[29]

Large firms with internal labor markets were not only characterized by explicit human resource policies administered by departments and personnel specialists. Workers in large enterprises in the 1970s and 1980s—regardless of union status—tended to be paid more than otherwise comparable workers in small enterprises and to receive better benefits and face more desirable working conditions than workers of comparable ability, productivity, and even “collar color.”[30] These large-firm wage effects began to shrink (although not disappear) only in the 1990s.[31]

Internal labor markets also brought expanded benefits to workers, particularly in large firms. This is reflected in the declining share of total employee compensation (wages plus benefits like pensions and health coverage, as well as legally required benefits like workers’ compensation) accounted for by wages. In 1951 wages represented about 83% of total compensation among a survey of large companies in the private sector. By 1961 that shrank to 78%, and by 1971 to 74%. By 1979 wages represented only 70% of compensation received by workers in large firms.[32]

Like wages, increases in overall benefit coverage particularly reflected the policies of the largest companies in the economy. In 1979 the share of employees with pension coverage rose from 21% among firms with 1–24 workers to 48% in firms with 25–99 workers and to 71% in firms with 100–499 workers; it reached 89% among firms with 1,000 or more employees. Similarly, group health coverage rose from 34% in firms with fewer than 24 workers to 76% in those with 100–499 workers and topped out at 86% in the largest firms, those with more than 1,000 employees.[33]

The Great Unraveling

The late 1940s through the late 1970s marked an era when conditions were quite favorable for a large segment of middle-class workers in the United States employed in the kind of enterprises discussed above. There were, of course, large numbers of employees—particularly concentrated in minority, geographically isolated, or immigrant communities—who worked under precarious labor market conditions.[34] Yet workers in the thriving manufacturing sector of the U.S. economy—auto, steel, rubber, food—enjoyed rising wages, a growing scope and quality of benefits (including health care and pensions), and access to representation through unions.

Employers in those industries operated in product markets very different from those we have come to associate with the manufacturing sector in industrialized nations. Companies had pricing power, increasing demand for their products domestically and abroad, and access to capital for expansion. Competition often operated on nonprice dimensions, leading firms to try to maintain or expand market share through advertising and ever-increasing product line offerings and by seeking new consumers in other parts of the world. This created a very stable environment for setting compensation, benefits, and other workplace policies. In fact, given the potential downside that attacking labor entailed in the form of potential strikes and other forms of production disruption, achieving labor peace as part of a larger strategy of expansion made good sense for the bottom line.[35]

One of the most vibrant times of labor movement growth coincided with this period. Beginning with the passage of the National Labor Relations Act in 1935, the number of workers and the percentage of the workforce in unions grew rapidly, from about 7%t of total employment at the time the act was passed to a high of almost 35% in 1954.[36] In particular, unions in the manufacturing and construction sectors reached their apogee, as did collective bargaining agreements covering wages, benefits, and workplace conditions.

The relatively uninterrupted ascent in the post–World War II era of core manufacturing industries—as well as of emerging industries like business computing, telecommunications, construction, and financial services—allowed creation of human resource policies that provided steady training and mechanisms for advancement. Centralized corporate personnel, benefits, and labor relations departments were developed to administer complex health and pension plans and to deal with unions in dispute resolution.

The system of labor relations and sophisticated internal labor markets was therefore built on product and capital markets characterized by relative stability. What began to emerge in the 1970s under the pressures of inflation and overheated macroeconomic demand, along with global competition in core sectors of the U.S. economy, shook the basis of those systems. As these features of the environment changed dramatically, basic firm strategies, including those related to the workplace, were challenged.[37]

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By the 1970s, lead companies across many sectors of the United States economy, among them General Motors, Hilton, IBM, Boeing, and Sears, had developed large workforces deployed across thousands of workplaces to carry out their core service, manufacturing, research and development, distribution, or retail roles. Large headquarters and division offices undertook strategic activities like marketing, product testing and research, and logistics, supported by finance, human resources, labor relations, accounting, IT, and other functions.

In large U.S. retail stores, manufacturing facilities, hotel properties, and other organizational units, employees tasked with core activities—building cars, helping customers at front desks, working in warehouse operations, or developing new computer hardware—worked alongside those providing support functions—janitors, maintenance staff, security personnel, and administrative employees. Elaborate internal labor market systems set wages, benefits, and other personnel policies, knitting together the very diverse set of people operating under the corporate umbrella.[38]

As a whole, the system reflected a distinctive solution to the complex coordination challenges facing firms and markets. But just as A&P's upheaval of retail distribution signaled new ways of coordinating economic activities, fundamental changes in the costs of coordination—an explosion in computing speed and memory, the creation of technologies like bar codes, GPS, and electronic sensors, and the promulgation of standards for sharing the resulting torrent of information—would lead to seismic shifts in what businesses chose to do inside or outside their walls in the closing two decades of the twentieth century.

3

Why Fissure?

The large corporation of days of yore came with distinctive borders around its perimeter, with most employment located inside firm walls. The large business of today looks more like a small solar system, with a lead firm at its center and smaller workplaces orbiting around it. Some of those orbiting bodies have their own small moons moving about them. But as they move farther away from the lead organization, the profit margins they can achieve diminish, with consequent impacts on their workforces.

It would seem that businesses would always have an incentive to shift out activities that were not core to their profitability to other firms if such activities could be done at lower cost externally. What changed that made this practice so much more pervasive? One of the unsatisfactory aspects of many analyses of contingent employment, precarious work, and the rise of workforce vulnerability generally is that they provide lists of usual suspects for the problems, but an incomplete account of why those factors together have led to the growing adoption of these practices. Although it is true, for example, that more industries are now exposed to international competition, simply asserting this fact does not mean that companies are in a better position to contract out work.

For an answer we must return to the business history described in Chapter 2: if the modern corporation that dominated the economic scene during of much of the twentieth century reflected adaptations to the market and technological forces acting on leading enterprises of the era, the decision to shed many of those activities to other business entities implies a change in both the forces acting on those companies and the technologies and organizational forms available to them to undertake business. In fact, that is exactly what happened.

The fissured workplace reflects two interrelated changes that led companies to shed more and more employment as they faced intensifying pressure to focus on their core competencies. First, capital markets demanded it, reflective of changes in how those markets operate and the standards to which they held (and hold) businesses seeking financing. Berle's and Mean's concern that the separation of ownership from management insulated the modern corporation from scrutiny was replaced by a concern that the harsh stewardship of capital markets caused corporations to focus too strenuously on the short term. Changes in the financial sector created powerful incentives for lead firms to redraw the very boundaries of the corporation.

Second, technological changes created new ways of designing and monitoring the work of other parties, inside or outside the corporation. This enabled companies to shed activities while still ensuring that subordinate businesses adhered to detailed and explicit performance standards. Over the past three decades, it has become far less expensive to contract with other organizations—or create new organizational forms—to undertake activities that are part of producing goods or providing services. That alters the calculus of what should be done inside or outside enterprise boundaries. As a result, lead companies can simultaneously focus attention on a core set of activities (and direct employment relationships) as demanded by capital markets and shed more and more of the actual work done by the enterprise. We look at both changes in this chapter.

Demanding Capital

In chronicling the rise of the modern corporation, Adolph Berle and Gardiner Means in the early 1930s worried about the social consequences of the divorce of ownership and control. John Kenneth Galbraith thirty years later expected this schism to lead to managerial dominance of the economic landscape, as corporate leaders and their minions sought stability and persistence of their positions, leading to business and cultural malaise. Mainstream economists, at the same time, worried that the principal/agent problem inherent in the separation would lead businesses to become fat and lazy, unresponsive to the need to create value for their shareholders and not willing to make the changes necessary for the United States to compete with emerging countries, particularly Japan.

These concerns look almost quaint now. Economists began to raise very different concerns a few years later, when they began emphasizing the disciplining effects of capital markets and the role of management in maximizing a business's value to shareholders, who are the residual claimants to what was produced by the firm.[1] The efficient market model of financial markets holds that the value of shares reflects the market's take on a company's underlying value and future prospects. Because capital markets are highly competitive, managers whose actions stray appreciably from those of owners—regardless of how diffuse those owners are—will quickly be reined in by the falling value of shares and the demand by shareholders to replace incompetent (or self-interested) managers with others more capable of obtaining full value from the business.[2] Major changes in financial markets have been the subject of many books, particularly in the wake of the Great Recession, and will not be recounted in detail here.[3] But a synopsis of the transformation of several critical pieces helps explain the growing demands placed on companies by public and private capital.

Institutional Investors

Sophisticated institutional investors who steer trillions of dollars into and out of private and public companies played a crucial role in disciplining the behavior of managers and keeping their attention focused on returns. One critical impetus arose from changes in the way households save for retirement. In 1980 about 58% of wage and salary workers with pensions had defined benefit pension plans, while less than 10% had defined contribution plans (with the remaining workers having a mix of both). By 2011 the balance had dramatically shifted, so that less than 10% of workers with pensions had defined benefit plans, while more than 60% had defined contribution plans.[4] The impact of this shift is significant: defined contribution plans require the recipients to invest money that has been contributed by the employer in stocks, bonds, and other assets that will one day fund (hopefully) their retirement.

The rise of defined contribution pensions—401(k) accounts—and the growth of IRAs (another replacement for traditional defined benefit plans) led to a huge infusion of household financial capital to be managed. In 1980, 3% of household financial assets in the United States were held in investment companies; by 2011 that share stood at 23%. A large portion of the capital held in 401(k)s and IRAs was managed through mutual funds, leading to an explosion in the assets held by those institutions.[5] In 1980 mutual funds were a backwater among investments, holding about $134 billion in financial assets. By 2011 mutual funds held $11.6 trillion in assets.[6]

Mutual funds are major investors in U.S.-issued stocks, holding 25% of outstanding stock at the end of 2011.[7] The management of assets in mutual funds is concentrated: in 2011 the largest five companies managed 40% of total net assets (versus 34% in 1990), the top ten managed 53%, and the top twenty-five managed 73%.[8] A small number of companies—BlackRock, Fidelity, Vanguard, T. Rowe Price—stand at the pinnacle of companies holding and moving capital assets. BlackRock, which managed $3.5 trillion in assets in 2011, owned at least 5% of the shares of more than 1,800 U.S. corporations. Similarly, Fidelity owned at least 5% of 677 companies and Vanguard owned 5% of 524. This made BlackRock the largest shareholder in one in five U.S. corporations, and Fidelity and Vanguard the largest owners in about one in ten U.S. corporations.[9]

The scale of assets managed by companies like BlackRock, Vanguard, and Fidelity, the fungibility of those assets, and the large number of alternative investments available to fund managers together breed little patience for low performance for stocks of a given risk level. Institutional investors increased the volatility in ownership of companies and the sensitivity of managers to changes in company valuations.[10] For example, mutual funds seldom buy and hold stocks, but rather buy and sell them frequently. In 2011 average weighted stock turnover in fund portfolios was 52% each year (a number somewhat below the almost forty-year average turnover rate of 58%).[11] Money flowing into publicly traded companies from mutual funds is therefore "impatient" and moves frequently in search of better returns for a given level of risk.[12] Other institutional investors, such as public pension systems like CALPERS, hedge funds, and insurance companies, utilize the growing range of instruments for investment and therefore play directly (through their clout in the market) and indirectly (through their daily trading activity) an equally aggressive role in the life of the companies held (or potentially held) by them.[13]

The Private Equity Model

The rise of private equity firms also played a growing role in forcing restructuring of leading businesses.[14] The number and value of deals from private equity firms expanded dramatically in the years before the 2008 recession. In 2001 there were only 20 deals, accounting for $335 billion of invested capital. By 2005 the number had grown to 171 deals, with a total of $1.077 trillion of capital invested, with the trend peaking in 2007 with 607 deals and $1.5 trillion in invested capital. Funds focused on buyouts make up about two-thirds of private equity capital, although given that private equity money is then heavily leveraged with capital borrowed by acquired companies (see below), the amount of money used in private equity buyout deals was probably well over $3 trillion in 2011.[15]

The methods employed by companies like BlackStone Group, KKR and Company, and Bain Capital involve not only the buying and selling of other companies, but a more direct role in the operations of those enterprises once acquired. In a typical deal, the private equity partners (who are designated "general partners") bring in investment capital from a set of limited partners, usually investors like pension funds, academic endowments, and wealthy individuals. The capital becomes the basis for a fund to acquire a portfolio of properties and companies. The general partners receive fees of usually 2% of the invested funds from the limited partners, as well as earning 20% of profits from the acquisitions once a hurdle rate for the limited partners has been achieved.

Using the investment funds, the private equity firms acquire a set of target companies that are viewed as undervalued by the market. Similar to leveraged buyouts in an earlier era, the private equity investors use only a portion of the investment funds to acquire the companies.[16] The remaining capital (far larger than the amount from the private equity investors) is borrowed through short-term (and high-interest) financing on the books of the acquired company from investment banks, other hedge funds, and other lenders.[17] At the end of the investment period for the fund, the value of the portfolio of companies is tallied and profits distributed to the fund's partners.

Profits for the group arise because the now heavily leveraged companies in the private equity portfolio face intense pressure to undertake radical restructuring, in part through the policies instituted by the new ownership group. Ownership conveys the right to take whatever steps—selling off of business units; restructuring those that are not sold; shedding particular activities—are deemed necessary to increase the value of the acquired companies so that they can eventually be sold at a profit. This creates a very high-powered and direct means of restructuring companies.[18]

Executive Compensation and Firm Performance

The demands of investors on companies to improve performance were further sharpened by the growth of incentive-based pay systems for CEOs and other senior executives. Performance-based pay flows from the property rights perspective of incentive design. If the owners of companies really seek to increase their returns, they should fashion contracts with top managers to give the latter the incentives to do so (rather than allow them to pursue their own interests at the expense of investors as forecast by Berle and Means).[19]

Executive compensation for CEOs of the fifty largest firms in the United States was relatively modest, holding steady around the $1 million mark (in 2000 dollars), from the late 1930s all the way until the early 1970s. Beginning in the 1970s, however, the pay of top executives began to rise dramatically, crossing a particularly steep inflection point in the 1990s, when median pay for executives soared. Among the top fifty firms, median CEO compensation (in 2000 constant dollars) increased from $1.2 million in the 1970s to $1.8 million in the 1980s, and then jumped to $4.1 million in the 1990s. For the period 2000 to 2005 real median compensation among this group of CEOs hit $9.2 million.[20]

This rapid rise in compensation reflected the shift to performance-based pay linked to stock prices and options in major companies. Salary and bonuses represented 100% of compensation for CEOs in the largest fifty firms in the United States from 1936 to 1950. In the 1960s, salary and bonuses still accounted for 87% of all compensation. However, in the 1980s, compensation in the form of salary and bonuses fell to 74%, dropping further, to 53% of compensation, in the 1990s. By the time stocks, options, and compensation peaked in the period between 2000 and 2005, top CEOs earned only 40% of their compensation from salary and bonuses, while 23% came from stocks and long-term incentive plans (largely restricted stock) and 37% from options.[21]

As academic studies and news exposés revealed, while rewards did accompany upside results, executives also seemed to be well compensated even when stock prices went in the wrong direction (sometimes drastically so). One reason is that performance-based compensation policies (and the academic literature that justified them) generally assume an "arm's-length model of bargaining" between the CEO and top executives on one hand and the board of directors on the other in setting up incentive schemes. The reality, as researchers like Lucian Bebchuk and Jesse Fried demonstrated, is far different; there are a variety of reasons that the relationship between executives and directors is far more intertwined than suggested by the arm's-length model often assumed in corporate governance.[22]

As a result of both the intended performance effects and the hidden self-dealing built into many compensation systems, executive compensation dramatically increased the earning of top corporate leaders relative to others. The ratio between the pay received by the average CEO in total direct compensation and that of the average production worker went from 37.2:1 in 1979 to an astounding 277:1 in 2007. The effects of the recession knocked the ratio back to a "mere" 185:1 in 2009.[23]

Capital markets were not fazed by the trends in executive compensation. In fact, investors widely applauded the companies for adopting these pay schemes. But they did because of the policies CEOs and other business leaders instituted in pursuit of higher valuations.

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Today, one would be hard pressed to argue that the distance between ownership and control allows the creation of the "planned society" and the new industrial state forecasted by Galbraith. While there is still intense debate about whether the end result of capital markets remains efficient or myopic, few would disagree that management of corporate enterprises faced enormous pressure beginning in the mid-1970s as U.S. dominance in many core manufacturing industries faded and capital markets became more fluid.[24] In response, the lead companies subjected to this pressure began to change strategies significantly, putting in motion policies that would fissure employment.

The Pursuit of Core Competency and Its Consequences

A new and clear message emanated from public capital markets and private equity companies, reaching a crescendo by the late 1980s and early 1990s. It was echoed in articles and books by academics in business schools as well as by an army of consultants in new and established consulting companies. The message was simple: firms should focus their attention and their resources on a set of core competencies that represented distinctive capabilities and sources of comparative advantage in the markets in which they competed. Anything that did not directly support those core competencies would be carefully evaluated as to whether it should (1) remain part of the business at all; (2) be restructured to be done more efficiently internally; or (3) be outsourced to some other party that could provide the necessary activity externally at lower cost. In essence, the message was, Find your distinctive niche and stick to it. Then shed everything else.

The idea of core competency begs the question of what is "core" to a firm. Most proponents stressed that it was not about particular services, products, or functions by which companies gained current success, but about the underlying skills, knowledge sets, or business platforms that consistently produced those successful products or services. For a components provider in the automobile industry, core competency meant consistently developing and refining new products for transmissions rather than production excellence per se. For a hotel company, core competency reflected the ability to consistently provide a certain kind of customer experience for a type of business traveler, rather than owning and running a particular property in an important city. For a retailer, it meant the ability to manage inventory risk while offering customers a broader selection of products at its stores.[25] In an article often cited for its articulation of the concept, Prahalad and Hamel wrote: "During the 1980s, top executives were judged on their ability to restructure, declutter, and delayer their corporations. In the 1990s, they'll be judged on their ability to identify, cultivate, and exploit the core competencies that make growth possible—indeed, they'll have to rethink the concept of the corporation itself."[26]

The idea of core competency pushes executives to not define their business in terms of current products or strategic business units. Even firms in concentrated industries face competition: assuming that the profitability of a current set of products assures long-term success ignores these competitive pressures. In the popular conception of a core competency, a company needs to be able to recreate the reasons for its current success over time if it is to remain profitable (and in the good graces of its investors). That is what gives it long-term advantages over competitors, such as an ability to create and bring to market distinctive new products; to deliver consistent, high-quality services in multiple markets; or to consistently drive down the costs of making its products.

The business history of Apple Inc. is illustrative. The company's soaring profitability over the past decade arises not from its products per se but from its capacity to design, engineer, and market high-quality digital products at the cutting edge of its consumer base's tastes. Its decision to focus on product design, marketing, and retailing rather than on manufacturing goes back to the days of the Apple II (the company's earliest successful line of home computers, introduced in 1977). An estimated 70% of the manufacturing of the Apple II series was outsourced to other companies. In addition, Apple outsourced parts of marketing, printing, and even design aspects to other companies.[27]

Reliance on outsourcing remained a basic part of strategy spanning 1986–1997, the troubled period when Apple's founder, Steve Jobs, was ousted from the company. With Jobs's return as CEO in 1997, Apple struck out in new directions with the introduction of the iPod and the corresponding iTune stores (2001), iPhone (2007), and iPad (2010), digital products that came to eclipse its computer lines. Apple maintained its focus on design, new product development, and retailing (including through its own Apple stores). At the same time, it further expanded its outsourcing of manufacturing. When asked by President Barack Obama in February 2011 at a dinner meeting of Silicon Valley executives what it would take to make Apple products in the United States, Jobs crisply replied, "Those jobs aren't coming back." By 2012 the company directly employed 63,000 workers (primarily in its design and engineering staffs as well as in its retail operations), while relying on an estimated 750,000 workers worldwide outside the company to manufacture, assemble, and distribute its products.[28] Investors were delighted by the outcomes of the strategy that decoupled the tasks of creating new products from manufacturing them: Apple's stock price went from $7 in 2003 to over $600 in 2012.

The search for core competencies—and the demand to produce results for investors that demonstrated success in defining them and implementing changes reflecting them—has been ongoing ever since. While the results have been defined and play out in different ways over time, three broad phases of activity can be articulated. First, the search for core competency led to the dismantling of conglomerate corporations generally. But it also meant selling off business units in more narrowly focused companies, a particular focus of new private equity owners and buyout specialists.

Second, companies sought to shed activities necessary for ongoing operations but judged peripheral to core activities. This meant a set of headquarters functions at large companies that had often become extensive in prior periods of rapid growth, such as human resources, accounting and finance, and, more recently, information technology (IT). Likewise, it meant shedding many activities at the front lines of companies—whether in manufacturing plants, store outlets, or service delivery units—that were necessary to ongoing operations but not central to the core business, such as maintenance and janitorial services or security.

In more recent times, the demand for focus has led businesses to shed activities that are part of the core competency itself. Even the elements that make up a core competency are not immune from being shifted outward to other parties.

Goodbye, Conglomerates

Between 1962 and 1969, 22% of Fortune 500 companies were acquired in mergers. A group of huge conglomerate companies selling a wide and frequently incoherent range of products and brands emerged from this binge. Creating conglomerate companies was controversial even at the time of their growth. The Federal Trade Commission deemed conglomerate accounting that masked the profitability of individual product lines "a tool of deception."[29] The actual performance of many conglomerates undercut arguments about the economies of scale arising from centralized management of diverse business units ("good management is the same for any business") or superior access to capital that being part of the conglomerate conferred. Instead, unhappy shareholders of public companies and private equity investors began to question the results of broad acquisition strategies.[30]

Weakening macroeconomic conditions and declining stock prices created further pressure on conglomerate companies by the late 1960s to demonstrate to investors the value of the highly diversified enterprises. Corporate raiders attacked them as unwieldy and underperforming behemoths. By acquiring the companies through corporate takeover and selling off the loosely related (or unrelated) units, investors could extract value through the improved performance of units closer to the core business, and also benefit by selling the other units to external investors who could gain greater value from them. The dismantling of the conglomerate in this view would reveal that its pieces were worth more than the firm as a whole.[31]

The rise and demise of Beatrice Foods is instructive.[32] The company was founded as the Beatrice Creamery Company in Beatrice, Nebraska, in 1894, beginning as a grading operation for other dairy producers but quickly becoming a butter producer and creamery with its own label and product line. It grew by perfecting methods of packaging and distribution. By the early part of the 1900s, the company distributed products, and by 1930 it had moved its headquarters to what was then the hub of the U.S. food industry, Chicago, where the company produced 30 million gallons of milk and 10 million gallons of ice cream annually. It continued to grow in the next decades through acquisition of other creameries and expansion of its own production, responding to growing post–World War II demand for food. Beginning in the 1950s, Beatrice began to expand into related areas of food by acquiring other branded companies and changing its name to the more expansive Beatrice Foods, eventually acquiring well-known companies and food brands like Hunt's (catsup), Tropicana (orange juice), Wesson (cooking oil), La Choy (packaged Chinese food), and Orville Redenbacher's (popcorn). Acquisitions began to change shape in the 1970s when it purchased brands and companies like Jolly Rancher and Good & Plenty (candy), Culligan (water treatment), Avis (rental cars), Playtex (undergarments), Samsonite (luggage), and Airstream (trailers).[33]

Kohlberg Kravis and Roberts (later KKR), a major private equity company specializing in leveraged buyouts, understood what many in the public did not: that Beatrice had acquired well over a hundred major and valuable national brands. It purchased Beatrice for $8.7 billion in 1986 and began over the next four years to sell off the welter of brands and companies under its umbrella. The final units still operating under the Beatrice name were sold to ConAgra in 1990.

By the late 1980s, the flagship conglomerate companies of the 1960s had been dismantled through the actions of private equity companies like Kohlberg Kravis Roberts, corporate raiders like T. Boone Pickens, and leveraged buyout machers like Michael Milliken. But breaking apart conglomerated behemoths like Beatrice represented only the start of efforts to focus on core competencies. Along with and following divestment of peripheral business units, the insistent effort to shed turned inward.

Cutting the Corporate Periphery

Headquarters offices of companies and divisions blossomed in size and scope during much of the twentieth century. In time, the large range of support activities, spanning accounting, human resources, and information technology, came under increasing scrutiny as potential sources of cost reduction. These activities, it was argued, could be more efficiently undertaken by outside entities with greater experience and cost advantages in their provision.

Personnel, benefits, labor relations, and human resource departments had been fast-growing areas in corporate and divisional offices. The growth of unions in the middle part of the century led firms covered by collective bargaining agreements to create larger bureaucracies to deal with labor relations and compensation policies. Later, passage of laws on safety and health, discrimination, and fringe benefits required additional expertise. Over time, the offices gravitated away from a sole focus on compliance toward the broader function of human resource policies as a source of potential efficiency for the company, and in some cases as a source of strategic advantage.[34]

Yet because these departments were almost always cost centers rather than profit centers, they became an early target of outsourcing. Payroll represented the first function to be outsourced under the personnel / human resource umbrella, in part because of the potential efficiencies of undertaking these relatively standardized functions. Given the specific legal requirements of state and federal policies, the common platform of many payroll procedures, and the potential scale advantages of developing software systems to handle large payroll requirements, companies like Automatic Data Processing (ADP), Paychex Inc., and Ceridian Corporation grew quickly. These companies handle payroll and benefit functions.[35]

The scope of human resource activities being outsourced, however, soon broadened to include design, development, and implementation of benefit plans and workforce diversity programs. The complexity of some areas of legal compliance also led businesses to shift this work outward, particularly in rapidly changing areas of law. By the early years of the twenty-first century, the human resource outsourcing industry was estimated to have annual revenues of $21.7 billion, which accounted for more than 8% of all human resource spending. Contractors offered services in most areas of human resource policy, and major companies in a variety of sectors drew on their services. For example, in 1998 BP entered a seven-year deal to outsource compensation, benefits, payroll, organizational development, performance management, employee development, training, recruitment, and relocation to Exult, a small start-up company. As the outsourcing arrangement progressed over the period, an estimated 40% of BP's internal human resource staff was cut.[36]

Exult and the series of companies that later acquired it signed similarly large deals with Bank of America, International Paper, Prudential Financial, and many others.[37]

Information technology activities in corporate offices became another common target for shifting outward. As with outsourcing payroll, companies seeking to trim overhead costs are attracted to the potential cost savings arising by bidding out IT activities to a competitive market with multiple vendors of similar services. An added impetus arises from the rapidly evolving nature of IT requirements and capacities: because of the pace of IT change, a company (even a large one) is challenged to keep abreast of software, hardware, and increasingly Internet-based innovations. For companies where IT is not central to the business model, contracting out provides access to the forefront of new services that may be applicable (at a comparable or lower cost than creating these capacities internally).

Even though outsourcing IT began only in the 1990s, by 1998, 38% of surveyed companies had shed some of their IT activities to outside vendors.[38] As was the case with human resources, the first IT activities to be shed were routine functions that were fairly standardized across companies or new services with which the organization had little prior experience. These included data center operations, application maintenance, and network management.[39] Because of the idiosyncratic nature of other IT work, the scope of outsourcing widened more slowly to IT functions serving more core activities such as marketing (through web design and maintenance), user support, and application development. But recent surveys indicate that expansion to these more customized areas is proceeding, facilitated by companies providing high-security cloud-based servers.[40]

Cutting the Workplace Periphery

In the past, major employers hired landscaping crews, janitors and maintenance staffs, and security providers to keep facilities clean, well maintained, and looking presentable to employees, customers, and the public. But just as departments like payroll, publications, human resources, and information technology showed up as cost centers rather than profit centers, these activities were not directly related to making products or delivering services. Given the rising pressure to focus on core competencies, janitorial and maintenance services were some of the early activities to be pushed out of large businesses.

The logic was clear: Why should a major company pay its own employees to mop floors, clean bathrooms, vacuum rugs, and mow lawns when a myriad of outside companies were willing to offer those services? The incentives at some companies were further sharpened by the fact that some of these activities were unionized (particularly facility security services) even in workplaces where other employees were not covered by collective bargaining.

These activities were also relatively self-contained, lowering the costs of shifting them out to other service providers once the decision to shed them had been made. And as more of these activities moved outward, new competitive markets for service provision grew. The competition in the new markets to provide janitorial and security services intensified, lowering prevailing prices and further benefiting lead companies.[41]

In some cases, lead companies hired other big companies for those services, for example ABM Industries, a $3.5 billion maintenance, security, and janitorial company. Those large companies often hired and trained their own employees to provide cleaning services. This was particularly true if maintenance services included specialized activities requiring a trained workforce, such as when cleaning required particular techniques or capabilities.

In other cases, companies hired third parties to coordinate maintenance for them, such as cleaning of company headquarters or landscaping of the grounds. In turn, those companies, acting much like general contractors in the construction industry, hired other, smaller businesses to undertake pieces of the contract. In some cases, different floors of the same company might be cleaned by separate cleaning contractors. Work and employment could be split even more as contractors further subcontracted the work.[42]

Franchising also began to expand in the outsourced cleaning industry. Janitorial service providers usually do their work after hours with no direct supervision from the customer. Assuring customers that cleaners will both meet quality standards and be trustworthy custodians of facilities after hours creates opportunities for branding janitorial services. A new industry formed for providing branded services to medium and large business users via franchised janitorial services.

Whether to specialty maintenance companies, to subcontracting networks, or to franchised enterprises, the shifting out of peripheral activities is significant. By 2000 an estimated 45% of janitors worked under contracting arrangements, and more than 70% of guards were employed as contractors.[43]

Cutting Deeper

As the pressure to focus continued, business units within many corporations sought further ways to shed activities and reduce costs while protecting the parts of the business central to profitability. Management scholars and consultants promoted the idea of streamlining business processes that had, over time, become encumbered, slow, and wasteful. Companies had allowed many operations to become flabby, in this view, and were weighed down by internal processes that were often redundant, inefficient, quality-plagued, and unproductive. To compete more effectively, companies needed to strip their business practices to the core, analyze what the critical features of them should be, and rebuild them accordingly.

"Reengineering" was an influential approach in this area first articulated by Hammer and Champy and then taken up by other business scholars and by management consultants; it involved taking apart the components of processes by which businesses made products or provided services. Through a rigorous examination of these pieces, the production process could be reengineered in order to reduce waste, increase throughput, speed up delivery processes, and improve productivity. In so doing, companies would be able to better provide their products at lower cost.[44]

One example of the ever-deepening effort to shed activities from the core of companies occurred in logistics and distribution. Moving intermediate products between different stages of production or out to retailers or customers is an intrinsic part of production. Changes in retailing discussed below have made logistics even more important. Auto parts suppliers providing components to car companies operating under lean production principles often must be ready to deliver parts in relatively short time spans requiring efficient logistic operations. Modern lean retailers similarly demand rapid replenishment of products and sophisticated logistic operations.

Nonetheless, manufacturers, agricultural companies, and retailers began to shift distribution operations outward. In the 1980s this began by having trucking companies take over more of the basic transportation activities formerly done by their own in-house transportation fleets. In the 1990s companies like DHL began to offer expanded services for clients in packaging, sorting, and labeling for internal and external operations. By the early years of the twenty-first century, integration of information technology with distribution activities allowed providers like UPS and Schneider Logistics to manage particular transportation operations such as product returns. Most recently, logistic operations have come to entail taking on the responsibility for the entire logistic activities of major companies.[45]

As in other cases, the first stage of shedding activities was fairly straightforward and standardized. Logistics providers can achieve lower costs by higher-capacity utilization of distribution facilities, by allocating those distribution facilities more efficiently, by more efficient transportation routing, and by other economies arising from providing services to multiple customers at once. They can also more effectively smooth the ups and downs of logistic needs across companies facing different demand patterns. As a result, transportation and distribution activities moved outward fairly quickly as the market for such services developed and the financial benefits of using them became apparent to many companies.[46]

If such economies arose in logistics, why not move up the production process to manufacturing or procurement? If an outside business could provide janitorial and landscaping services to hotels, why not find other providers to clean rooms, or to run the kitchens of chain restaurants? The logic of shedding activities could potentially be applied deeper and deeper into the core operations of businesses—as long as the crown jewels of core competency were not compromised.

Dangers of Shifting Too Much

The benefits and costs of shedding corporate, divisional, and facility-level activities to other companies become more complex as the activities go deeper into the core competency of the lead company. Businesses face significant risks if outsourced functions interact with decisions central to core competency or require nuanced understandings of customers, markets, or other external factors. For example, companies have found that shifting away major human resource and IT functions can backfire if it impinges upon the development of key staff positions in the case of personnel or undermines building strategic data systems or services in regard to IT. The problem is intensified if business functions are hard to bring back in-house once outsourced.

Shifting out core production activities came to the manufacturing sector in the late 1980s. In a detailed study of the use of temporary employment agencies at an automotive supply company, Erickcek, Houseman, and Kalleberg found that four of the five auto supply plants they studied used temporary agencies, with two of the plants relying on them for more than 20% of their production employment.[47] In a period of rapid growth, the company chose to rely on lower-paid temporary workers alongside a relatively high-paid non-union workforce.

However, the strategy was not without its problems. The extensive use of temporary workers impacted the quality of the supplier's products. As the share of workers from temporary agencies increased beyond one-quarter of the workforce, this problem became particularly acute. The human resource director described the tension between plant managers concerned about quality and executives concerned about lowering costs:

> And . . . quality is starting to have problems . . . and now it's like, "We've got to get this temporary ratio back down." We'll start edging back down to 20, and . . . then the goal becomes 15 percent . . . and now there's always this discussion, "Well, it's more cost-effective to have the temporaries." So it doesn't seem to be an initiative with the executives to get that ratio down. So even though they talk about it, we are never going to get this high rate down.[48]

In the end, the human resources director notes that the cost advantage concerns raised by senior executives prevailed and that the plant settled at operating "within 20 to 25 percent . . . But we are in this constant state of denial, yet that number still stays up there and . . . the vice president of human resources is . . . [saying], "We've got to get it down."

The auto supplier story reveals a tension created by fissuring, relating to what is called a principal/agent dilemma. Because the interests and objectives of subordinate providers of fissured activities are different than those of the lead business, the incentives of the business doing the work of the lead company may undermine some of the latter's objectives. In pursuit of its own profits, an independent provider of a service may choose to compromise quality, use lower-skilled employees, or be more likely to violate workplace laws than the lead company. The more misaligned the incentives of the secondary provider are relative to those of the lead company, the bigger the problem.

Shedding activities to other organizations creates a second problem. By shifting employment to another party and paying for services provided, the lead employer is less able to monitor performance, since those doing the work are now potentially hidden within another organization. Once again, this problem can be addressed in part by how the lead company carves up the work to be done, ensuring that the performance is as observable as possible. If so, the lead company will be able to detect if it is getting the performance it needs, and the market forces created by secondary businesses jockeying to be providers of the service will push toward pricing linked to performance (which is the point). However, if performance is not easily observed, other mechanisms must be devised to provide better information if the strategy is to succeed.

A third problem arises when shifting out activities to others creates the threat of "holdups." Engaging outside parties to undertake important activities for the lead company risks allowing those outsiders to use their potential leverage to withhold those activities to capture some of the benefits that arise from fissuring. This problem becomes particularly vexing if the subordinate unit has significant ability to advance its internal agenda over that of the primary organization, such as through the control of skill.

A central task for successful fissuring is to strategically shift out work so that the lead firm remains in what Red Barber, the famed announcer for the Brooklyn Dodgers, called "the cat- bird's seat." That is, make sure the subordinate players have limited power to stray from the central objectives of the lead company. For example, one way to limit the potential for holdup is to have many potential businesses available to provide the fissured activity. The more competitive the market for those services, the less able any one company will be to demand to share more of the benefits from fissuring.[49]

The fissured workplace therefore does not reflect an either/or strategy, but rather a careful balancing act. On one hand, the lead organization wants to protect and enhance the core competencies driving its profit model. On the other, it wants to shift work to other parties to the extent possible. But here is where balance is crucial. Shifting too much work out or selecting the wrong party to do that work can undermine the crown jewels arising from the core competencies of central concern to customers and investors. One needs a glue to hold the two pieces together.

New Technology and the Falling Cost of Coordination

The corporation of the twentieth century had a set of organizational arrangements to solve the boundary problems of firms and markets, built on the communication technologies, monitoring and coordination mechanisms, and systems of contracts of that era. The revolution in computing power (and the impact of Moore's Law, which says that the number of transistors on integrated circuits doubles every eighteen to twenty-four months) has lowered the costs of acquiring information in regard to selection and monitoring.[50] The expansion and ubiquity of communication provided by the Internet and digital communication systems similarly lower the cost of acquiring and sharing information relevant to these purposes.

The development of complementary technologies that allow low-cost collection and instantaneous transmission of data—everything from bar codes and scanners (2-D and now 3-D), small, even microscopic, wireless sensor technologies of all varieties including motes, and geo-coded transponders—creates unparalleled (a.k.a. scary) capabilities to track detailed information at minute levels of time and geographic specificity. Together, these technologies enable new relationships in all aspects of how businesses, markets, and their boundaries are configured.

A final form of cost reduction developed alongside the above-mentioned high-tech forms is more low-tech in nature. A variety of new organizational methods of contracting came into their own in the 1980s going forward that lowered the costs of shifting work out. The most striking of these was franchising. Although traditional franchising arose much earlier as a unique business form to enable distribution in a small number of industries, its application to fast food and later to other sectors (what is called business-format franchising) transformed it into a malleable way of structuring business relationships. The development of new forms of contracting and the establishment of law and experience around it lowered the cost of applying the fissured idea to new industries and relationships.[51]

Fissured workplaces could not have spread absent the falling cost of gathering information and undertaking monitoring in light of developments in the digital world. Two examples illustrate the implications of information and communication technologies in this way.

Falling Information Costs in Trucking

Running a trucking business inherently raises the problem of costly information. The work requires hiring individuals to transport valuable goods from one place to another, unmonitored for much of the time between when they are loaded on and taken out of the vehicle. Not only is the cargo valuable, but so is the vehicle used to move it. Along with the security of the goods, delivering them on time is also a key outcome for the end customer and the trucking business. So the trucking company faces the problem of both selecting good drivers and monitoring them as they drive and deliver the goods.

Falling information and communication technologies gave rise to a solution: onboard computing (OBC). OBC allows truckers to find the best routes for travel and to avoid potential delays. More importantly (from the perspective of companies), it allows trucking firms to know where drivers are at any time. The arrival of OBC and the falling costs of information associated with it should therefore lead trucking companies to realign their relationships with truckers. Baker and Hubbard, in a series of papers on the impacts of OBC on organizational structure and outcomes, point out that OBC can affect trucking companies in two ways. On one hand, it lowers the direct costs of monitoring truckers, allowing the company to watch drivers more closely. This might induce companies to keep truckers as direct employees, because they can use ongoing information to keep truckers on schedule and prevent unauthorized detours or stops (and also to detect costly behavior like speeding on highways or even falling asleep at the wheel).[52]

However, OBC also reduces the cost of coordinating drivers, since it provides real-time information on location. With lower costs of coordination, if a company could assure that its packages would move from point A to point B on time but could secure those services more inexpensively through, say, treating the truck driver as an independent operator outside of the pay structure of the large firm, so much the better. This increases the lead company's ability and interest in contracting out trucking activities rather than doing them on an in-house basis.[53] The OBC example also points out that fissuring, as enabled by falling information costs, is not simply a yes/no decision but still involves a balancing of the first two elements of the recipe, albeit with a greater tip toward shifting that work outward given the lower costs.

Falling Information Costs in Retailing

As in trucking, the technologies that allowed for the lean retailing revolution require a rebalancing of the benefits and costs of contracting. In this case, the key technologies are bar codes, scanners, and electronic data interchange (EDI), along with the falling costs of computers, allowing use of abundant real-time sales data. On one hand, these technologies lower the cost of monitoring the performance of suppliers and could push toward greater backward integration by retail firms. In this sense, digital information systems helped solve Ford's problems of overly ambitious backward integration in the 1930s by improving the lead company's ability to watch key suppliers.

On the other hand, as with trucking, the digital technologies allow better coordination of suppliers. This means that the retailer, as the coordinator with the principal economies of scale in distribution, can take greater advantage of its logistics competency, while leaving the provision of goods to manufacturers who have scale advantages in production. So the retailer coordinates the system (increasingly not with its own trucks, but using subcontracted trucks under close scrutiny) but keeps the production activity safely ensconced with the supplier. Enhanced monitoring allows it to carefully scrutinize performance. Along with the availability of multiple suppliers in increasingly global supply chains, the advantage remains on the side of the lead retailer, lowering holdup and associated dangers.

What the Glue Must Do

For fissuring to be successful, the lead company must design and deploy mechanisms that assure that the businesses in orbit around it operate in a way compatible with its core strategies.[54] Importantly, the chosen organizational mechanisms must ensure that the secondary players do not undermine the basis of the lead company's core competency (for example, brand image, product quality, coordination economies).[55] Easier said than done.

The principal/agent problem—that is, the difficulty faced by one party (the principal) of using another party (the agent) to undertake work on its behalf—arises because information is costly. First, it is costly for the principal to gather information about the agents in selecting across them: some agents may have qualities that might undermine the objectives of the principal. If the characteristics of the agent are particularly hard (costly) to see, the agents who approach the principal first might be the ones who in fact the principal wants to avoid. This issue, called *adverse selection,* can be alleviated the more the principal can make informed decisions about the agents it chooses.[56]

The second problem arises from the cost of observing the agent once hired. Many of the activities that the principal wants the agent to undertake are hard to observe directly (our discussion of employment picked up this problem in regard to setting wages). The harder (or, once again, more costly) it is to observe and monitor the agent, the more its actions may diverge from what the principal wants.[57]

To play its crucial role as glue to assure that subsidiary businesses undertake the activities shed by the lead organization without undermining outcomes central to its core competencies, the lead company must promulgate and communicate standards and see that they are followed. This requires significant investment by the lead organization beyond simply listing what it wants its subordinates to do. Specifically, standards and accompanying policies must accomplish three things:

1. Provide clear and explicit guidance on what is expected. This is the nub of standards promulgated by many lead organizations in different forms.
2. Provide a system of monitoring and auditing to ensure that those standards are followed.
3. Provide for significant penalties in the face of failure to meet goals.

Of course, the problem of incomplete contracts remains even given explicit standards: there will never be sufficient pages in a manual or enough lawyers to craft them to cover every exigency that might arise to assure that the core values of a company are protected while shifting work to others. But the contract systems that have emerged, and the organizational forms that have grown around them, clearly try to do so to the extent possible and significantly curtail the principal/agent problems that may arise. Examining the three elements of standards reveals how serious companies are about keeping the core elements of fissuring from undermining one another.

Explicit Standards: What We Expect

The glue for fissured employment rests on explicit and detailed standards crafted by lead businesses and followed by all subsidiary organizations. The competitive importance of standards, as well as their detailed content, has been overlooked in much of the literature dealing with incomplete contracting.[58] One reason is that standards reflect core competencies and reveal strategic—and proprietary—aspects of the lead business. They are therefore jealously guarded and difficult to obtain. I present many different examples of standards in reviewing "fissured forms" in Part II. But several examples illustrate their general nature.

The information technologies and related systems underlying lean retailers dramatically reduce the amount of time between purchase of goods and provision to customers. But this technology platform also alters the relationship between retailers and their complex network of suppliers, in particular by specifying in great detail the logistical arrangements required for delivering and replenishing products.

Saks Fifth Avenue, a publicly held department store catering to upper-end customers, has adopted lean retailing principles as part of its core competency. It depends on its vendors to comply with rigorous delivery standards and provides them with a standards manual with clear guidelines on their interaction. The manual covers issues ranging from methods of payment and order shipment protocols to the consequences of failing to meet standards. The preamble to the manual makes the importance of standards to Saks's core competency very clear:

> Saks Fifth Avenue is committed to supporting the Universal Product Code (UPC), Electronic Data Interchange (EDI), and the GS1 US standards. We believe that by implementing these technologies and guidelines, we can expedite our merchandise flow to the selling floor, manage our inventories better, increase sales, and enhance customer service. This in turn allows us to continue to build a more successful and mutually profitable partnership with our vendors.[59]

The Saks Fifth Avenue vendor standards manual makes the importance of vendor adoption of these standards very clear in its opening pages. For example, it provides explicit instructions on the preparation of cartons, orders, labeling, and packing for all products shipped to it in order to "utilize available technology to implement efficiencies and improved management within the supply chain while expediting our merchandise to the selling floor and enhancing our service to our customer." To achieve this objective, the standards specify that the vendor's shipments must be accurate and received 100% "floor ready," without any merchandise preparation required by the retailer.

This in turn entails adoption of a complex set of requirements around using the correct hangers and other display materials (ten pages on such matters, including detailed pictures) and labels (eight pages on these matters).

Subcontracted work for lead businesses in technical fields requires similar attention to detail. These businesses require not only specific terms about when and how the particular subcontracted work is to be conducted, but exacting terms about the quality, pace, and technical standards to be achieved. AT&T, for example, provides a detailed task matrix for subcontractors that undertake maintenance activities on the company's cell towers, specifying not only the particular work expected of the contractor, but also the role of AT&T and subordinate organizations in monitoring that work.

With branding as their defining core competency, fast-food restaurants insist that franchisees adhere rigidly to standards regarding products, service, and physical facilities. The preliminary documents prospective franchisees receive make the centrality of standards in the operation of the business explicit. The Dunkin' Donuts standard franchise agreement is typical (and blunt) in its statement of this principle: "All Dunkin' Donuts Stores must be developed and operated to our specifications and standards. Uniformity of products sold in Dunkin' Donuts Stores is important, and you have no discretion in the products you sell."[60] Taco Bell's franchise agreement similarly states that the franchisee

> shall faithfully, completely, and continuously perform, fulfill, observe and follow all instructions, requirements, standards, specifications, systems and procedures contained therein [the company's franchise operations manual]; including those dealing with the selection, purchase, storage, preparation, packaging, service and sale (including menu content and presentation) of all food and beverage products, and the maintenance and report of Restaurant buildings, grounds, furnishings, fixtures, and equipment, as well as those relating to employee uniforms and dress, accounting, bookkeeping, record retention and other business systems, procedures and operations.[61]

All fast-food franchises provide detailed standards setting out the terms for prospective franchisees and an even more detailed operating manual once franchisees have joined the chain.[62] Table 3.1 gives excerpts from several fast-food franchise agreements, illustrating the detailed standards incorporated in them as well as the requirement that franchisees adhere closely to them.

Table 3.1 Franchise agreement statements regarding compliance with brand standards: Fast-food industry, selected examples

Eating/drinking brand	Excerpt from franchise agreement
Dairy Queen	Your operating agreement is a contract between you, ADQ and us. You are a part of the national and international franchise system of DQ Grill & Chill and Dairy Queen franchisees and sub-licensees, and you must adhere to various system standards of quality and uniformity that ADQ establishes and modifies periodically, as well as standards and requirements that we establish and modify periodically. You will use ADQ's nationally recognized trademarks and service marks that are approved for your concept; have access to the distinctive operational and management attributes of the DQ system; participate in ADQ's national and regional sales promotion programs; and receive the benefits of association with a nationally recognized franchise system, including various forms of training, opening and operational assistance (see Item 11).[1]
Dunkin' Donuts	If you sign a franchise agreement, you will operate a franchised *Dunkin' Donuts* Store. Under our franchise agreement, we grant our franchisees the right (and they accept the obligation) to operate a *Dunkin' Donuts* Store, selling doughnuts, coffee, bagels, muffins, compatible bakery products, croissants, pizzas, snacks and other sandwiches and beverages that we approve. We may periodically make changes to the systems, menu, standards, and facility, signage, equipment and fixture requirements. You may have to make additional investments in the franchised business periodically during the term of the franchise if those kinds of changes are made or if your store's equipment or facilities wear out or become obsolete, or for other reasons (for example, as may be needed to comply with a change in the system standards or code changes). All *Dunkin' Donuts* Stores must be developed and operated to our specifications and standards. Uniformity of products sold in *Dunkin' Donuts* Stores is important, and you have no discretion in the products you sell. The franchise agreement is limited to a single, specific location and we have the right to operate or franchise or license others who may compete with you for the same customers . . . The distinguishing characteristics of the *Dunkin' Donuts* System include, for example, distinctive exterior and interior design, decor, color and identification schemes and furnishings; special menu items; standards, specifications and procedures for operations, manufacturing, distribution and delivery; quality of products and services offered; management programs; training and assistance; and marketing, advertising and promotional programs, all of which we may change, supplement, and further develop.[2]

(*continued*)

Table 3.1 (continued)

Eating/drinking brand	Excerpt from franchise agreement
Einstein Bros. Bagels	Restaurants are characterized by our system (the "System"). Some of the features of our System are a specially-designed building or facility, with specially developed equipment, equipment layouts, signage, distinctive interior and exterior design and accessories, products, procedures for operations; quality and uniformity of products and services offered; procedures for management and inventory control; training and assistance; and advertising and promotional programs. We may periodically change and improve parts of the System . . . You must operate your Restaurant in accordance with our standards and procedures, as set out in our Confidential Operating Manual (the "Manual"). We will lend you a copy of the Manual for the duration of the Franchise Agreement. In addition, we will grant you the right to use our marks, including the mark "Einstein Bros." and any other trade names and marks that we designate in writing for use with the System (the "Proprietary Marks").[3]
KFC	KFC outlets must be built to specifications approved by KFCC. The KFC Operating Standards Library (the "Standards Library") explains the required standards for preparing products to be sold at the KFC outlet and operating the outlet (see Standards Library—Table of Contents attached as Exhibit I). The KFC outlets are characterized by a unique system which includes special recipes and menu items; distinctive design, décor, color scheme and furnishings; standards, specifications and procedures for operations; procedures for quality control; training and assistance; and advertising and promotional programs (the "System").[4]
Long John Silver's	LJS Restaurants offer a limited menu featuring fish, seafood, chicken and related items. The Restaurants are designed to serve food promptly and offer dine-in, take-out and in a significant number of Restaurants, drive-thru service. Your Restaurant must be built to LSJ's specifications and operated in accordance with LJS's standards.[5]
Pizza Hut	A broad spectrum of the general public patronizes Restaurants as a source of high-quality pizza and related products and services. A unique system characterizes Restaurants that consists of special recipes, seasonings, and menu items; distinctive design, décor, color scheme, and furnishings; standards, specifications, and procedures for operations; procedures for quality control; training and assistance programs; and advertising and promotional programs (the "System"). A variety of trademarks, service marks, slogans, logos, and emblems that PHI designates for use in connection with the System (the "Pizza Hut Marks") identify the System. PHI has operated Pizza Hut "Red Roof" restaurants since 1958, when PHI opened its first restaurant.

Table 3.1 (continued)

Eating/drinking brand	Excerpt from franchise agreement
	PHI has granted franchises for Pizza Hut "Red Roof" restaurants since 1959. PHI has operated Pizza Hut "Delivery" restaurants and PHI has allowed its franchisees to engage in delivery of pizzas since 1984. PHI has operated Pizza Hut "Express" restaurants (a concept not offered under this disclosure document) since 1987.[6]
Taco Bell	You must operate your facilities according to methods, standards, and procedures (the "System") that Taco Bell provides in minute detail. The System is Taco Bell's sole property and is embodied in the Franchise Operations Manual, commonly referred to as the Answer System (the "Manual"). Taco Bell will furnish you with Books 1, 2, 3 and 5 of the Answer System at no cost and you may order, at your option and expense, Books 4 and 6, all of which are also currently available in cd format. The Manual is incorporated by reference into and is part of the Franchise Agreement, and has the same force and effect as other provisions of the Agreement. Taco Bell may choose to provide the Manual to you via electronic access to a confidential website, in which case Taco Bell will notify you that all or part of the Manual is posted on the website. You agree that it is your responsibility to provide access to the website to those of your employees (but no other persons) for whom the website is intended by Taco Bell. Your failure to follow the System as described in the Manual is a breach of the Franchise Agreement.[7]

1. American Dairy Queen Corporation: Dairy Queen Franchise Disclosure Document, April 17, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

2. Dunkin' Donuts Franchising LLC: Dunkin' Donuts Franchise Disclosure Document, March 28, 2008. Accessed through BlueMauMau.org, http://www.bluemaumau.org/ufocs_free_and_without_a_salesman_attached.

3. Einstein and Noah Corporation: Einstein Bros. Restaurant Franchise Disclosure Document, December 20, 2005. Accessed through FREEFranchiseDocs.com, http://www.freefranchisedocs.com/einstein-and-noah-corporation-UFOC.html.

4. KFC Corporation: KFC Franchise Disclosure Document, March 24, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

5. Long John Silver's Inc.: Long John Silver's Franchise Disclosure Document, March 24, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

6. Pizza Hut Inc.: Pizza Hut Franchise Disclosure Document, March 25, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

7. Taco Bell Corporation: Taco Bell Franchise Disclosure Document, March 24, 2009. Filed and accessed through the California franchising database, http://134.186.208.233/caleasi/Pub/Exsearch.htm.

Monitoring and Auditing: Do What We Ask

In order to ascertain if the businesses undertaking the work are doing what the lead organization intends, the contracts, standards manuals, and franchise agreements provide for explicit forms of ongoing monitoring. These are usually a combination of self-audits and audits (sometimes surprise inspections or, in the case of franchising, customer visits by undercover staff of the franchisor) undertaken by the lead organization or on their behalf by third parties.

Saks Fifth Avenue conducts accuracy and financial audits on vendor shipments as they arrive at distribution centers. This allows the company to validate shipment accuracy "by comparing and verifying the electronic information transmitted in your ASN [advanced ship notice] in conjunction with the associated GS1-128 label (at store, style, color, size, size, quantity level) or on your invoice against the physical units of the contents of your cartons." It also uses a random audit process to create for each vendor a performance index gauging its accuracy level; vendors are ranked in tiers, from "platinum" (best) to "targeted level" (worst).

Subcontracted relationships in many of the agreements reviewed in Part II usually include an escalating level of audits, based on the degree of quality, deadlines, or other compliance issues. Typical is a contract between a major telecommunications carrier (Cingular) and its subcontractors used to undertake ongoing maintenance work; it includes an escalating system of audits, increasing as the number of quality problems increases. Under the audit system, Cingular

> will audit 15% of all Sites awarded in a market at Vendor's expense . . . If greater than 1% of the initial 15% of individual Sites audited per market have Major Defects, then Cingular may request an additional 5% of Sites be audited in that market at Vendor's sole expense.[63]

Franchising agreements similarly provide for the usually unrestricted right of the franchisor to conduct inspections. The Taco Bell agreement, for example, states:

> The Company shall have the right at any time and from time to time without notice to have its representatives enter the Restaurant premises for the

> purpose of inspecting the condition thereof and the operation of the Restaurant for compliance with the standards, specifications, requirements and instructions contained in this Agreement and in the Manual, and for any other reasonable purpose connected with the operation of the Restaurant.[64]

In addition to surprise inspections of facilities, chains in the eating and drinking industry also use "secret shoppers" to gauge adherence with service standards.

Penalties and Other Consequences

A system of standards is ultimately only as strong as the potential costs they impose on those who are required to follow them. Though they take different forms and escalate with varying tolerance for noncompliance and quality infractions, the standards underlying fissured employment all include significant consequences for failing to live up to them. These take two principal forms. First are fees or penalties related to specific failure to meet standards, which may begin with warnings and proceed to fees related to the costs (to the lead organization) imposed by the infraction, a fee deemed a form of liquidated damages, or a penalty simply intended to impose a cost (but not directly related to the quality or service infraction).

For example, the Saks Fifth Avenue vendor agreement grants Saks the right to

> refuse and/or return all goods which do not meet our purchase order specifications of style, size, color, quantity and/or quality (including unauthorized substitutions); or which are shipped before the ship date, or after the cancel date, or without valid purchase order numbers or without valid department numbers . . . To cancel a purchase order, in whole or in part, in the event the goods are not shipped in accordance with the terms and conditions hereof . . . To cancel a purchase order, in whole or in part, in the event the goods are shipped after the cancel date, time being of the essence.[65]

The manual presents an extensive list of "offset charges and codes" that indicates the "expense offset" that will be charged to the company for being out of compliance with standards specified in the manual. For example, if a vendor includes more than one purchase order in a carton, it will be charged $5 per carton or $150 per shipment, whichever is greater. Ticketing a product with the wrong retail price is assessed at $25 per shipment plus $.05 per unit with the wrong price. A late advanced ship notice costs $5 per carton (with no stated upper limit). Saks reserves the right to either deduct total charges from its payment to the vendor for the products or "demand direct payment of expense offset fees . . . specified in the Vendor Standards Manual." These offsets can become quite costly, as can those associated with having the order returned for failure to hit the delivery window.

The telecommunications contract frames penalties (in the form of liquidated damages) specifically around the importance of time: "SUPPLIER recognizes the importance of meeting Delivery Dates and agrees to the following liquidated damage provisions and procedures." If a contractor fails to meet a deadline after the parties have attempted to resolve a delay, the carrier is given the right to cancel the order and to recover liquidated damages specified in the contract. The damages are "the greater of either (a) 15% of the price of Delayed Materials and/or Services or (b) a specified $ amount for each day of delay."

The second type of penalty, which is even more costly, is the loss of the contract, supply relationship, or franchise. The right to revoke the agreement is usually explicit and places a great deal of power in the hands of the lead organization. In the telecommunications case, Cingular (the carrier) states in its terms with subcontractors that "CINGULAR may Terminate the Agreement, or any Order in whole or in any part, at any time, for its own convenience and without cause, without any charge, liability or obligation whatsoever upon written notice to SUPPLIER."[66]

In franchising, agreements usually require the franchisee to correct any failure to meet standards found in the course of inspections. If the franchisee fails to correct the problem, the franchisor retains the right to fix the deficiency itself and charge the franchisee for the cost of doing so. Pizza Hut's franchise agreement includes the right to close an outlet where a failure to meet standards potentially threatens the health and safety of either employees or customers.[67] The ultimate penalty for failing to live up to standards is loss of the franchise itself and the associated investments of the franchisee. Given the size of these investments, they are an area of significant tension and litigation. But as I explore in Chapter 6, the franchisor retains significant authority to terminate franchisees.[68]

Coming Full Circle: Capital Market Responses to Shedding Employment

Financial markets increasingly drive companies under their exacting scrutiny to focus on shareholder value. This leads them to shed business units and products no longer viewed as core and to prune away remaining activities even in the core that might be viewed as peripheral. Several recent studies provide evidence underscoring the connection between capital market pressure and employment restructuring.

Employment Impacts of Private Equity Activity

Based on a study of 3,200 firms that were targeted by private equity firms between 1980 and 2005 and the 150,000 establishments connected to them, Steven Davis et al. estimate the impact of private equity buyouts on employment growth and destruction relative to a control sample of similar firms and establishments that were not acquired. The study finds that establishments controlled by the targets of private equity had employment declines of 3% over the two years following the buyout and 6% over five years relative to the control sample. The authors note that "these results say that pre-existing employment positions are at greater risk of loss in the wake of private equity buyouts." The employment declines are particularly large in cases where publicly held companies are acquired and taken private by the private equity firms.[69]

However, the study also finds employment increases at new establishments of the target firm opened after acquisition. When those increases are included, overall net relative job losses at target firms are less than 1%. Nonetheless, the net employment impacts at targeted firms in public-to-private buyouts remain high: over 10% net loss two years following the transaction.[70]

A companion study by the same research team examined productivity effects in manufacturing firms targeted by private equity.[71] They found higher labor productivity growth in establishments targeted by private equity than in a control set of firms, attributable to shrinking or closing less productive establishments in the targeted firms. This is consistent with the shedding process described in this chapter. The study does not provide direct evidence on the types of jobs that are being eliminated in the period following acquisitions or on the types of new jobs created later. However, the aggregate net employment changes and productivity effects found in the studies are consistent with a story where targeted firms eliminate jobs in business units, product areas, or functions no longer judged as core by the private equity owners, and expand, later on, in only those job areas directly related to their core activities.[72]

Stock Market Effects of Downsizing

In June 2012 Dan Akerson, the CEO of General Motors, announced a series of new policies to cut employment at its European and Canadian operations while streamlining its global product development functions "as key priorities to boost the automaker's lackluster stock price."[73] GM's share price increased in the days after the announcement was made.

If financial markets increasingly push companies to pare activities and focus on core competencies, one would expect to find evidence of a relationship between such employment reductions and increases in the share prices of publicly held companies. In the middle part of the past century, when large companies directly employed large and diverse workforces, a layoff would be perceived by investors as a sign of retrenchment by that company in light of an anticipated downturn in demand and therefore a need for employment reductions. Reduced employment spelled trouble for a company and its investors, and stock prices would fall in the wake of that news.

But the reaction of stock markets to employment reduction announcements began to change in the 1990s, as reflected in research by Hank Farber and Kevin Hallock.[74] They show that the stated reason for major layoffs has changed over time. As one would expect, companies cite factors directly related to slumps in demand following business cycle trends, although those reasons were cited less frequently during recessions in the early 1990s and 2000 than in the 1970s and 1980s. Reorganizations were more commonly cited as reasons for layoffs in recent years, particularly in the 1990s and during the recession in the early years of the twenty-first century. Cost control issues were also cited more frequently as causes for layoffs, being invoked in about 6.5% of all job announcements in the 1970s, 10% in the 1980s, and 17% in the 1990s.

But the most striking findings concern the effects of job loss press releases on changes in stock prices before and after the announcement.[75] Share prices responded negatively following job loss announcements in the 1970s and 1980s. However, stock prices actually rose on average following job loss announcements in the 1990s and were not significantly affected by layoff announcements in the first decade of the twenty-first century. The fact that capital markets responded less negatively, and in some of Hallock's and Farber's estimates positively, to announcements of layoffs implies that mass layoffs in recent decades are viewed very differently than they were in the era of large employers. Rather than seeing them as signs of weakening positions, investors seem to view layoffs at worst as routine corporate activities and even positively as a signal that executives have decided to redraw the lines of what will and will not be done by the company going forward.

4

Wage Determination in a Fissured Workplace

Compelled by capital markets and enabled by technology and new organizational forms, companies in a growing number of industries transformed the way they organized themselves to undertake business. The movement of activities from inside to outside the boundaries of a company alters employment and, as discussed in Chapter 3, leads to both a deepening and a spreading of the fissured workplace. The consequences for employment are profound.

Chapter 2 described how complicated internal labor markets emerged in large businesses of the twentieth century. How does shifting activities to other parties alter the nature of employment? The answers are subtle and fundamental, and are often missed by analysts who cast outsourcing, subcontracting, and even misclassification as tactics solely instituted to dodge legal obligations or by proponents who defend those practices as inherently a positive reflection of the modern, flexible business organization.

The story of why shifting employment outward has deeper advantages is somewhat complicated. Before exploring it further, let's cut to the chase. For any successful company, profits are shared among two groups: workers, in the form of better wages and benefits, and investors, in the form of higher returns. In the markets described in Chapter 2, where lead companies directly employed many workers, workers received a significant share of the profitability in terms of both wages and benefits. Fissuring changes how gains are shared in a fundamental way: by shifting work out, lead firms no longer face a wage determination problem for that work, but rather a pricing problem in selecting between companies vying for it. That change is critical because it results in fewer gains going to the workers who undertake those activities. It instead shifts those gains to investors. To see why, we must delve into the factors that drive wage setting.

Round Up the Usual Suspects

In virtually any market situation, businesses face incentives to lower costs. The more intense the competition, the greater is that pressure. Although the changes in capital markets sharpened that pressure, it would be folly to forget its ongoing presence in markets.

It is therefore almost axiomatic that businesses will seek methods to reduce labor costs. Unit labor costs are driven by two factors: the price of labor (a.k.a. wages and benefits) and the amount of output produced per each unit of labor input (a.k.a. productivity). To the extent that shifting employment to other firms through practices like outsourcing reduces labor costs without compromising product or service integrity, one would expect a movement in that direction.

Many discussions of elements of fissuring—the increasing use of contracting and outsourcing and contingent work arrangements—focus on motivations driven by reducing labor costs. One important example is the long-term effort by businesses to avoid unionization. Unions raise wages, increase benefits, reduce management authority to unilaterally dismiss workers, and increase scrutiny of compliance with workplace regulations. The National Labor Relations Act precludes employers from simply closing down workplaces solely because of the presence of unions, or threatening to do so if a union is elected.[1] But shedding employment can provide more subtle ways to shift away from a highly unionized workforce or move work to forms of employment that are both legally and strategically difficult for unions to organize, at least historically (as we shall see through a number of cases in Part II).

A second explanation is the desire to shift a wide range of required social insurance benefits like unemployment insurance and workers' compensation premiums as well as private benefits like insurance and retirement to other parties. Socially required and privately provided benefits make the cost to employers of hiring workers far greater than wages or salaries. Wages and salaries comprise 69.4% of employer costs per hours worked in the United States for all workers. An additional 7.8% of employer costs are related to federally required benefits (Social Security, Medicare, and federal unemployment insurance) as well as state benefits (unemployment insurance and workers' compensation). Privately provided benefits for insurance (health, life, disability) and retirement average an additional 13.5%.[2]

To the extent that institutions like temporary agencies or smaller companies doing subcontracted work for a lead business comply with the law, required social payments should be captured in the price those subordinate labor providers charge. Part III will document many instances, however, where compliance is far from complete among subordinate employers to lead businesses due to employee misclassification, pay systems that subvert legal requirements such as overtime, or because workers are paid under the table in cash.

Even given payment of legally required benefits, subordinate businesses may provide fewer—or no—benefits in the area of insurance or retirement, lowering the costs to the lead businesses that may draw on them. For example, the federal laws regulating employee benefits require that if a benefit like health care is offered to one worker, it must be offered to all workers. By shifting out employment to another business (such as a temporary agency that does not provide its workforce with health benefits) the company can lower the de facto cost of hiring additional workers.[3]

A third incentive for shedding employment arises from the desire to minimize liability. With employment comes responsibility for outcomes like workplace injuries, illnesses, and fatalities as well as for discrimination, harassment, and unjust dismissal. If shedding employment shifts liabilities to other parties, it lowers expected costs to lead businesses. Liability is indeed an important element of the story of fissuring, and I explore it in detail in Chapter 8.

All of the above explanations can reduce labor costs and the risks associated with employment. But attributing the dramatic rise in shedding employment solely to them does not adequately explain how lead businesses balance the benefits of lower costs from shedding employment against the benefits of continuing to use workers from inside their company, and why the fissured workplace has spread and deepened.

There is something more subtle afoot. It requires thinking about wage determination in large companies.

Large Firms, Monopsony Power, and Wage Determination

The most autocratic and unfettered employer spontaneously adopts Standard Rates for classes of workmen, just as the large shopkeeper fixes his prices, not according to the haggling capacity of particular customers, but by a definite percentage on cost.

—Sidney and Beatrice Webb (1897)

The large employers that dominated business in much of the twentieth century were in a different position than employers in traditional labor market models. The extreme case occurs in a company town where a single employer essentially provides the only jobs in the labor market. Such an employer (or monopsonist) faces the entire labor supply, and must pay higher wages if it wishes to increase the number of people employed.[4] For a unitary employer paying the same wage rate to workers for a similar job, the cost of an additional hired worker not only reflects the wage for that worker, but also the incremental costs for all employees who have already been hired for that job because the company pays all workers at the same wage as that paid to the last worker hired. As a result, the employer hires fewer workers and pays a lower wage than would occur in a competitive labor market with multiple employers.[5]

Company towns are rare, but an employer need not rule over a coal town to wield some level of monopsony power.[6] A common source of employer power in a labor market arises from information problems. A labor market works by matching workers' job preferences with employers' demand for workers. That makes information a critical lubricant in the operation of a labor market. Pure labor market models (which assume that markets function like a freewheeling bourse) assume that such information costs are minimal. Employer suitors quickly find their employee mates.

But information is not costless, nor is it held equally by all the parties in a labor market. In practice, a worker's search for a job is limited by time, knowledge, and geographic preferences. Large employers have more robust information because of their size, sophistication, and economies of scale in acquiring it. Workers, however, face "search frictions" in the labor market because of limited information on employment options as well as family, social, and other geographic ties that restrict their willingness to move.

Information asymmetries and search frictions create some degree of monopsony power, meaning that large employers set wages rather than simply accepting the going rate in the labor market. This gives them greater latitude in establishing compensation policies, although the employer's policies still must reflect the supply of workers and their contribution to the production of the firm.[7]

Some level of monopsony control and discretion in setting wages underlies the compensation and human resource policies set by major companies across the economy. As the social scientists Beatrice and Sidney Webb pointed out at the turn of the twentieth century, large employers that dominated the economy and the labor market required unified personnel and pay policies and internal labor markets for a variety of reasons: to take advantage of administrative efficiencies, to create consistency in corporate policies, and to reduce exposure to violations of laws.[8]

There is an extensive literature that seeks to square the general existence of elaborate internal labor markets and findings like wage premiums in large firms with the operation of competitive labor markets. One view argues that these phenomena are not incompatible with the functioning of competitive labor markets, but simply reflect the complexity of labor as an input in production—an input whose productivity changes over the course of employment. Walter Oi explains wage policies in many large firms as outgrowths of the quasi–fixed-cost nature of labor, where the hiring of workers requires firms to invest in search and training costs, irrespective of how long a worker stays with the company. This fixed element of compensation gives employers incentives to create compensation systems that allow them to recover these costs through ensuring longer-term attachments (via higher wages or changing earnings profiles over time) as provided by many internal labor market policies. In a related vein, Becker explains the features of compensation systems as methods to create sufficient incentives for firms to invest in workers and to collect on their investment in job-specific human capital over the course of employment. Personnel policies lead firms to pay workers somewhat above their marginal productivity early in their tenure, when they are learning a job, and to pay them below their marginal productivity later on, when their job-specific skills have less value on the external market, leading firms to recapture their investment while giving workers an incentive to stay on in later periods.[9]

Another set of theories explains internal labor markets and "implicit contract" theory, where risk-neutral employers strike agreements with risk-averse workers that smooth wages over time, accommodating both parties in the process. These arrangements have some of the characteristics of internal labor markets (for example, job classifications or grades and wages linked to internal practices) but arise from underlying supply and demand features.

A third view explains internal labor markets as the methods by which firms overcome the day-to-day holdup problems, given that the employment contract between workers and employers is inherently incomplete—that is, it cannot adequately commit to language the complicated and changing nature of what the employer wishes the worker to do. As a result, a combination of explicit and implicit contract devices arises to prevent either party from cheating the other. In this view, the overall employment relationship creates value that the parties then must figure out a way to share in the course of ongoing employment. These contracts reflect both conditions in the external labor markets and relative bargaining power within the firm.[10]

None of these explanations, however, recognizes a basic aspect of the workplace: it brings together large groups of people, and people by nature are deeply social beings. Workers operating under one roof communicate and quickly discover a lot about their co-workers. This includes whether the person sitting in the next cubicle is being paid more for doing the same job. Paying individuals who do similar jobs different wages could have deleterious consequences on productivity, increase turnover, or even inspire a union-organizing drive. Unified personnel policies and simplified compensation structures for workers with varying levels of productivity play a fundamental role in reducing frictions among workers.

Fairness and Wage Determination

Fairness matters. In contrast to assumptions of traditional economics that individuals maximize gains solely for themselves, a large empirical literature from psychology, decision science, and more recently behavioral economics reveals that people care not only about their own gains but also about those of others. In fact, people frequently gauge the magnitude of their own benefits relative to those of others. And they are often willing to sacrifice some of their own gains because of equally important beliefs about fairness.

The "ultimatum game" is one of the best demonstrations of the importance of fairness in human interactions and has been extensively tested experimentally and in the field. The game is simple: two people are told there is a pot of money (say $10) to be split between them. One player gets the right to decide how to split it. The second player can accept or reject the first player's decision. If the second player rejects it, no one receives anything. If people were completely self-interested, the expected result would be clear: the first player would keep almost everything and leave a few crumbs (coins) for the second player. Since the second player is still better off with a little (for example, $.50) than before the game started, he or she should accept any non-zero offer.

But that is not how the game turns out. The typical person in the second player position will reject lowball offers (looking across studies, offers below 20% of the pot of money are usually rejected)—even at the expense of walking away with nothing. Equally important, first players seem to understand this in advance, because they typically offer the second player between 40% and 50% of the pot.[11] The results, which have been replicated many times in many different forms, attest to the importance of fairness, because they are based on one-round (nonrepeat) games where the incentives are high for the proposer to take as much as possible and for the responder to accept any offer. When ultimatum games are played in multiple-round scenarios, the incentives to share that pot only become higher.

Fairness perceptions affect all kinds of real-world interactions and relationships. Relationships are an intrinsic part of the workplace, and fairness perceptions are therefore basic to how decisions are made within it. The factors driving wage setting arise not just from an employer's consideration of the additional output a worker might provide if given a higher wage, but on the worker's perceptions of the fairness of that wage. For example, Daniel Kahneman, one of the pioneers of behavioral economics, showed that people's perception of the fairness of a wage cut depends on why they feel it was done: cuts driven by increases in unemployment (and therefore more people looking for work) are viewed as unfair; a company that cuts wages because it is on the brink of bankruptcy is judged more favorably. Like the proposer in the ultimatum game, managers seem to understand this and seldom cut nominal wages in practice.[12]

Similarly, fairness considerations about compensation depend not only on how much I think I deserve to be paid on an absolute basis (given my experience, education, skills), but also on what I am paid relative to others. Who are relevant comparison groups? It depends on where I am when making the appraisal. If I am looking for a job, my assessment is based on what I see in the labor market—as predicted by traditional economic theory. My sources of information may be incomplete, but I will be looking at comparable jobs in my search.[13] The acceptability of a wage offer will bounce up and down with the overall conditions in the labor market.

Once I am inside an organization, however, the wage level that becomes relevant to me focuses on other workers in my company. Just as, in experiments, how two people split their joint gains matters as much (or more) than their absolute gains, once inside an employer's organization, I care more about what the person in the next cubicle is being paid than about what someone across the street doing the same type of work is being paid by a different employer.[14] "Referent wages" are important not only in terms of others doing work similar to mine, but also for those I perceive as at higher and lower levels of the organization. In order to understand why large employers adopted the wage and internal labor markets used in previous decades and why they have moved toward fissuring, we need to probe two kinds of fairness notions as they apply to wages: horizontal equity (how people think about different pay rates for similar work) and vertical equity (how they think about different pay rates for different types of work).

Horizontal Equity and Pay Policy

The Webbs' observation is most apparent in the area of horizontal equity: Am I being paid the same as other people who are similar to me? The need to address fairness concerns within a type of job that pushes for a common rate is balanced against the desire to provide incentives for improved performance and quality. If an employer can track performance relatively easily, the pay policy may have a component related to performance. The more that performance is observable and has important consequences for a firm, the greater the incentive to design policies that link the two. But there will still be a benefit that the design applies equally to all workers in that grade.[15]

One method for doing so is compensating workers on the basis of a piece rate—paying a standard rate linked to output, thereby allowing higher-productivity workers to earn more than lower-productivity workers even if they are sitting beside each other.[16]

Piece rates have always been found in a relatively limited set of industries (agriculture, garment production, and some manufacturing), and not those one would associate with large employers with labor market power. Even beyond piece rate systems, there are far fewer incentive pay systems than one would expect given what would seem the benefits of linking pay and performance. In large nonunion companies, for example, Fred Foulkes noted in 1980 that "while merit pay plans are common in the entirely nonunion companies studied, for a variety of reasons they are frequently not administered as the stated policies would have one believe. Instead, the principles of seniority, automatic progression, and equal treatment seem to be given much weight."[17] Bewley documents a similar reluctance to embrace merit pay systems two decades later. Why is that the case?

The most common reason cited is that it is very difficult to actually observe performance in many job situations.[18] First, many outcomes in workplaces arise not from individual activities but from teamwork. It is often hard to observe individual contributions to team outcomes. Second, it may be that the nature of production may lead to outcomes affected (positively and negatively) by other factors not in control of individuals. A bad sales day in a resort town may be the result of unmotivated sales people, a bad patch of weather, or a longer-term economic downturn. Third, even if performance impacts can be measured, to do so is costly. It becomes even more costly as an organization grows in size or complexity.[19] Fourth, employers usually care about not one, but multiple outcomes, creating difficulties in creating an incentive scheme that aligns with different (and sometimes competing) objectives.[20]

But once again, that the practice of paying for performance is not more widespread reflects underlying perceptions of fairness. Incentive pay schemes assume that individuals work hard only if they are given incentives to expend effort. But the experimental evidence suggests that people expend more than minimal effort at a task if they believe they are being paid fairly for it. Higher pay elicits higher effort among fairness-minded individuals ("that's why you are paying me more"). In a "repeated game" situation, this behavior is further reinforced—you treated me fairly in the past, so I will exert more effort next time, and know you will pay me fairly in the next round. Even in cases where a significant number of fellow workers are "self-maximizers" who look out only for themselves, the presence of even a small number of more altruistic workers can lead employers to set wages at higher levels out of deference to fairness.[21]

As a result, large employers historically fudged horizontal compensation problems by creating consistent pay for people in comparable positions in a company, even if their performance varied. The vast majority of businesses (78%) interviewed in Bewley's study of compensation policies cited "internal harmony and morale" as the main reason why internal pay equity was important.[22] Labor market studies show that wages within firms vary far less than one would expect given the existence of considerable differences in productivity across workers.[23] Firms move toward a single-wage policy for workers of similarly observable skill/ability because of the negative consequences arising from having multiple rates for workers who otherwise seem similar.

A very common method of achieving fairness ends while providing some incentives linked to performance is seniority. Seniority pay provides a steady increase in pay with tenure in a firm. Assuming that retention is a signal of meeting at least minimum performance standards, if workers improve their performance over time, compensation moves with it. If I can expect my pay to rise over time, in a manner similar to that of my coworkers, I will judge the system as fair, and the employer will gain benefits (and share them in the form of higher wages) from my improved performance over time.[24]

Vertical Equity and Compensation

Workers' contentment with their wages, however, arises not only from what they are paid relative to others in a comparable job or place in the organization, but also from how they are paid relative to those above and below them in the organization. In particular, experimental and empirical evidence points to the fact that people look "up" in judging their pay, asking, What is my pay relative to the jobs at the next rung in my organization? If the pay of the group just above me is too high—or if the gap widens over time—I may be less and less happy with the pay I receive, regardless of its absolute level.

Psychologists have long known that people care more about a small loss in income than about an equal gain in income.[25] This effect—called loss aversion—means that perceptions of being adversely affected by a change in a current situation will make people feel worse than a comparable improvement in position makes them feel better. In a workplace context, loss aversion means that if a worker's pay situation changes in a way that is judged unfair, it will have larger effects than if the situation changes in a way that is judged as improving fairness.

Wage comparisons across different occupations or jobs can have this effect. Imagine that I have a job I view as "better" (for example, requiring more skill or savvy) than another job at my workplace. One day, I find out what people in that job are paid. I will be more upset to find out that I am being paid relatively *less* than someone holding that job than I would be happy to find out I am being paid *more* (by the same amount) than the same person. This behavior also suggests I will tend to look up rather than down in the wage structure in assessing whether I am being paid fairly. A janitor in a car factory will be more attuned to the wage paid to the assembly worker whose station he cleans than to that of the groundskeeper maintaining the lawn outside.

In a large organization, vertical equity issues like these can be particularly vexing. Unionized workplaces in traditional manufacturing solved this problem through collectively bargained deals that linked these grades—often providing for upward ratcheting of the whole wage system (leaving relative wages intact) over time. The collectively bargained contract creates a transparent set of expectations of what is fair (in part because it reflects the preferences of the workforce, at least as represented by the union's negotiating committee).

Large nonunion workplaces also must accommodate the demands of vertical equity in setting compensation policies, even though unfettered by collective bargaining. Higher wages in part reflect an effort to avoid unionization, but also to avoid the kind of internal frictions described above.[26] In his studies of wage policies, Bewley also found that nonunion executives justified formal internal pay structures on the basis of equity.[27] Although they acknowledged that differences in pay between grades proved useful as incentives, 69% of the businesses interviewed cited "internal equity, internal harmony, fairness, and good morale" as the principal justification.[28]

A repercussion of the need to satisfy vertical equity demand is that a large employer might end up paying workers at lower ends of the wage system a higher wage than it might prefer in order to preserve internal labor market peace. As we shall see, a number of studies show this to be precisely what happens in wage setting.

Take My Workers—Please!

Taking horizontal and vertical equity concerns together leads to a prediction that large firms might end up paying more for jobs at different levels of the organization to solve these problems than would occur on the outside. This aspect of wage determination explains the large-employer wage premium discussed in Chapter 2.

The basic monopsony model assumes that an employer will set a single wage rate for workers of a particular type (that is, skill or occupation) rather than follow what is called in a monopoly situation a price discrimination policy (that is, charging different prices to different consumers). The need to set a single wage for the workplace has the effect of pushing up the cost to the employer of hiring more workers of a given type, since the additional cost of one more worker requires paying him or her more, as well as more for all who are already employed at that type of work.[29]

In principle, an employer with monopsony power could compensate workers according to their individual contribution to production (or "marginal product," the additional output per worker) if it pursued a varied wage policy. But this goes against the fairness grain and, as we have seen, has never been a common form of compensation. Wage discrimination (à la price discrimination) is rarely seen in large firms despite the benefits it could confer. As long as workers are under one roof, the problems presented by horizontal and vertical equity remain.

But what if the large employer could wage discriminate by changing the boundaries of the firm itself? What if, instead of facing a wage determination problem for a large and varied workforce, it creates a situation of setting prices for work to be done by other parties external to the enterprise? If multiple businesses compete vigorously with one another to obtain that firm's business, each small firm would offer its workers wages to perform work for the lead firm. Under this setup, the large employer (or now former employer) receives a price for the contractors' services or production rather than being required to directly set and pay wages to the individual workers who actually undertake the work.

As such, the larger employer creates competition for work among different purveyors and pays them based on its assessment of their contribution. Less-efficient producers could be paid less than more-efficient producers. In this way, the lead organization faces a schedule of *prices for services* rather than *wages for labor,* leaving the task of compensation to the individual providers of the service or product. In effect, the lead firm devolves its employment activity to a network of smaller providers. In so doing, it creates a mechanism—a competitive market for services that in the past was handled internally through direct employment—in the form of a network of service providers.

By shifting employment to smaller organizations external to the enterprise that operate in competitive markets, the lead firm creates a mechanism whereby workers will receive a wage close to the additional value they create. At the same time, this avoids the problem of having workers with very different wages operating under one roof. The lead firm captures the difference between the individual additional productivity of each worker and what would be the prevailing single wage rate if it set one.

As a result, two workers on the same project may effectively end up being paid very different wages, closer to something reflecting their individual marginal productivity than would be the case if they were in the direct employ of the parent organization.[30] Such a mechanism would benefit the employer over the case where it set a single wage rate for workers with similar job titles but variation in productivity, or in cases where an employer's wage policy affects the market as a whole.

A related argument for shifting work outward arises from the problems created by vertical equity expectations in internal labor markets. Even if workers have differing skill levels and job assignments, vertical equity norms in firms may lead large employers to pay lower-skill workers higher wages because of the presence of higher-paid workers whose compensation becomes a referent wage within the internal labor market.[31] Shifting those lower-skilled jobs outward can solve this problem.

Setting Wages by Setting Prices

Imagine that the DW Hotel (or, to be more upscale, simply the DW) directly hired all of its workers—from landscapers, to maids, to valets, to front desk personnel. Horizontal equity would require comparable pay for those in a grade—and maybe even across the properties in a metropolitan area (particularly if the workforce moved among properties). Vertical equity would require considering the pay of maids and valets in setting the pay of landscapers and considering the wages of managers in setting the pay of desk personnel. The DW would be required to create and administer a comprehensive pay and human resources policy.

But what if the DW focuses its attention on its reputation (its core competency) and no longer sees the actual administration of hotels as central to its business strategy? This would allow it to cut loose the messy process of hotel operations to other organizations—particularly organizations that might bid against one another for the right to undertake that activity. Now the DW could transform the production of hotel services into a market, with different entities competing for pieces of the business. Each provider would offer its services—which once would have been undertaken directly by the DW—for a price.

As a result, the DW would create competition for work among different purveyors and pay them a price based on its assessment of their contribution. Less-efficient producers could be paid less than more-efficient producers. In this way, the DW faces a schedule of prices for services (for example, management of its workforce) rather than wages for labor, leaving the complex task of compensation to the individual providers of the service or product.[32] In effect, the lead enterprise devolves its employment activity to a network of smaller providers. In so doing, it creates a mechanism—a competitive market for services that in the past were handled internally through direct employment—in the form of a network of service providers.

By shifting employment to smaller organizations operating in competitive markets, a large employer creates a mechanism to pay workers closer to the additional value they create but avoids the problem of having workers with very different wages operating under one roof. In so doing, the employer captures the difference between the individual additional productivity of each worker and what would be the prevailing single wage rate if it set one.[33]

Businesses at the top of supply chains split off employment so that they can focus their attention on more profitable activities connected to the revenue side of their income statement, leaving the manufacture of products or the provision of service to be fissured off. This has important implications for how the profitability of those companies is shared between different parties. Recall that in the former, integrated model of large employers, firms ended up sharing part of their gains with the workforce in the form of higher pay to deal with internal perceptions of fairness. That meant less to share with consumers in the form of lower prices and with investors in the form of higher returns.

With fissuring, the fairness problems are less acute and wages can be pushed downward. That means more gains to be passed on to consumers as lower prices or better returns for investors. In those fissured structures where a firm's core competency has attracted a particularly devoted customer base through branding or the ongoing introduction of cool new products, the reduced wage costs will flow particularly toward investors.[34] Shifting work outward allows redistribution of gains upward.

Paying Janitors and Guards Inside and Outside the Walls

As noted in Chapter 3, janitors and security guards were in the vanguard of fissuring. By 2000 about 45% of janitors worked under contracting arrangements, and more than 70% of guards were employed as contractors.[35] Shifting janitors and security guards from inside to outside the walls of lead businesses has had significant impacts on pay for workers in those occupations.

The impact of shedding janitorial jobs in otherwise higher-wage companies is borne out in several studies of contracting out among janitorial workers. Using a statistical model to predict the factors that increase the likelihood of contracting out specific types of jobs, Abraham and Taylor demonstrate that the higher the typical wage for the workforce at an establishment, the more likely that establishment will contract out its janitorial work. They also show that establishments that do any contracting out of janitorial workers tend to shift out the function entirely.[36]

Wages and benefits for workers employed directly versus contracted out can be compared given the significant number of people in both groups. Using statistical models that control for both observed characteristics of the workers and the places in which they work, several studies directly compare the wages and benefits for these occupations. Berlinski found that janitors who worked as contractors earned 15% less than those working in-house, and contracted security guards earned 17% less than comparable in-house guards. Dube and Kaplan found similar impacts of contracting, with a "wage penalty" for working as a contractor of 4%–7% for janitors and 8%–24% for security guards.[37] The latter study also found that contractors in both occupations are much less likely to receive health benefits: about 60% of in-house guards received health benefits versus 38% of contract guards; similarly, 49% of in-house janitors received some health coverage versus 24% of contracted janitors.[38]

These results therefore suggest that otherwise comparable workers doing janitorial or security work in comparable places are paid very differently.[39] It is worth reiterating the distributional implications of this finding: by "solving" the problem posed by the Webbs at the outset of this chapter by shifting work outward, lead companies have redistributed part of the profits once shared with the workforce because of fairness concerns to consumers and particularly to investors.[40] And as we shall see in detail in Part II, companies have devised a number of different organizational methods to do so beyond the contracting/outsourcing used in the case of janitors and security guards.

In a series of articles about the use of subcontracted janitors to clean major supermarkets and retail establishments in Southern California, Nancy Cleeland describes in more evocative terms the consequences of fissuring for janitors. One story focused on a man who worked the midnight shift seven nights a week. His duties required

> stripping, waxing, and buffing the floors . . . He says he earns far less than the minimum wage, and just laughs when asked about overtime pay for his 56-hour weeks. Strong chemicals make his nose bleed, burn his fingers and eat the soles of his cheap sneakers . . . Not only are many janitors earning subminimum wages—about $550 to $750 twice a month for 56-hour weeks—they are also untaxed.

None of the janitors interviewed by Cleeland could name the company employing them—only the person who paid them with personal checks.[41]

The Social Consequences of Fissured Employment

The fissured workplace is not simply another term for subcontracting, outsourcing, or offshoring. Nor does it solely arise from lead companies seeking to avoid payment of private or socially required benefits. Rather, the fissured workplace reflects a fundamental restructuring of business organizations. Employment decisions arise from a careful and ongoing balancing act by lead companies and the subsequent behaviors of the many smaller companies operating beneath them.

What makes sense from a private calculus of balancing the benefits and costs of shedding business functions and employment relationships may differ from what is socially desirable. The economic concept of an externality—the failure of private parties to fully weigh the social costs of their actions—can be usefully applied here. A major retailer or telecommunication company may decide that it can reduce its costs and exposure to liability by contracting out work to another party (who in turn breaks the task into several additional layers of contractors) and still maintain quality, technical requirements, or brand reliability through some of the mechanisms described above. But if the consequence of the decision to shed activities is to reduce the labor force's pay, protections, benefits, and access to longer-term career opportunities, the social costs of those actions are borne by others.

The integrated elements underlying the fissured workplace help explain why trends like wage stagnation have been so persistent and noncompliance with workplace laws increasingly common in many parts of the economy. They help explain why work has become so much worse for so many, even as the share of national income going to reward investors (and the very top of the income distribution) has increased. Part II provides a deeper look at how the fissured workplace has played out and its public consequences in a variety of industries and organizational forms.