The Hidden Microlevel Crisis in U.S. Manufacturing[1]

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Abstract

Manufacturing plays a central role in promoting economic growth, but recent decline in this sector has spelled trouble for the economy. A key reason for this decline is the growing tendency of manufacturing firms to outsource production, both to domestic and overseas locales. In response to these trends, the IAM has used its collective bargaining agreements and relationships to engage employers in productive discussions about the economic value of outsourcing. On the basis of years of negotiations and ongoing consultation with employers on this issue, we conclude that outsourcing decisions are often based on unreliable data and/or faulty analysis and hence are more likely to be driven by noneconomic factors than economic ones. We propose a tripartite effort—involving companies, unions, and neutrals—to improve the quality of make/buy analysis. These efforts will promote better decision making on the firm level with respect to outsourcing decisions, helping to strengthen the manufacturing sector as a whole.

The manufacturing base in the United States continues to erode. Whatever yardstick we use—the share of Americans working in factories, growth in value added by manufacture, our balance of trade with the rest of the world—the trends all point in the same direction. Recent research has demonstrated that growth in imports of intermediate goods has played a significant role in the disappearance of our manufacturing base—a reflection of the growing trend toward global outsourcing.[2]

Although the macrolevel effects of the manufacturing crisis are very real indeed, it is important to remember that they are the product of thousands of

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microlevel decisions made day in and day out inside the companies that make up our economy. And although the common discourse around outsourcing focuses around themes like “cost-competitiveness” and “core competences,” we believe that, in many manufacturing companies, the manner in which outsourcing decisions are made represents a hidden microlevel crisis that has not merely wreaked havoc on employees’ job security, but also may actually be damaging firms’ financial and competitive performance. Indeed, our experience in this area has alerted us to a troubling trend: in far too many cases, the decision to farm out work (either domestically or overseas) is not always based on “good business” factors like what is the most productive, least cost, most efficient or profitable way to do the work. Rather, all too often, decision making is based on buzzwords, management fads, or dubious accounting practices and not on what is truly in the best economic interest of the company and thus, at the aggregate level, our national economy.

Union Involvement in the Make/Buy Decision Process

Unions, generally speaking, do not seek to be involved in outsourcing decisions, or what we call the “make-versus-buy” (or make/by) process, as an end unto itself. Involvement in the process is one way to approach the all-important fight for job security, and, as the outsourcing threat to job security has grown, a union priority in many negotiations has been to supplement strong scope clauses with clear language in our collective bargaining agreements that involve the union in the make/buy process. Such language includes requirements to provide the union with advance notice of the movement of work, joint labor/management committees, access to information, the ability to negotiate over alternatives to sending work out, and protecting the job security or providing compensation to those workers impacted by the movement of work.

International Association of Machinists (IAM) members have benefited in numerous cases from the union’s involvement in the make/buy process, especially at employers with high performance work organization partnerships.[3] In the successful cases, jobs have been preserved, new work has been brought in, work previously performed internally has returned, or, if our work was moved, at least our local committees understood the economic or strategic justification behind the decision. Unfortunately, the “ideal case” has been the rare case. Our overall experience with a wide variety of employers has for the most part been one of frustration, because of the flawed way that many employers make decisions related to make/buy evaluations.

As the corporate scandals and collapse of investor confidence over the past few years have shown, there is a major crisis in accounting and decision making at the “macro” level. This crisis has featured questionable accounting practices, misleading reporting, overly optimistic assumptions, unqualified decision makers, and faith in management fads that defy the basic rules of economics and finance. Our involvement in the make/buy process has led us to the conclusion that at too many employers there is an equally troubling, but still well hidden, accounting and decision-making crisis at the "micro" level. In addition to the serious problems for our members that this microlevel crisis is causing in terms of eliminating good jobs, this crisis is also costing employers money and may be undermining the financial performance and long-term viability of many firms.

In our experience, this crisis has become apparent by asking simple questions about how costs and other factors were determined for both the "make" and "buy" side of the evaluation. We have consistently found that the "make" costs are grossly overstated, often by two or three times what they truly are, and the "buy" costs are grossly understated, often by equally large margins.[4] In most of the situations we have reviewed, if an accurate make/buy evaluation had been done, it would have indicated that it is less expensive or in an employer's best interests to use its own unionized workers instead of outsourcing, subcontracting, or transferring the work. The following examples illustrate the types of serious flaws we have come across in our review of make/buy decisions.[5]

The Battle of the "Burden Rate"

The biggest single flaw we come across in this arena is the use of "burden rates," which express a wide range of costs on a per–direct labor hour basis.[6] ("Direct labor" refers to the workers who make the products and perform the services.) Our concern is not that employers use burden rates as tools to evaluate production costs, develop budgets, or perform other analyses that management views as appropriate.[7] The problem is that, in a make/buy evaluation, many employers fail to limit their calculation of cost savings to only those portions of the burden rate that will be eliminated if bargaining unit work is outsourced, subcontracted, or moved. For example, part of the burden rate might be relevant to the make/buy decision, such as pay for direct labor hours, paid time off, inspectors, and direct supervisors. But other portions are not relevant, such as administrative costs, management salaries, other fixed costs, and payments to parent companies—these will not be reduced when bargaining unit jobs are eliminated. If portions of the burden rate that will remain are included in the make/buy evaluation, the projected savings from eliminating bargaining unit work are overstated.

Some examples will illustrate the kind of confusion we come across. "Employer A" presented its burden rate to the union as 117% of the hourly direct labor cost, which included $39 per direct labor hour for "corporate overhead." When asked for details on what expenses were included in "overhead," the IAM was told that nearly half, or $19 per hour, was for "redistribution." When the IAM asked for more details on "redistribution," the employer told the union that nearly two-thirds, or $12 per direct labor hour, fell into a category labeled "Other." When asked for more details, the company was never able to explain what expenses were in the "Other" category. The company was not able to provide any information indicating that outsourcing our work could eliminate any part of the $39 per hour for corporate overhead. This is an obvious problem but a common one—costs that on the one hand cannot be properly identified are simply assumed to vanish once the work in question is outsourced.

Another company, "Employer B," was proposing to ship work out of its IAM-represented plant to a nonunion plant it owned in another location. The burden rates for the IAM plant included $27 per direct labor hour for "plant overhead," but the burden rate for the nonunion plant included only $1 per direct labor hour for "plant overhead." For this data to be accurate, plant overhead would have to be 2,700 percent higher at the unionized plant than at the same employer's nonunion facility in a neighboring state. In this case, the employer ignored the IAM's request for details to show that these plant overhead figures were accurate and comparing similar costs.

All too often, we have found companies treating overhead as the cost accounting equivalent of the "junk drawer" in everyone's kitchen. In the corporate context, costs that cannot be assigned to a specific category (production, sales, administration) are sometimes simply dumped right into the overhead category. But the problem arises when overhead represents as much of your cost base as your direct costs of production (labor, materials, etc.), which is often a sign that it might be time to focus your managerial energies on, if not cleaning out the junk drawer, at least looking to see what is in there. Instead, the quick fix, more often than not, is "outsource some work to get costs down." Unfortunately, the more companies do that, the higher their overhead rates (and burden rates) continue to climb, as a fixed set of costs are spread over an ever-smaller direct labor base.[8] The "battle of the burden rate" has led us to the observation that, in many organizations, decision-making structures and processes are inflexible, resistant to change, and cannot be questioned. The view of the forest is lost for the trees.

Inflating In-House Costs, Underestimating the Cost of Farming Out

Other analytical errors we uncover in our reviews are more obvious, but that does not make them less common. For example, "Employer C" projects its make/buy costs out over a 10–year period. The employer applies a 3.5 percent annual inflation rate to the in-house labor costs, including the burden rate, but assumes no inflation for vendor costs even though the contract under consideration with the potential vendor is not a fixed cost for the 10 years. Thus, the costing model eventually shows savings that increase over time because only in-house costs are inflated.

Employers also underestimate the cost of outsourcing in other ways. For example, employers often omit from their analyses the costs associated with the administrative hassle involved with bidding the work, dealing with nonperformance issues, etc. Another issue is failing to account for severance payments for workers laid off as a result of the movement of work. "Employer D" was one such employer, who would have incurred large expenses for layoff benefits, severance payments, and early retirement if bargaining unit jobs were eliminated. But the employer did not include these costs when claiming it would save money by outsourcing. When the union asked why these expenses were not included in the make/buy evaluation, the employer stated that it was "not considered in our decision. This is a cost of doing business." What the employer missed is that it is a cost that would never occur if the work were kept in house.

Unfortunately, examples like these demonstrate that decisions are often based on directives from top officers to cut the workforce, and the fact that outsourcing may in fact be bad for a business cannot override the job-cut benchmarks that will be used to evaluate success. Although anti-union feelings are sometimes driving job-cutting decisions, it is more often based on a perception that Wall Street demands layoffs, advice from consultants, or corporate fads.

Getting to the Core of "Competence"

When challenged on whether the numbers actually support the "business case" of outsourcing, many companies attempt to avoid the issue by appealing to strategic management theories or business school buzzwords. One example was "Employer E," who stated that the work performed by IAM members did not fit into its "center of excellence" and "core business" strategies. When the union asked for the analysis showing how our work did not fit into these strategies, the employer replied, "There is no formal written strategy beyond the explanation provided." After continued attempts by the union to obtain further explanation or analysis, the employer's only additional response was, "Mission Statement: Exceed customer expectations in the manufacturing and assembly of [product] at the highest quality and lowest cost in a safe workplace by teams that are responsible and adaptable to future changes."

Responses like these lead us to believe that corporate decision makers often do not understand or review the data they are using. But good business decisions require that they must, rather than relying on corporate buzzwords. And although those buzzwords may be compelling to those in management, when our local unions become involved in the make/buy process, they demand facts instead of vague clichès as reasons for eliminating bargaining unit jobs. Another problem we have experienced is that our interface with the company is most often through the human resource or industrial relations departments, which are frequently “out of the loop” in terms of knowing what a company’s plans are or in having any input in the make/buy decision. Having a gatekeeper that is only given information on a “need to provide” basis makes obtaining the necessary information to evaluate the financial rationale behind a decision more difficult than it needs to be. Even when we are able to directly communicate with the “source,” (personnel in finance, accounting, or procurement departments), these employees often have never dealt with the union or union members and find labor/management committees an alien concept, which can make the open sharing and review of information a challenge. And finally, it is simple human nature not to like to be second-guessed or criticized. For many managers, it is simply too much to bear for that questioning to come from the union! Unfortunately, it appears that antiunion sentiments and old stereotypes about unions being unsophisticated are still with us.

Playing in Someone Else’s Sandbox

This “turf” issue, more than any other, is the one that is the most difficult to find a resolution to. Take the example of “Employer F,” who agreed to contract language that created joint labor/management teams to evaluate make/buy decisions. That language required the employer to “provide the information and documents necessary for the [labor/management] team to make an assessment of the relative costs of subcontracting, offloading, or performing the work in the bargaining unit.” During the life of the agreement, the IAM repeatedly exposed major flaws, errors, and omissions in the employer’s analysis. But instead of the company using the IAM’s input to fix its process to generate better business decisions, the employer viewed the contract language itself as the problem. In the next negotiations, the employer was able to replace the phrase “information and documents necessary” with a watered-down requirement that it provide the union with the same “information used by the Company’s Work Transfer Groups.” Because the company’s groups use data similar to the information that the IAM already has shown as being flawed, our access to better information now depends on midlevel management employees in these groups being willing to tell their bosses that the data the groups were told to use is bad.

Overall our experiences leave us with the view that many companies are balkanized organizations where departments, locations, and divisions fight among themselves, do not share information, and the leaders at various levels are more interested in their own power base than in what is best for their employers. We also frequently see that procurement or purchasing departments view their job narrowly as helping the company to outsource or subcontract work, not on some grand level as doing what is best for the employer to achieve productivity, efficiency, and profitability. This challenge is one that unions and managements will have to work hard to overcome.

Conclusions

Even with our many concerns about how employers reach make/buy decisions, the IAM does not regret using, and plans to continue using, our limited rights under the law and the stronger rights we have negotiated. While we have not saved all of the targeted jobs we have fought for, we have often reduced the number of job losses, delayed the impact of job losses, and increased our leverage in negotiating severance and early retirement packages. Our members appreciate that we are fighting on their behalf and shedding light on the reasons behind job cuts. We also feel that our willingness to fight strengthens our members' solidarity and discourages employers from advancing more job cuts that they know we will challenge. There are many lessons that we have learned from our involvement in the make/buy process, and from these experiences we have advice for employers, unions, and neutrals.

We believe that, if employers truly want to reach make/buy decisions that are in their best financial interests, they need to design, with input from their union(s), a well-thought-out make/buy process that includes an appropriate methodology, based on all relevant data. Unions and their members would much prefer to have a company willing to make a detailed evaluation of the costs and benefits of the make/buy alternatives and then let the facts drive the decision than have some other criteria driving the process. The worst possible business decision is one that is made ahead of time, before the facts are in. In those cases, the make/buy evaluation is either manipulated to generate the desired outcome or the process is so flawed that it automatically biases any decision against keeping the work in-house. Good business decisions require unbiased analysis.

For our brothers and sisters in the labor movement, we have additional advice. We have found that support from the top officers of the union for getting involved in the make/buy process makes all the difference in the world, since this process will require a commitment of time and resources to provide adequate support and training to local committees. Local leaders must be involved in the creation of the make/buy process. Unless they understand and agree with the strategy, they will not be able to carry out their central role as the people who must meet and work with the employer, evaluate make/buy costs, propose alternatives to save jobs, and take action to protect their legal and collective bargaining rights. Training of local leaders and committees is critical. The process cannot work if the local relies on the union headquarters or a consultant to do everything for them. Employers should pay for the time union representatives spend working on make/buy decisions, because this involvement enhances the company's ability to make good business decisions. Finally, union-side lawyers should be brought into the process early. They can provide useful input on contract language, information requests, and record keeping.

There is also a role for "neutrals" (arbitrators, mediators, National Labor Relations Board agents, judges, etc.) in supporting make/buy processes that will result in good business decisions. We have been discouraged that some neutrals have not taken seriously union complaints that company data is bad or inadequate. By and large, neutrals are well educated and experienced, but unfortunately many have only a cursory understanding of financial analysis. The underlying assumption many neutrals appear to bring to the table is that companies "know what they are doing" when it comes to financial decisions. The same company that must prove its case on more traditional labor disputes (firings, promotions, wage increases, etc.) is often given more deference, and in our view too much deference, when it comes to claims about saving money. If the labor movement becomes more involved in the make/buy process, we will be able to build up credibility on this issue. Over time, we hope that more neutrals will view our complaints about phantom cost savings as having merit. Just as unions have gained credibility on corporate governance issues through their steady efforts on those topics, so can we build up our "bona fides" on make/buy decisions.

In conclusion, the IAM has been making and will continue to make a good-faith effort to work with its employers to make intelligent make/buy decisions. We encourage unions, management, and neutrals to work together to address the accounting and decision-making crisis where it exists at the microlevel. With all sides engaged in the process, we can put an end to bad business decisions that hurt unionized workers, cost employers money, and continue the pace of deterioration in America's manufacturing sector.

Notes

1. The views presented herein are those of the authors and not necessarily those of the International Association of Machinists and Aerospace Workers.

2. See Bivens (2003).

3. The IAM's High Performance Work Organization Partnership program is a leading example of how joint labor/management consultation and involvement can achieve the twin results of financial success for the company and job security for union employees.

4. For the purposes of our discussion, "make" means the production of goods or provision of a service "in house" by our bargaining unit, and "buy" includes outsourcing the work

to a vendor who will perform the work elsewhere, subcontracting the work to a vendor who will perform the work at the bargaining unit worksite, and/or transferring this work to another facility owned by the same employer.

5. Because of confidentiality constraints and out of concern for maintaining labor/management relationships, employers cited in these examples will not be named.

6. Burden rates typically include costs for items such as benefits and payroll taxes for direct labor, nonproduction hours for direct labor (paid time off, training, unallocated time), indirect labor (maintenance, inventory, inspection, engineering, etc.), sales, administration (including the outsourcing department), management, utilities, supplies, fixed costs (depreciation, rent, property taxes, etc.), and payments to parent companies. They sometimes include unusual items, such as restructuring charges, fines, environmental cleanup, and goodwill from mergers and acquisitions.

7. The common use of direct labor as the cost driver in traditional cost accounting has long been criticized by advocates of "activity-based accounting," who explain that as direct labor makes up a smaller and smaller portion of a manufacturer's cost base, it becomes less and less reliable in accurately portraying or predicting a company's true production costs.

8. The problem of overbearing overhead is not a new one. See Kaplan (1984).

References

Bivens, L. Josh. 2003. "Outsourcing and Labor in U.S. Manufacturing." EPI Working Paper, forthcoming. Washington, DC: Economic Policy Institute.

Kaplan, Robert S. 1984. "Yesterday's Accounting Undermines Production." Harvard Business Review, July 1.