County of Walworth, Wis., 64 LA 1328 (Epstein, 1977) (contractual limitation on subcontracting contained in nursing home contract was not violated when the counseling center discontinued use of nursing home to provide food service since the subcontracting clause at issue did "not relate to subcontracting by the County in other of its units which are covered by other agreements").

City of Milwaukee, 59 LA 537 (Mueller, 1972) (city violated subcontracting provision which prohibited contracting out where cost savings were based on the lower wage rates paid by the contractor).

Gary School Bd. of Trustees, 71-1 ARB §8213 (Sembower, 1971) (contracting out operation of elementary school violated several contractual provisions).

II. THE HIDDEN COSTS OF OUTSOURCING: A UNION VIEWPOINT

SHELDON FRIEDMAN*

Introduction

The issue of subcontracting is a perennial one for the National Academy of Arbitrators. Conference papers dating back to the late 1950s have addressed and revisited the issue on several occasions.[1] Most of this past work has been analytical, focusing on the criteria used by arbitrators to settle subcontracting disputes.

That will not be the approach taken in this paper. The debate about the relative merits of the reserved rights versus the implied obligations doctrines, as applied to subcontracting disputes, is an important one. For a trade unionist it is disheartening that many arbitrators uphold the right of employers to subcontract work from recognized bargaining units. It is distressing that some arbitrators still refer to the reserved rights doctrine when giving management the right to erode a bargaining unit. As a matter of logic and fairness, it is not proper to

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[1]Sinicropi, *Revisiting an Old Battle Ground: The Subcontracting Dispute*, in Arbitration of Subcontracting and Wage Incentive Disputes, Proceedings of the 32nd Annual Meeting, National Academy of Arbitrators, eds. James L. Stern and Barbara D. Dennis (Washington: BNA Books, 1979), 125–166; Crawford, *The Arbitration of Disputes Over Subcontracting*, in Challenges to Arbitration, Proceedings of the 13th Annual Meeting, National Academy of Arbitrators, ed. Jean T. McKelvey (Washington: BNA Books, 1960), 51–77.

require the union to be the moving party to protect itself with detailed contract language against subcontracting, rather than to require the employer to secure the right to take work out of the bargaining unit. Since the union is the recognized bargaining agent of employees performing certain work, the party seeking to change the status quo should have the burden of securing that right.

The purpose of this paper is not to revisit such analytical questions. The focus is on the economics of outsourcing, with emphasis on its many hidden costs. While arbitrators must decide their relevance to the resolution of outsourcing disputes, several suggestions in this regard are offered. A concluding section steps back from the economics of outsourcing to ponder the consequences for arbitration and labor-management relations of the fact that most unions perceive arbitration to be an unfriendly forum for settling subcontracting disputes.

The Rapid Growth of Outsourcing

The rapid growth of outsourcing in recent years is worrisome. Although it has contributed to the weakening of unionism, its harmful effects go beyond that. Many U.S. corporations have responded to tough competition in a global economy by foreign sourcing, instead of investing in the revitalization of their U.S. operations. Even as pro-business a source as *Business Week* magazine has noted with alarm the harmful economic consequences of this trend toward the "Hollow Corporation."[2] According to Sony's former chairman and co-founder, Akio Morita, outsourcing has been destructive to the U.S. economy. As Stephen Cohen and John Zysman explain in their recent book, the erosion of the industrial base caused by outsourcing and other factors is a most serious matter:

> If the United States loses control and mastery of manufacturing production it is not simply that we will not be able to replace the jobs lost in industry . . . by service jobs; nor simply that those service jobs will pay less; nor that the scale and speed of adjustment will shock the society—and the polity—in potentially dangerous ways. . . . if we lose mastery and control of manufacturing, the high-paying service jobs that are directly linked to manufacturing will, in a few short rounds of product and process innovation, seem to wither away (only to sprout up offshore, where the manufacturing went). . . . In

[2]*The Hollow Corporation*, Business Week (March 3, 1986), 57–85.

brief, in order for the shift of employment to services to be developmental and not become a shift to poverty we must maintain mastery and control of manufacturing production.[3]

Impact on Workers and the Economy

For the workers who lose their jobs as a result of outsourcing, the consequences are devastating. According to the Bureau of Labor Statistics (BLS), more than two million workers are dislocated each year as a result of outsourcing or other causes. These workers face long spells of joblessness. Almost half the blue-collar workers displaced each year remain jobless for more than six months; 20 percent remain unemployed for more than two years.[4] When and if they find a new job, dislocated workers typically experience loss of benefits and significant declines in earnings. According to the BLS, displaced blue-collar workers average 16 percent lower pay when they are subsequently re-employed; for one-third of displaced workers, the drop in pay is more than 25 percent.

The experience of permanently laid off members of the United Auto Workers (UAW) is similar; according to a survey made several years ago, by their last month of layoff the income of dislocated autoworkers in Michigan had declined 61 percent.[5] Of those workers who had any savings prior to layoff, 40 percent used up their entire savings during their period of layoff. With regard to health insurance, one-third had no coverage at some time during layoff. Many workers reported that for themselves and their families needed medical care often was deferred. As bad as these statistics are, they fail to capture the added costs to workers, their families, and society, since long-term job loss contributes to alcoholism, suicide, child abuse, and divorce.

Even when company outsourcing decisions do not immediately cause layoffs, there are other serious adverse economic consequences. The average quality of newly created jobs in the U.S. has decreased sharply in recent years, as relatively high-

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[3]Cohen and Zysman, Manufacturing Matters: The Myth of the Post-Industrial Economy (New York: Basic Books, 1987), 20–21.

[4]Podgursky and Swaim, *Labor Market Adjustment and Job Displacement: Evidence From the January, 1984 Displaced Worker Survey* (Washington: Bureau of Int'l Labor Affairs, U.S. Dep't of Labor, 1986).

[5]Bluestone, et al., The Unemployment and Reemployment Experiences of Michigan Auto Workers (Boston: Social Welfare Research Inst., Boston College, 1985).

wage manufacturing jobs have disappeared while the new jobs taking their place are predominantly in the service sector and pay lower wages. Between 1979 and 1985 average weekly earnings were only $258 in industries experiencing employment growth, versus $402 in industries where employment was on the decline.[6] Outsourcing, which transforms well-paid manufacturing jobs into lower-paid manufacturing or service-sector jobs (in many cases offshore), is an obvious contributor to this worrisome trend. With the newly created jobs paying much less than the jobs that are disappearing, it is little wonder that many dislocated industrial workers experience substantial pay cuts when they become re-employed. Many young people entering the labor market face very different and greatly restricted opportunities compared with those existing when job growth was concentrated in high-wage industries and employment in low-wage industries was on the decline.

With the quality of newly created jobs down sharply, more family members have been working longer hours to maintain family earnings. These efforts have not been sufficient to offset the impact of lower real wages stemming from the disappearance of good jobs. Family income is lower today than it was in 1978, and was lower in 1978 than in 1973.[7] We have reached a historical watershed: young families today can no longer expect the kind of improvement in living standards during their lifetimes that previous generations took for granted.

How this ties in with foreign sourcing was established by economist Lester Thurow in 1985. He found that while median earnings in the economy as a whole were $16,168 in 1983 dollars, median earnings were $18,637 in export industries and $19,583 in import-competing industries.[8] As the trade deficit widens, high-wage jobs disappear and median earnings decline. With foreign sourcing by U.S. corporations accounting for perhaps a third of U.S. imports of manufactured goods, the link between outsourcing and the disappearance of high-wage jobs, even if no one is directly laid off, is clear.

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[6]Lawrence Mishel, communication to Henry Lowenstern, editor of the Monthly Labor Review.

[7]*Money Income and Poverty Status of Families and Persons in the United States 1986*, Current Population Reports, Consumer Income Series P-60, No. 157 (Washington: Bureau of the Census, U.S. Dep't of Commerce, 1987). *See also Family Incomes in Trouble*, Briefing Paper (Washington: Economic Policy Inst., 1986).

[8]Thurow, *The Hidden Sting of the Trade Deficit*, New York Times (January 19, 1986).

Hidden Costs of Outsourcing

Whatever its adverse impact on workers and the economy, outsourcing is commonly considered beneficial to the corporation undertaking it. Why else would the decision to outsource have been made? Particularly with offshore sourcing, however, the benefits to the corporation may turn out to be less than initially expected. While there may be benefits to the corporation in the short-run, there are often many less discussed hidden and long-run costs.

It is therefore important to be aware that, from the standpoint of the company's "bottom line," outsourcing can be a two-edged sword. While outsourcing may produce short-term cost savings, it may involve many long-term risks. Low wages, low or nonexistent benefits, long workweeks, and lucrative public investment incentives that make outsourcing attractive on the surface to companies can be offset by cost penalties and long-term competitive disadvantages which may be less evident.[9]

Some cost penalties result from the fact that outsourcing, especially foreign sourcing, typically requires establishment of a long pipeline of products. In addition to the costs of freight, duty, and insurance, this usually entails higher inventory carrying costs; higher packaging costs (as outlays for materials and labor must be duplicated at both ends of a long supply pipeline); higher quality control costs (including incoming inspection and repair, another duplication of work done at the production site); and higher warehousing or other product-storage costs, since the added supplies of outsourced products must be kept somewhere.

Other hidden costs stem from the fact that outsourcing requires greater management time and attention than is initially contemplated. Top managers must make extensive, repeated visits to offshore locations. Other high-priced company personnel, such as manufacturing engineers and quality control specialists, must fly back and forth to distant locations. Communications costs may increase dramatically. Extra staff is often needed

[9]Ira Magaziner, *Sourcing Issues* (unpublished, undated mimeograph); *see also The Hidden Costs of Outsourcing*, UAW Research Bull. (September 1987); McElroy, *Outsourcing: The Double-Edged Sword*, Automotive Industries (March 1988), 44–46; and Berg and Markides, *Manufacturing Offshore Is Bad Business*, Harvard Business Rev. (September–October 1988).

to maintain the new purchasing agreements, and greater legal, tax, and accounting complications associated with international transactions add to the corporation's expenses.

Growing concern about the hidden costs of outsourcing prompted the National Tooling and Machining Association to commission a major report, issued in September 1987, which states:

> Many American industries are under increasing pressure from foreign competitors offering significantly lower prices for roughly comparable products and services. On their face, these substantial price differentials appear to give foreign suppliers a competitive advantage. In many cases, however, the apparent differential between quoted prices is not all that it appears to be. This is because *hidden costs* are often not reflected in the quoted price for certain foreign-made products. . . . Thus, the true cost of sourcing abroad is considerably higher than quoted prices, so that the actual cost differential between the foreign and domestic products is much smaller, or even reverses the foreign advantage implied by quoted prices alone.
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> Some hidden costs are obvious and can easily be quantified, such as customs duties, freight and insurance. Others are harder to define and are difficult to calculate, such as delays in delivery, difficulties with design changes or alterations in engineering specs, delays and errors due to communications problems, and additional paperwork. *Under ideal circumstances, a purchaser who is quoted an attractive price for a foreign-made product should be able to identify and then calculate all relevant hidden costs; the true cost of the product would then be known and a realistic comparison could be made. . . . But in reality, this often does not occur. Too few U.S. buyers systematically look beyond the prices quoted for foreign manufactured goods to determine all the hidden costs—relying instead primarily on apparent price differentials. . . .*[10]
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> *One reason . . . hidden costs often do not enter into final contract selection is that the lack of quantification makes it difficult to communicate their importance to senior management who review the contract awards. Many purchasing managers . . . said their finance departments and other executives who have no direct appreciation for hidden costs, often demand added justification for contracts awarded to a supplier other than the lowest bidder.*"[11] (emphasis supplied)

Not only are the costs of outsourcing often underestimated, the projected benefits may be overestimated. The company may surrender control over quality levels and delivery targets, neither of which may meet expectations. Productivity levels off-

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[10]Quick, Finan and Associates, Contracting for Machining and Tooling: The Hidden Costs of Sourcing Abroad (The National Tooling and Machining Ass'n, 1987), Preface.
[11]*Id.* at 11.

shore are often lower than expected, with indirect costs resulting from poor infrastructure and inadequate support services, such as transportation, utilities, maintenance, and availability of supplies, often offsetting the labor-cost advantage. In case after case in a wide range of industries, benefits from outsourcing have fallen far short of the company's expectations.

In the long run outsourcing may cause more serious problems. Outsourcing often nurtures competitors who may subsequently pose a serious threat to the prosperity, and possibly the survival, of their customers. While this process may take a long enough time to be of no immediate concern to senior managers who will be retired by then, it is of substantial concern to workers and their unions. Foreign sourcing gives potential competitors a larger volume base, thereby lowering their production costs. The potential future competitor learns modern methods and technologies in product design and quality control, while gaining valuable practical experience. Potential competitors learn how to market in the United States, what the regulatory requirements are, and how best to meet them. Their cash flow gets a significant boost. Customer acceptance of their products in the U.S. market increases as dealers become familiar with handling them and the trade press publicizes them.

In industry after industry, outsourcing arrangements have nurtured powerful foreign competitors who later contended successfully for their former U.S. customers' markets and market share. The transition can be as abrupt as it is devastating, particularly when carried out pursuant to a national economic development strategy of "export-led growth." Foreign governments that have offered incentives to foster the initial outsourcing arrangement can turn less friendly after the relevant technology and jobs are transferred offshore.

These long-run hidden costs are often compounded by the customers' decisions to close plants or withdraw from production of certain product lines in the United States. This leads to loss of manufacturing competence in the outsourced product or component as relevant workers, managers, and engineers are laid off, reallocated within the company, or retire without being replaced. Research and development is neglected or eliminated, since it is expected that the new supplier will take on these functions.

The cost of re-entering the outsourced business at some future time is likely to be greater than the cost of investing to

revitalize and maintain the business in the first place. Potential suppliers, aware of the vastly increased cost of subsequent re-entry, may offer price quotes for initial business which are temptingly low. These price quotes may be far below the supplier's costs and may be offered to get a foot in the door. Any initial losses will be recouped later on, as prices escalate when the customer withdraws from the market and faces a prohibitively high cost of re-entry. Where it can count on government backing or other sources of "patient capital" in support of its strategy, the supplier is free to engage in a lengthy period of predatory pricing.

Predatory pricing also plays a significant role in domestic outsourcing as new companies with substantial financial backing aggressively seek to penetrate new markets and build market share. When an industry is characterized by excess capacity, as is currently the case in the auto industry, outside suppliers may base price quotes on variable costs in an effort to utilize as much of their plant capacity as possible, even though the job in question is done at a loss.

It is important for arbitrators to be aware that outside-supplier price quotes may also reflect the impact of factors under the customer's control, but not revealed to the arbitrator or to the union. The customer may have assisted the prospective supplier with equipment, technology, or low-cost capital. It may have supplied proprietary dies and designs, and proprietary information as to production cost and methods, including methods of cost reduction that had been jointly developed with the union. The low outside-supplier quote may be the result of a requirement by the customer that the supplier cut its prices; this new, lower quote may be used to threaten the union with further outsourcing unless additional in-house cost reductions are achieved; or to justify additional outsourcing which the customer wishes to undertake for other reasons.

The company's in-house production cost figures may also require careful scrutiny. In dealing with major corporations, it has been our union's experience that the first "piece cost" figures supplied by the corporation to justify a tentative outsourcing decision are based on full corporate cost. In other words, the cost figure includes not only all the costs actually required to make the component in question, but also allocations for other factory costs and corporate costs that are typically assessed to the individual plant. Many of these costs are fixed costs that continue

regardless of whether the item is outsourced or produced in-house. Unless the fixed costs associated with the job disappear as a result of a decision to outsource, those components of the in-house piece-cost estimate should be deducted when compared with the outside supplier's quote. The most serious hidden cost of outsourcing is worker loyalty and trust. For corporations aspiring to foster teamwork and a sense of common purpose among their workers, decisions to outsource send precisely the wrong message.[12]

Relevance of Hidden Costs to Arbitration

Some arbitrators may question the relevance of these hidden costs, feeling that inquiry into them in an arbitration proceeding intrudes upon the *Trilogy's* requirement that a decision be based on an interpretation of the agreement or, worse, asks arbitrators to substitute their judgment for the judgment of those entrusted with running the business. Yet every time arbitrators uphold a grievance, they are quite properly and of necessity substituting for management's judgments.

How does this apply to outside contracting? When an agreement is silent on subcontracting, most arbitrators appear to agree that the so-called rule of reason applies. The rule of reason, by definition, requires that the arbitrator be more than a rubber stamp to the employer's offered evidence of business justification. The rule of reason, indeed almost every arbitration case, requires a balancing of competing facts and values and some effort by the decision maker to find the truth. In cases involving outside contracting, clearly this necessitates analysis of hidden costs.

In addition, where the agreement is not silent and requires "adequate," "significant," or a "sound" basis to justify the subcontracting decision, such phrases open the door to an examination of all factors relating to the decision, including hidden costs. For the arbitrator, sensitivity to the hidden and longer-run costs of outsourcing can therefore be extremely important. In disputes where employers claim that good-faith business reasons rather than antiunion bias are the motivation for their decisions

[12]This conclusion was given by Professor William N. Cooke in Labor-Management Relations in the Auto Industry: Shifting into Second Gear, presentation given at the Eighth International Automotive Industry Conference, University of Michigan, Ann Arbor, March 23, 1988.

to outsource, the pervasiveness of hidden costs suggests that a thorough examination of the economic facts is highly relevant to the determination of whether the decision to outsource was motivated by antiunion bias.

For example, when an employer justifies a decision to outsource on the basis that its in-house piece cost is higher than a supplier quote, but it is subsequently established that the in-house piece cost figure in question is based on full corporate cost including a sizable allocation for fixed costs, then the veracity of that employer's alleged motivation may be cast into doubt. Perhaps even more suggestive of antiunion bias would be an employer's assistance, or failure to disclose its assistance, to the prospective outside supplier, in the form of low-cost capital, technology, equipment, dies, or designs. Similarly, if the outside quote is predatory and the low supplier price therefore cannot reasonably be expected to last, the veracity of the employer's motivation may be called into question. These are only illustrations; as indicated earlier, the range of possibilities with respect to hidden costs is extremely broad.

When antiunion motivation is not suspected or alleged, hidden costs still may be relevant to arbitration. Improved knowledge of hidden costs may have a salutary effect on the widespread misconception that in-house production is inherently inefficient or high cost. In cases where arbitrators would be inclined to uphold an employer's right to outsource (depending on contract language and other factors), they may well decide to rule differently if the economic facts of the case suggest that the item in question could have continued to be produced in-house competitively—defined broadly to include not only cost, but also quality and delivery date specifications and other pertinent considerations, relative to prospective outside suppliers. While outsourcing may not be a violation of the agreement per se in such cases, it may become a violation when the product in question can be produced in-house competitively.

In these cases analysis of hidden costs may figure importantly. The kind of advance notice, disclosure, and "meet and discuss" contract language on outsourcing which is quite widespread these days often cries out to be interpreted in a way that requires thorough analysis of hidden costs. When an employer commits not to outsource without first giving the union prior notice, disclosing the relevant economic information, and meeting with the union to discuss alternatives to the contemplated outsourc-

ing—and when such alternatives are found—outsourcing may be a violation of the agreement. In the course of these discussions, analysis of the hidden costs of outsourcing becomes a significant factor.

The hidden costs of outsourcing also have implications for the arbitrator's determination of remedy. If it is the arbitrator's intention to restore the pre-outsourcing status quo or to deter outsourcing violations of the agreement in the future, it is important to be aware of the increased cost of re-entry after an activity has been outsourced. Traditional remedies therefore typically fall short of inducing the employer to reverse the outsourcing decision and fail to deter future outsourcing violations.

Better understanding of the hidden costs of outsourcing can improve the quality of arbitrators' decisions in this critical area. Ultimately arbitrators are faced with the responsibility of balancing conflicting equities. The workers' equity in the employer's decision to outsource is very great. It may be naive to expect arbitrators to ask themselves how many suicides may result if the employer proceeds with the plan to outsource at a savings of, say, 50 cents per unit. It is not simply melodramatic to assert that the stakes can be that high. As the foregoing analysis of hidden and long-run costs shows, the employer's economic benefit from outsourcing is often far less than is commonly supposed.

Conclusion

In closing I offer several broad observations on the arbitration of outsourcing and outside contracting disputes. The conventional wisdom is that there is a widely accepted, reasonably uniform framework for handling these disputes. Implied, if not explicitly stated, is the comforting conclusion that while neither labor nor management is totally satisfied with the way such cases are handled, on the whole the approach taken by arbitrators is logical and consistent, and the system is working reasonably well.

From the vantage point of this nonarbitrator, the conventional wisdom overlooks more important questions. While the volume of subcontracting cases appears heavy, what proportion of potential cases do these represent? How frequently are cases involving substantial outsourcing or outside contracting referred to arbitration? Relative to other areas of contract

administration, such as discipline and discharge, the proportion of subcontracting cases submitted to grievance procedure and arbitration is probably small. Though their volume may be great, cases brought before an arbitrator tend not to involve issues of major principle between the parties or large numbers of jobs. Measured by this yardstick, arbitration comes up short.

The most significant reason for this state of affairs is that unions perceive arbitration as an unfriendly forum for resolving outsourcing disputes. In the area of outside contracting, unions have experienced poor decisions and worse remedies. While unions have been encouraged by a few arbitrators, they have been disappointed by the majority. Arbitrators are reluctant to challenge managerial decision making in this area and are reluctant to undo its adverse effects. Unions that would prefer to resolve subcontracting disputes peacefully through arbitration thus become reluctant to pursue this alternative. Where there is an alternative to arbitration the union uses it, especially when the dispute is a serious one. Disputes about outsourcing tend to get resolved in contract negotiations or directly between the parties during the term of the contract, particularly where the right to strike is available.

Certainly the UAW experience has been consistent with this perspective. In the administration of major UAW contracts, the most significant disputes about outsourcing, of which there are a considerable number, rarely find their way into arbitration. While there is considerable diversity among UAW contracts, the approach taken in recent "pattern" contracts has been to protect job security by requiring the employer to retain on the payroll workers who would otherwise be laid off as a result of outsourcing.[13] There is, in addition, a procedure to which the company must adhere, that can be summarized as follows: the company must notify the union 90 days in advance of contemplated outsourcing actions, disclose all relevant information to the union, and discuss the matter fully prior to implementation in order to afford the union and the company an opportunity to find ways jointly to keep the work in question in-house competitively, thereby reversing the tentative outsourcing decision. While it would normally be a violation of the agreement for the company

[13]Agreements Between UAW and the Ford Motor Company, Volume I (Detroit: UAW, National Ford Dep't, 1987); Letters of Understanding Between UAW and the Ford Motor Company (Detroit: UAW, National Ford Dep't, 1987).

to fail to provide the required advance notice, fail to disclose all relevant information, or fail to keep the work in-house if joint discussions succeed in developing methods for it to be retained competitively, invariably the disputes that arise about these matters with major employers covered by master agreements are settled by means other than arbitration.

The above procedure relates to *outsourcing*. Several of the major UAW agreements prescribe a different kind of treatment for *outside contracting*, defined as bargaining unit work performed *on the employer's premises* by nonbargaining unit personnel (whether employees of the corporation or of a subcontractor). With respect to such outside contracting, the language in several of the major pattern auto agreements reserves to the union the right to choose between strike action or arbitration as a means for settling disputes. Securing the option to strike during the term of the agreement over outside-contracting disputes became a priority in major auto negotiations in the mid-70s, after years of frustration over the union's inability to curb outside contracting abuses in any other way.

A leading counterexample of union reliance on arbitration to solve outside-contracting disputes is provided in the Steelworkers' agreements with basic steel employers. These agreements rely heavily on arbitration, including expedited arbitration as an option. Implementation of management's tentative contracting-out decision is held in abeyance pending the arbitrator's award. These contracting-out clauses contain unusually detailed language to guide the arbitrator every step of the way.[14]

While there may be other exceptions, it can safely be concluded that unions generally are reluctant to resort to arbitration for the resolution of outsourcing disputes. To the extent that arbitration is viewed as a socially preferable alternative to direct economic conflict between management and labor, low utilization of arbitration to resolve major disputes about outsourcing and outside contracting should be a cause for concern to arbitrators. The consequences of outsourcing are substantial not only for unions, but also for the future health of the economy.

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[14]Summary of Tentative Agreement Between Bethlehem Steel Corporation and United Steelworkers of America (Pittsburgh: United Steelworkers, 1986), 29–38.