Chapter 5: Labor Market Frictions, or How Things Can Get Hot and Sticky

Chapter Five of *Modern Labor Economics* discussed a variety of labor market frictions that can result in an analysis much less clear than a simple supply and demand graph. These frictions are not the product of some perverse mind, dreaming up complications to make the life of students more difficult. Rather, they are routine occurrences in real life that violate the simplifying assumptions of our most basic economic models. But, be not dismayed, for Chapter Five also showed that the issues raised by various frictions, while a challenge for modeling, can still be incorporated into our analysis. Some of the challenges facing firms because of various frictions were nicely illustrated in several recent articles in *The Wall Street Journal*. The strategies discussed there offer some guidance to employers on how to deal with problems stemming from **monopsony power**, **employee turnover**, and **quasi-fixed costs of employment**.

The existence or even prevalence of monopsony power can sometimes be a difficult concept for students of labor economics to grasp. Some of the best examples to illustrate the phenomenon simply don’t resonate with students because they fall outside of their own personal experience: Few of us have lived in a “company town” that only had one employer or at least one so large that they dominated the market; perhaps even fewer have or ever will be professional athletes under contract and not yet eligible for free agency. But a recent article by Erin White in *The Wall Street Journal* plainly shows that employers understand how monopsony works, though sometimes they find that it may not be best for them in the long run.

Focusing on the firm 1-800-Flowers.com, Ms. White described how the firm received a rash of customer complaints about service after they had moved call centers overseas in a cost-saving move. The company responded by bringing the jobs back to the U.S., but deliberately located their centers in small rural towns where they could take advantage of relatively low local wages coupled with relatively high levels of education. But what looked like a monopsonist dream hasn’t turned out as well as had been expected, forcing the company to be creative in responding to new problems.

First, small town markets have a relatively small number of workers to draw from. However, if the location was attractive to you, it might well be attractive to other employers, creating occupational mobility for the local work force. The result, according to the CEO of a company that helps other companies staff home-based call agents: “...you’re going to burn through that in a couple of years—just about everybody who could work there has worked there, and has moved on.” After experiencing high turnover rates and finding it difficult to attract new applicants after just three years, Flowers found that it had to implement new policies to sustain its workforce. Among the steps taken were increased training for managers to improve their people skills, seeking more input from employees as to their workplace concerns that might contribute to turnover and greater flexibility in scheduling work.

Turnover was the subject of a Carol Hymowitz article in *The Wall Street Journal*, with the focus again being on what role managers could play in taking proactive steps to reduce it by keeping employees happy. Turnover costs contribute to the quasi-fixed costs of employment and in some cases can be very high, especially when workers have high skill levels. In some cases, turnover is the result of circumstances beyond a firm’s control, such as a family situation or the departure of a worker’s friends. But some reasons for turnover may well be within a firm’s control, such as a lack of challenging opportunities for talented workers or workers simply not getting along with their boss. In any case, Ms. Hymowitz suggested the importance to firms of recognizing when it had turnover concerns and, rather than denying or ignoring them, working on solving the problems that were causing the turnover.

The costs of not fully accounting for quasi-fixed costs of employment, to the extent that firms now find themselves subsidizing turnover, was illustrated in a third *Wall Street Journal* article, this one by Jeffrey McCracken. He described a program at Ford that was offering employees half their annual pay for four years, plus health insurance and up to $15,000 per year to pay for education expenses. The reason Ford is doing this is to pare the size of their workforce and to reduce their future obligations to retiree medical benefits, which buy-out recipients must give up as part of the deal.
All three major U.S. automobile companies have long had an agreement with the United Automobile Workers that provided full pension and health care for workers and their spouses after thirty years of service. Health care costs are estimated to add $1000 to $1500 to the price of a U.S. brand vehicle relative to a U.S.-made Toyota, so the companies are trying to get out from under them. (See more on this issue in the case study to accompany Chapter 13.) In addition to the Ford plan, General Motors has been offering lump-sum buyouts of up to $144,000 to reduce the size of its workforce and get its workers to retire before hitting the 30-year mark.

Sources:
"Call Centers in Small Towns Can Face Big Problems," by Erin White, The Wall Street Journal, October 22, 2007 (p. B3);

Questions:

1. If a large employer moves into a small town, it seems likely that they may have to pay wages above the local average in order to attract enough workers. Would this result be contrary to the theory of monopsony?

2. What sort of costs are likely to be higher due to employee turnover? Can’t firms just agree to match any better wage offer its employees receive as a way to reduce turnover?