



# The national internal labor market encounters the local labor market: Effects on employee retention<sup>☆</sup>

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## Abstract

Formal salary systems are commonplace among medium to large-sized firms and within the United States government. However, there is little evidence regarding the costs, if any, of such systems. This study analyzes the effects on retention within the United States Air Force from an inflexible wage system failing to adequately compensate personnel for local compensating wage differentials. Using location-specific Air Force personnel records, I compare the differences between military and civilian wages, by occupation, across locations to determine if local labor markets play a significant role in the stay or leave decisions for personnel. Results show that rigid wage constraints do in fact impose costs on the firm through increased turnover in locations that fail to adequately adjust wages for the cost of living and amenities.

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## 1. Introduction

Although formal salary systems are commonplace among medium to large-sized firms and within governments, there is little evidence regarding the costs, if any, of such systems. In fact, in studying internal labor markets, economists are unsure “whether personnel policies have real effects, or are just a veil through which the pressures of the external labor market act relatively unimpeded” (Gibbs and Hendricks, 2004).

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Economic theory would suggest that rigid pay systems are likely inefficient because salaries are determined by the position versus the individual characteristics of the employee. Such a system would likely underpay high performers and overpay low performers. As evidence, Baker et al. (1994a) found that those who are promoted the fastest also exit more often. Additionally, large corporations and government organizations with employees in multiple locations, may fail to compensate individuals adequately for the cost of living and amenities of the location due to the rigidity of the pay system.

The U.S. Department of Defense is one such organization, which employs personnel in locations around the world and has a historically inflexible wage system. Economists have long pointed out that the military pay table does not adequately distinguish among occupational subgroups within the services (Rosen, 1992; Asch and Warner, 2001; Asch, 1993). This incomplete pay distinction results in specific occupational shortfalls and surpluses, resulting in inefficiencies in the military labor market (Rosen, 1992). Additionally, one could argue that military wages are also out of line with local labor market wages. With the exception of housing allowances, military wages do not vary across locations within the United States.<sup>2</sup> However, the theory of compensating wage differentials predicts that wages adjust according to the cost of living and amenities of a location (Rosen, 1979; Haurin, 1980; Roback, 1982; Blomquist et al., 1988; Graves et al., 1999). Other evidence suggests that wages are adjusted to fully compensate workers for the cost of living in a location (Aggarwal and Kenny, 1996; Kenny and Denslow, 1980). This leads one to ask whether the retention of military personnel is significantly affected by the rigid pay structure, which fails to fully adjust wages for the local labor market where personnel are assigned. That is, are personnel more likely to exit the military when local civilian wages are relatively higher than military wages (or more likely to stay when civilian wages are relatively lower) at the location of assignment?

To determine if external local labor market pressures significantly affect employee retention, this study analyzes personnel records for 95,000+ first-term U.S. Air Force personnel across 67 locations from 1996 through 2001. Results show evidence of the costs associated with a rules-based compensation system, which fails to fully adjust wages for local labor market conditions. Retention is significantly lower in locations in which military wages are less competitive with local civilian wages after controlling for all occupational differences at the national level.

## 2. Background

Traditional labor economic theory suggests that wages should be determined individually in a spot market (Baker et al., 1994a). However, this is not the case in many firms where compensation is often rules-based. Doeringer and Piore (1971) describe the idea of an internal labor market as:

...an administrative unit, such as a manufacturing plant, within which the pricing and allocation of labor is governed by a set of administrative rules and procedures. The internal labor market, governed by administrative rules, is to be distinguished from the *external labor market* of conventional economic theory where pricing, allocating, and training decisions are controlled directly by economic variables.

<sup>2</sup> Modest Cost of Living Allowances (COLAs) are provided in high cost areas of the country. These COLAs do not affect a high percentage of military personnel in the Air Force, the organization studied here, with only 2 of 67 bases receiving a COLA (Los Angeles AFB, CA and Hanscom AFB, MA). For example in 2001, junior enlisted personnel received \$19 per month in COLA in Los Angeles.

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