

BACKGROUND BRIEF • OCTOBER 2012

## Six Reasons Why Government Contracting Can Negatively Impact Quality Jobs and Why it Matters for Everyone

By Dr. Janice Fine, School of Management and Labor Relations, Rutgers University

**A**lmost one of our every 5 non-farm workers in the US is employed in the public sector, with half of those working in K-12 schools, public colleges, and universities. Recessions and corresponding budget deficits, coupled with the mistaken belief that the private sector is always more efficient

### AT A GLANCE

This paper summarizes recent research that shows how the public sector provides quality middle-class jobs, and describes how government privatization eliminates these good jobs without much savings to the taxpayer, and increases inequality, which is costly – today and in the future.

than the public sector, has led the federal, state and local governments to contract out many of the services they once provided.

There is considerable and growing evidence that contracting out does not save government and taxpayer money and negatively impacts quality of service. Privatization of public functions reduces government jobs, especially for non-managerial and administrative workers and eliminates good jobs for workers without college degrees. While it may

sound like a good idea, contracting out deserves a closer look. This white paper

summarizes recent research that shows how the public sector provides quality middle-class jobs, and describes how government privatization eliminates these good jobs without much savings to the taxpayer, and increases inequality, which is costly – today and in the future. As mounting evidence shows, when government functions as a model employer in employment and compensation practices, our families, neighborhoods, communities, states, and society as a whole benefit.

### **Contracting out often ends up costing more and lowering service quality.**

There is a strong correlation between privatization, which is typically accompanied by reductions in wages and benefits for workers, and declines in quality of service. In 2008, Professors Mildred Warner and Amir Hefetz analyzed the ICMA Survey of Alternative Service Delivery, which conducts annual surveys with municipal administrators. They found the most common reason that local governments cited for bringing services back in house was decline in quality of service. 72.7% of municipalities that answered the question “Why did you bring services back in house within the last five years?” said it was because service quality was not satisfactory and 51% reported that cost savings were insufficient.<sup>1</sup>

Research shows that when workers earn living wages they deliver a better product. For example, economists have documented that when worker wages increase, non-wage labor costs, such as turnover<sup>2</sup>, can fall and workforce effort and productivity can increase<sup>3</sup>. When employee turnover occurs, employers incur significant costs from replacing employees including recruitment, selection and training, and lost productivity as new workers must learn the job.<sup>4</sup>

- Using the 2003 California Establishment Survey, researchers estimated that the average replacement cost for a blue collar worker in California was \$2,000.<sup>5</sup>
- A study of the cost of supermarket turnover for the Coca Cola Research Council estimated the replacement cost for an \$8/hour non-union worker at \$4,199 a year.
- Jacobs and Graham-Squire estimate that applying the Service Contract Act, which requires the payment of prevailing wage rates to be paid to employees of federal contractors, to cafeteria workers would result in a projected 40% decline in turnover. Assuming an average replacement cost of \$2,000, this would result in average savings of \$804 per worker.<sup>6</sup>

### **When governments contract out public work, many good jobs disappear; in particular wages, benefits and hours decrease when jobs are privatized.**

Good quality government jobs have played a key role in growing the American middle class. This includes teachers, social workers, police and firefighters. Public sector workers without college

degrees, such as janitors, postal and sanitation workers, and bus drivers, have also been able to earn a decent living. However, the growth of government contracting<sup>7</sup> threatens that, by pushing wages and benefits down, most often without any savings for taxpayers.

Economists find that contracted employees are much less likely to earn family-supporting wages:

- According to the Economic Policy Institute (EPI) in 2006, close to 20% of federal contract workers earned wages under the poverty threshold of \$9.91 an hour and 40% earned less than a living wage.<sup>8</sup>
- A 2008 study by the Center for American Progress found that of the 5.4 million federally contracted service workforce, an estimated 80% earned below the living wage for their city or region.<sup>9</sup> Four types of contracts were particularly likely to pay low wages: utilities and housekeeping; property maintenance and repair; clothing and apparel; and food preparation.
- A recent study by the Political Economy Research Institute (PERI) examined the City of New Haven's proposed contract to outsource its public school custodial services to a private firm. The study found that average wages would be reduced by 40% from \$20.90 an hour to \$12.50 per hour. In addition, the 186 full-time custodial positions would be replaced by largely part-time positions for which there would be no health insurance benefits, overtime pay or bonuses. Retirement benefits would be eliminated for all positions.<sup>10</sup>
- In New Jersey, the median hourly wage for contracted food service workers in K-12 public schools in 2007 was \$8.15 and many of these jobs paid no more than the state minimum wage of \$7.15. Most workers receive few, if any health insurance benefits leaving them either uninsured or likely to enroll in the state public health insurance programs. In fact, the food service industry sector was found to have one of the highest levels of employees and their children enrolled in the New Jersey FamilyCare program. These workers are paid only for their work during the school year and are not paid for school holidays or days when schools are closed.<sup>11</sup>

The Bureau of Labor Statistics projects that nearly half of all jobs in 2014 will be filled primarily by individuals with no more than a high school diploma and close to 30% of all jobs will be filled primarily by those with some college education.<sup>12</sup> The choices society makes about the levels at which these workers are compensated will determine the economic mobility of many generations of American families.

One out of every six adults 25 years and older in the United States is not a high school graduate<sup>13</sup> and not every high school graduate desires, and many cannot afford, a four year college education. Most geographic labor markets require a mixture of interests and capabilities, but when blue collar jobs don't pay living wages, they cease to be occupations in which people can support themselves and their families in a dignified manner. Historically, many successful college graduates have been the sons and daughters of postal, sanitation and clerical workers, janitors and bus drivers. Many public sector employees have been able to enter the middle class because they have been paid a family supporting wage.

In New Jersey, Rutgers Professor Jeff Keefe has documented that, while white collar government workers are compensated considerably less than their private sector counterparts, government jobs for non-high school graduates pay 38% more than the private sector, and 10% more for high school graduates than the private sector.<sup>14</sup> In contrast to recent trends in the private sector in which CEOs and upper level management have seen their salaries skyrocket and lower-level employees have seen wage losses, the government is still a source of good quality jobs; in fact, the private sector is three times more likely than the public sector to employ workers at poverty-threshold wages.

Scholars have observed important “spillover effects” from minimum wage and living wage policies. When workers without college degrees in government jobs are paid decent wages, similar private sector workers in the surrounding communities can also benefit. These are referred to as “horizontal wage pushes” in which employees in comparable service sector occupations receive wage increases because of competitive pressure to pay workers more.<sup>15</sup>

Income mobility across generations plays a determinant role in the living standards of American families. It is a key determinant of how many generations a family will be stuck at the low end of the income scale. EPI found a significant decline in the rate at which income has grown for prime-age wage earners from the mid-1970’s through the mid-2000’s. A prominent mobility expert finds that children of low-income fathers have slightly less than a 60% chance of reaching above the 20<sup>th</sup> percentile of the income distribution by adulthood, a 20% chance of exceeding the median and a very slight chance of ending up above the 80<sup>th</sup> percentile. In other words, the son of a father that earns about \$17,000 a year has only a one in twenty chance of earning over \$60,000 per year.<sup>16</sup>

## **Contracting out not only leads to degraded jobs in communities, it also comes with hidden costs to government and taxpayers.**

On the surface, contracted jobs may look like they provide cost-savings, but when government contractors pay very low wages, taxpayers often end up paying as much as or more than before the services were contracted out. The contracted jobs often pay so little that workers and their children become eligible for public services such as Medicaid, food stamps, the Women, Infants and Children (WIC) program for supplemental nutrition, and free or reduced-priced school meals. Most workers employed at or near the minimum wage are not offered or cannot afford health insurance from their employer, leaving them with a high probability of being uninsured. When people lack health insurance, they often end up using emergency rooms as provider of last resort—and for the public, an extremely costly choice.<sup>17</sup>

- Jacobs and Graham-Squire found that school cafeteria workers employed by private contractors are nearly twice as likely as the workforce as a whole to participate in one or more public assistance programs: 36.3% compared to 19.7%.<sup>18</sup>
- One study of federal apparel contractors found that workers were relying on Medicaid, food stamps and tax credits under the Earned Income Tax Credit in order to supplement their incomes. The total amount of public assistance for which each 100 person factory qualified was estimated to cost taxpayers \$292,000 per year.

- The University of California Institute for Labor and Employment estimated that the state of California spends \$10.1 billion every year in public assistance for working families with full-time jobs that paid less than \$8 per hour—nearly half of the state’s total expenses on these programs.<sup>19</sup>
- In Arizona, 51% of cafeteria workers employed by private contractors relied on a public program and these numbers were similar in other states: California 44%, Michigan 34% and New York 38%.
- Jacobs and Graham-Squire estimate that the average cost to the public per school cafeteria worker employed by a private contractor for participation in the following public assistance programs: EITC, CHIP, Medicaid, Food Stamps, and TANF, comes to \$1,743 annually.<sup>20</sup>

## **Government outsourcing disproportionately impacts African American workers.**

The public sector is the single most important source of employment for African-Americans — approximately one in five who are employed hold public sector jobs. This means that they are also more likely to be affected by government lay-offs when those services are outsourced. Prevented by racial discrimination from entering many private sector occupations,<sup>21</sup> historically public sector jobs have been important vehicles for black workers to move into the middle class. Due to strong equal opportunity requirements, comparatively high rates of unionization, and more employment transparency and enforcement of anti-discrimination laws than in the private sector, jobs in government have served as an extremely important foothold in African-Americans’ ability to secure decent employment and attain upward mobility.<sup>22</sup>

A recent study by economist Steven Pitts at the University of California<sup>23</sup> found:

- African American public sector workers earn 25% percent more than other black workers.
- During 2008-2010, 21.2% of all black workers were public employees, compared with 16.3% of non-black workers.
- Both before and after the onset of the Great Recession, African Americans were 30% more likely than other workers to be employed in the public sector.
- For both men and women, the median wage earned by black employees is significantly higher in the public sector than in other industries.
- Prior to the recession, the wage differential between black and white workers was less in the public sector than in the overall economy.
- Examining the five primary industries employing black workers, the public sector employed the greatest proportion of black men and black women in higher paying occupations.

A recent study by the Brookings Institute found that 45% of African-American children who start out in middle-income families experience significant downward mobility, ending up in poor

families, as opposed to 16% for whites. Income mobility is especially important for African-Americans who have historically faced steep mobility barriers. Public sector jobs have strongly contributed to African-American upward mobility.

Public sector employment has been crucial to black employment and access to good jobs and career ladders. Privatization has a dramatic impact on job quality for African-American workers, decreasing the number of quality public sector jobs available.

## **The degradation of good jobs due to contracting out is bad for families and communities.**

Privatization's downward effect on wages and benefits goes beyond the individuals who hold public sector jobs--it has profound implications for our communities and our society as a whole.

**Families:** When workers are paid a decent wage, provided quality benefits and opportunities for training, they are more able to be economically self-sufficient, purchase homes, live in safer neighborhoods, access ongoing healthcare, send their children to stronger public schools, and shop in vibrant local business districts. Education is a central gateway through which economic mobility takes place. Families cannot send their children to schools of average quality now without spending significantly more on housing than they did in 1980.<sup>24</sup> Economists refer to the wage advantage of more highly educated workers over those with less education as "education returns"-- children living in poorer communities are less likely to attend strong schools, which dramatically affects their future earnings potential.

**Communities:** When workers are paid a decent wage, they are more able to contribute financially to local, state and federal tax bases. Longer job tenure, another feature of government employment, is also associated with promotion and wage gains, which strengthens tax bases continually over time. In addition to more taxes paid, higher wages have other "positive externalities" for communities; workers with good quality jobs are also able participate more fully in civil society: voting at higher levels and actively participating in neighborhoods, local schools, charities, voluntary associations and faith institutions.<sup>25</sup>

**Social Trust:** Workers with good quality jobs achieve a level of stability that makes them more able to build ties of trust and reciprocity--which has important implications for all of society. In the United States people who trust other people are more likely to cooperate for the common good,<sup>26</sup> to support the rule of law and to donate time and money in support of others<sup>27</sup> — even to work together to survive natural disasters.<sup>28</sup> A number of studies have even found that people with high levels of trust live longer.<sup>29</sup>

## **Contracting out leads to greater economic inequality.**

Privatization typically fails to save taxpayer dollars, and instead creates more low-wage and unstable jobs. It contributes to perhaps our most pressing problem in the United States: economic inequality. Scholars across a range of disciplines have demonstrated that inequality is not only bad for the least well off, but negatively affects the vast majority of the population.

Inequality in the United States is extremely high. According to the Congressional Budget Office, between 1979-2005 real income growth for most low and middle income households, was minimal to moderate, which eventually resulted in stark differences in actual income levels. According to EPI, data on income concentration going back to 1913 indicate that the top 1% now holds 23% of total income, the highest inequality level in any year on record except for 1928. In 2007, the 20% of families with the highest incomes claimed 47.3% of all family income while the poorest 20% of families held only 4.1%. Within the top fifth in 2006, the top 5% received 20.1% of all income, more than all of the families in the bottom 40% combined.<sup>30</sup>

- EPI has documented an unprecedented gap between the growth of median family income and that of productivity.<sup>31</sup> Economists have long assumed that when an increasingly efficient workforce produces more goods and services per hour of work, families can more readily meet their economic needs and aspirations. But, if the benefits of heightened productivity flow largely to those at the top of the income scale, the potential lift to living standards from increased productivity growth does not reach middle, working, and lower classes.
- Increased spending by those at the top of the earnings distribution has tangible costs for everyone else. Economist Robert H. Frank shows that increased expenditures on housing by top earners seems to have catalyzed an “expenditure cascade” resulting in increased housing expenditures even among those whose incomes have not risen.<sup>32</sup>
- Across whole populations, health and social problems are more common in countries such as the United States, with bigger income inequalities.<sup>33</sup> In fact, if we set aside the poor in the U.S., health problems across the population persist and most of the problems of health inequalities remain untouched; similarly if we look only at the death rates of white Americans, they still do worse than the populations of most other developed countries.<sup>34</sup>
- More unequal nations have significantly higher rates of mental illness including drug and alcohol addiction, infant mortality, teenage pregnancy, low child educational performance, obesity, imprisonment and homicide.<sup>35</sup>
- Inequality also has been found to have contributed strongly to two major economic crises in the past century: the Great Depression beginning in 1929 and the Great Recession starting in 2007.<sup>36</sup>

Privatization, because it so often results in lower wages and benefits, exacerbates economic inequality in the United States which is already too high and has consequences for all Americans. Our government should not be in the business of making more money for corporations while blocking opportunity. There is a much better alternative. Keep or bring back government jobs. They are a better use of taxpayer funds *and* a model of secure and decent employment.

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<sup>1</sup> Warner, M. E. and Hefetz, A., "Managing Markets for Public Service: The Role of Mixed Public-Private Delivery of City Services," *Public Administration Review*, 68: 155-166. doi: 10.1111/j.1540-6210.2007.00845.x (2008).

<sup>2</sup> Holzer, Harry J., Wages, "Employer Costs and Employee Performance in the Firm," 43 *Industrial & Labor Relations Review*, 147-5 (1990); Levine, David I., "Can Wage Increases Pay for Themselves: Tests with a Productive Function," 102 *Economic Journal*, 1102 (1992); Katz, Lawrence 1986. "Efficiency Wage Theories: A Partial Evaluation." *Brookings Papers on Economic Activity*; Cotton, John L. and Jeffrey M. Tuttle, "Employee Turnover: A Meta-Analysis and Review with Implications for Research," 11 *Academy of Management Review* 55 (1986); Dube, Arindrajit, Freeman and Reich, "Employee Replacement Costs," UC Berkeley Institute for Research on Labor and Employment, Working Paper No. 201-10 (2010); Reich, Hall and Jacobs found that a mandated living wage at the San Francisco Airport resulted in a dramatic decrease in turnover rates in certain sectors, "Living Wage Policies at the San Francisco Airport: Impacts on Workers and Businesses" *Industrial Relations*, Vol. 44, No. 1 (January 2005) pp. 125-126.

<sup>3</sup> Reich, Hall and Jacobs, "Living Wage Policies at the San Francisco Airport: Impacts on Workers and Businesses" *Industrial Relations*, Vol. 44, No. 1 (January 2005). The authors found that employers at the SF Airport reported that higher wages and better benefits translated into improved worker performance in the areas of overall work performance (35%), employee morale (47%), absenteeism (29%), disciplinary issues (44%), equipment maintenance (29%) equipment damage (24%), and customer service (45%). 19.8% of employers reported an increase in initial or on-the-job training provided.

<sup>4</sup> See Joseph La Lopa, Kavanaugh and Ghiselli, "The Impact of Offering Benefits To Part-Time Employees on Turnover Rates at Indiana's Quick Service Hamburger Restaurant Chains," 12 *FoodService Res. International*, 263, 264-265 (2000).

<sup>5</sup> Dube, Arindrajit, Freeman and Reich, "Employee Replacement Costs," UC Berkeley Institute for Research on Labor and Employment, Working Paper No. 201-10 (2010).

<sup>6</sup> Ken Jacobs and Dave Graham-Squire, "Labor Standards for School Cafeteria Workers, Turnover and Public Program Utilization," *Berkeley Journal of Employment & Labor Law*, Vol. 31:2.

<sup>7</sup> In 2007, the federal government spent \$436 billion in contracts, more than double the amount spent in 2000 of \$209 billion. See David Madland and Michael Paarlberg, "Making Contracting Work for the United States: Government Spending Must Lead to Good Jobs" Center for American Progress Action Fund American Worker Project, December 2008.

<sup>8</sup> Kathryn Edwards and Kai Fillion, "Outsourcing Poverty: Federal contracting pushes down wages and benefits" *Economic Policy Institute Issue Brief #250*, February 11, 2009.

<sup>9</sup> Living wages are based on one adult raising one child from Penn State University "Poverty in America Living Wage Calculator" developed by Amy K. Glasmeier, as cited in Madland and Paarlberg.

<sup>10</sup> Jeannette Wicks-Lim, *Pushing Working Families Into Poverty*, March 2011, p. 1.

<sup>11</sup> Mary McCain, "Serving Students: A Survey of Contracted Food Service Work in New Jersey's K-12 Public Schools" Rutgers University Center for Women and Work.

<sup>12</sup> US Bureau of Labor Statistics, Dixie Sommers, Assistant Commissioner for Labor Projections, 2007.

<sup>13</sup> US Census Bureau 2010, <http://www.census.gov/hhes/socdemo/education/data/cps/2010/tables.html>

<sup>14</sup> Jeff Keefe, "Public/Private Wage Comparisons in New Jersey" *Economic Policy Institute*, 2011.

<sup>15</sup> Reich, Hall and Jacobs, "Living Wage Policies at the San Francisco Airport: Impacts on Workers and Businesses" *Industrial Relations*, Vol. 44, No. 1 (January 2005) pp 118-119.

<sup>16</sup> Lawrence Mishel, Jared Bernstein and Heidi Shierholz, *The State of Working America 2008/2009*, Economic Policy Institute, ILR/Cornell University Press, p. 105.

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<sup>17</sup> In 2008, a group of uninsured low income adults in Oregon were selected by lottery to be given a chance to apply for Medicaid. A recent study analyzing the outcomes for those selected found higher rates of health care utilization (including primary and preventive care such as outpatient visits, mammograms and cholesterol monitoring as well as hospitalizations), lower out of pocket medical expenditures and medical debt and better self-reported physical and mental health. See Amy Finkelstein, Sarah Taubman, Wright, Bernstein, Gruber, Newhouse, Allen, Baicker and the Oregon Health Study Group, "The Oregon Health Insurance Experiment: Evidence From the First Year".

<sup>18</sup> Ken Jacobs and Dave Graham-Squire, "Labor Standards for School Cafeteria Workers, Turnover and Public Program Utilization," *Berkeley Journal of Employment & Labor Law*, Vol. 31:2.

<sup>19</sup> Carol Zabin, Arin Dube and Ken Jacobs, "The Hidden Public Costs of Low Wage Jobs in California," 4 St. Cal. Lab. 3 (2004).

<sup>20</sup> Arindrajit Dube and Ken Jacobs, "Hidden Cost of Walmart Jobs: Use of Safety Net Programs by Wal-Mart Workers in California" University of California Berkeley Center for Labor Research and Education, August 2004. Jacobs and Graham-Squire found that school cafeteria workers are nearly twice as likely as the workforce as a whole to participate in one or more public programs: 36.3% compared to 19.7%. Nationally, the highest participation is in the Earned Income Tax Credit (31.4%), followed by Children's Medicaid or SCHIP (15.3%) Medicaid (14%), Food Stamps (8.5%) and TANF (1.7%). In California, 44% of cafeteria workers relied on a public program, Arizona 51%, Michigan 34% and New York 38%. See Ken Jacobs and Dave Graham-Squire, "Labor Standards for School Cafeteria Workers, Turnover and Public Program Utilization." Also see Zabin, Dube and Jacobs, "The Hidden Public Cost of Low-Wage Jobs in California," 4 St. Cal. Lab. 3 (2004).

<sup>21</sup> See for example, Stephen Steinberg, *The Ethnic Myth: Race, Ethnicity and Class in America*, pp. 173-200, Thomas Sugrue, *The Origins of the Urban Crisis: Race and Inequality in Postwar Detroit*, Princeton University Press, 1996, Karen Olson, "Old West Baltimore: Segregation, African-American Culture and the Struggle for Equality" in the *Baltimore Book: New Views of Local History*, Fee, Shopes and Zeidman editors, Temple University Press, 1991, Ira Katznelson, *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth Century America* W.W. Norton, 2005. Roger Waldinger, *Still the Promised City? African-Americans and New Immigrants in Post-Industrial New York*, Harvard University Press, 1996, pp. 137-173, Marianne Bertrand and Sendhil Mullainathan "Are Emily and Greg More Employable than Lakisha and Jamal? A Field Experiment on Labor Market Discrimination" NBER Working Paper No. 9873, July 2003.

<sup>22</sup> Heather Boushey, "No Way Out: How Prime-Age Workers Get Trapped in Minimum Wage Jobs" *WorkingUSA: The Journal of Labor and Society*, 1089-7011, Vol 8, December 2005, 659-670.

<sup>23</sup> Steven Pitts, "Black Workers and the Public Sector" Research Brief, University of California Berkeley, Center for Labor Research and Education, Work in the Black Community Project, April 4, 2011

<sup>24</sup> Robert H. Frank, *Falling Behind: How Rising Inequality Harms the Middle Class*, University of California Press, 2007 pp. 44-45.

<sup>25</sup> See Sidney Verba, Kay Lehman Schlozman and Henry E. Brady. *Voice and Equality: Civic Voluntarism in American Politics*, Harvard University Press 1995.

<sup>26</sup> See Robert Putnam, *Bowling Alone: The collapse and revival of American Community*, New York: Simon & Schuster, 2000.

<sup>27</sup> Eric Uslaner, as quoted in Richard Wilkinson and Kate Pickett, *The Spirit Level: Why Greater Equality Makes Societies Stronger*, Bloomsbury Press, 2010 pp. 56-57

<sup>28</sup> See for example Eric Klinenberg, *Heat Wave: A social autopsy of disaster in Chicago*, Chicago University Press, 2002.

<sup>29</sup> J.C. Barefoot, K.E. Maynard, J.C. Beckham, B.H. Brummett, K. Hooker and I.C. Siegler, "Trust, Health and Longevity" *Journal of Behavioral Medicine*, (1998) 21 (6) : 517-26 (as quoted in Wilkinson and Pickett, *The Spirit Level* (2009))

<sup>30</sup> Lawrence Mishel, Jared Bernstein and Heidi Shierholz, *The State of Working America 2008/2009*, Economic Policy Institute, ILR/Cornell University Press.

<sup>31</sup> *Ibid*, p 66.

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<sup>32</sup> Robert H. Frank, *Falling Behind: How Rising Inequality Harms the Middle Class*, University of California Press, 2007 pp. 43-51.

<sup>33</sup> According to the United Nations Development Program, *Human Development Report*, New York: Oxford University Press, 2006, the countries with some of the highest rates of inequality are Singapore, the United Kingdom, the United States and Portugal.

<sup>34</sup> Wilkinson and Pritchett, *The Spirit Level*, 2009, pp. 176-177.

<sup>35</sup> *Ibid*, pp. 18-24.

<sup>36</sup> See Michael Kumhof and Romain Ranciere, "Inequality, Leverage and Crises," April 2011.