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NEW ZEALAND BUSINESS ROUNDTABLE

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Contents

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He has been a member of the American Academy of Arts and Sciences since 1985 and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the *Journal of Legal Studies* from 1981 to 1991, and as editor of the *Journal of Law and Economics* from 1991 to 2001.

His books include *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 7th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure, communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

Introduction

Geof Shirtcliffe,
Chapman Tripp Sheffield Young

It is a great pleasure to welcome professor Richard Epstein. He is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago. Since 2000, he has been the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution. Before joining the University of Chicago Law School he taught at the University of Southern California.

Professor Epstein is a man who leaves in his wake a string of inferiority complexes with his daunting curriculum vitae that includes books, articles and lectures on all manner of subjects. I heartily recommend people with a problem of over-confidence to perform a Google search on Richard's website. Once they have found his homepage, they will feel much more normal within two minutes.

Professor Epstein will address the question, 'Is there unequal bargaining power in the labour market?'. Frankly, I would have thought the answer was self-evident. As in other markets, there is and often has been unequal bargaining power in the labour market in the sense that supply and demand are not always in balance. In New Zealand over the past 15 years or so there has been two distinct periods. When unemployment was high in the late 1980s and early 1990s, there was unequal bargaining power on the side of employers. In more recent years, and particularly in today's tight labour market, the inequality has changed to favour employees. I am sure these curious developments will be further elucidated by professor Epstein.

Is There Unequal Bargaining Power in the Labour Market?

Introduction

The question to which this paper is devoted contains a latent ambiguity that Geof Shirtcliffe has brought out in his brief, but pointed, introduction. Usually, a discussion on this theme will focus on the extent to which employers enjoy market dominance. However, as Geof indicated, the balance of advantage can go in both directions. You can easily have unequal bargaining power in favour of workers – presumably subject to the same objections associated with fairness and resource allocation that are brought against regimes of employer domination. In New Zealand and elsewhere supporters of the status quo may labour to defend the current legislative fix under the illusion of perfect equality. However, in a more open debate, the real question might be whether elements of employment law unfairly penalise employers rather than employees.

Before examining the claims of unequal bargaining power in a New Zealand context, I would like to look at the principles that will assist us to understand and evaluate the overarching argument in defence of this commonly accepted viewpoint. If the fatal phrase 'inequality of bargaining power' had never been coined, how would we analyse the operation of labour markets? I start with an assumption that there is no coordination between sellers on one side of the market, or buyers on the other. Then, by relaxing that assumption, I examine how the labour market would operate with coordinated efforts on one side or both. After going through this process, I ask whether the notion of inequality of bargaining power retains any credence as an explanatory or normative tool, even though its political and rhetorical influence is enormous.

At this point, the discussion turns toward simple economics, for which I make no apology. Generally, I find today's economists are too worried about complicated problems that cry out for mathematical solutions that prove some complex 'existence theorem' of which the content may be known only to the gods in heaven, but which elude us mere mortals on earth. However, economics should not be a branch of recreational mathematics. I believe the priority should be to understand the basic phenomena that have greater and more immediate institutional importance in contexts that truly matter to the well-being of any society. The labour market is such a phenomenon.

There is an advantage to being determinedly simple-minded about matters like this. It is important to get the first approximations right and worry about refinements later. That is what I plan to do in this paper. I take the two paradigm cases first, and then introduce a degree of complexity to see how the results change.

Competition in the labour market

Some would say a competitive labour market demonstrates a high level of social efficiency because it is characterised by misery on both sides of the transaction. Employers complain, 'this is a terrible, dog-eat-dog world. If I lower wages by a cent, I can't get a single taker among workers. And if I raise wages by a cent, then my business goes under'. Before playing the violins for the employer, it should be noted that, in this uncoordinated market, workers are just as miserable. They say, 'if we make a wage demand a cent above the competitive price, employers won't accept it. And if the demand is a cent too low, we can't make ends meet'.

Looked at from the perspective of either group, this situation appears pathological. It is easy to make predictions that such a baleful situation is unsustainable. But these appearances mislead. From a broader societal perspective, it is enormously positive. Neither side has any degree of market power; nobody can change prices and retain the worker or the job. In effect, there is a unique price equilibrium, which means the number of transactional obstacles that lie in the path of agreement will be small. Because everybody will instantly converge on this ideal competitive wage, the amount of joint productive gain will be high while the transaction costs are low. It is a sign of

social health when transaction costs are low relative to the number of transactions that are consummated. It is a delusion that has afflicted many 'progressive' writers to think that haggling over the price of a cow across the farmyard fence represents some economic Shangri-La. But it is exactly the reverse, unless the bargaining process is treated as some kind of consumption good instead of the economic cost that it truly represents. Smooth and rapid transactions are the end that market participants seek.

How then is that desirable state of affairs achieved? Once again it is back to basics. The competitive labour market should be thought of in terms of the traditional intersection of supply and demand. If there is a labour shortage, employers will bid up the price, drawing forth extra workers to take jobs. If there is an abundance of labour the opposite will occur, as workers leave their jobs to pursue other options. By allowing the free movement of price and quantity, powerful forces will result in a convergence at the optimum level. In this type of market, any transactions worth undertaking will take place. If prices are raised or lowered by government fiat, then we shall all pay a high price: certain kinds of gainful transactions would be precluded.

The single most important thing to understand about the operation of a standard labour market is that it is immensely boring. It does not present any difficult transactional problems or generate negative externalities that require government control. Compared with network industries or intellectual property, dealing with labour markets appears a piece of cake, so long, at least, as we have the courage to leave well enough alone.

Coordination in the labour market

If we relax our assumptions and allow coordination to take place, employers could associate through trade associations while workers could join trade unions. We do not have to refer to inequality of bargaining power to see that our previously happy story evaporates. The moment coordination is allowed, actors on one side or the other will move wages away from the competitive equilibrium.

Generally, people are suspicious of monopolies because they recognise that the equilibrium reached in a typical case is inferior to that reached through

competition. In a labour market, workers fortunate enough to organise a monopoly will have incentives to constrain the supply of labour and seek higher wages. The private gain from pushing wages above competitive levels would be smaller than the social losses suffered by employers and third parties, such as unemployed job-seekers and consumers (including employees of other companies) who use the products of the firm.

A zero transaction cost model has some plausibility in a competitive market, but less if a monopoly is present. There will be political jockeying to decide who is accepted as a member of a union and who will be excluded. To maintain its monopoly, the union must appeal to the state to prevent new entry by excluded workers, because their uncontrolled actions would return the price to the competitive level.

The same results would occur if employers were organised and workers were not. An effort to lower wages would cause a reduction in labour supply. There would be constant manoeuvring and cheating by employers in the fashion of all cartels. Some would honour the agreements, while others would hope that their cheating would go undetected. More likely than not, the large number of players would be unable to resist the persistent efforts to return to the competitive equilibrium.

If both sides are allowed to establish strong bargaining power by combining forces it will create a bilateral monopoly situation. There is no determinate wage or quantity of work to be done, a huge amount of negotiating will take place, but relatively few stable bargains will emerge. It may well be the case that we should prefer the unfairness of having a monopoly on only one side of the market. Even if someone does not like the skewed distributional consequences from having such a monopoly, third parties would be left better off. The creation of a bilateral monopoly introduces the risk of massive instability that could close down an entire business: witness the shutdowns that occur from time to time in the airline industry and professional sports, where a bargaining impasse leads to strikes with strongly negative third-party effects. The theory of 'countervailing power' popularised a long time ago by John Kenneth Galbraith is suspect precisely because it overlooks these systematic consequences.

Analysing bargaining power

If the goal is to maximise productivity with minimum transaction costs, it is clear that the competitive situation will work best. So why is inequality of bargaining power even worthy of serious discussion? There are two approaches to this question. The first relies on a belief that, in my view, takes us nowhere. The second is important when more complicated labour markets, in which workers and employers are not homogeneous, are considered.

The exploitation hypothesis

The approach that does not work particularly well hypothesises that, in a competitive situation, one side has an advantage caused by size, net worth, experience or some other factor that allows it to push wages to a point that makes the other party unhappy with any agreement that emerges from this process. This hypothesis is closely associated with the Marxist notion of exploitation. In this version employers use their bargaining power to keep pushing wages down. If this were true, labour markets would be no different from theft, because we would have a situation in which one party won and the other lost, losing perhaps even more than the winner gained. Something would have to be done to stop contracts from being made, given that they would, by assumption, lead social institutions into a downward spiral.

However, an attempt to identify the equilibrium conditions in this situation will not find any that survive analysis. If you held inequality of bargaining power independent of the market structure, you would continue exercising it to the point where the other side had abjectly to surrender. The only equilibrium position I can envision is where employers receive an infinite amount of labour for a zero wage. Why would any employer, with this advantage, settle for anything less advantageous? Yet a pattern of zero wages exists in no labour market.

Historically, employer cooperation has been an important issue. Antitrust laws apply but in many settings they have little application, even if on the books. Labour markets tend to be thick and diverse. Mechanics, for example, are not restricted to working in one trade but can work in many different trades. The concentration sometimes seen in product markets is not generally

a feature of labour markets. Therefore, it seems much more important to stress the alternatives available to both sides and examine whether, and if so how, people on one side of the market are able to cooperate with one another. The exploitation model is a dead end because it cannot explain any features that we see in labour markets, most obviously the spirited competition that takes place at every level for honest, able and ambitious workers who are the heart and soul of any business, large or small. Managers who work under the illusion that they possess this enormous bargaining power will learn to their personal regret how wrong their world view is.

Bargaining over rents

A second, and more sensible approach to the subject becomes possible, however, when we reject the useful but artificial assumption of perfect homogeneity in the marketplace. Just think of the easy cases in which that assumption is routinely violated. When a new position in a firm opens up, many potential applicants will apply. But even if they were all identical at the outset, that condition would not last long. While on the job each worker builds up specific human capital. When the question of contract renewal, advancement or promotion arises, there will be room for bargaining on both sides precisely because of the individuation that has taken place.

It is easy to imagine a situation where a worker would stay in a role if offered a 2 percent wage increase while the employer would be prepared to pay up to 10 percent more to retain that employee. Somebody has to decide how to divide the spoils between the two sides. In these circumstances, the measure of inequality of bargaining power comes down essentially to who is likely to get more than 50 percent of the difference. An immense number of games or theoretical complexities could be identified, but virtually nothing can be done to eliminate the difficulties of figuring out who gets how much. The process may yield an ambiguous result, but the theory could never tell you in advance what that would be. After all, in this simplest of examples, I simply chose two numbers. Yet, in any real-world setting, I would have no idea what the reservation prices were on either side, or even if the parties knew their own reservation prices or had some sense of the other player's. These are all guesses on my part, rather

than precise knowledge. Even if the parties had that information in digestible form, it is highly unlikely that any third party could figure out in advance what tactics they would adopt or what the outcome of their negotiations would be.

Typically – and I suspect this is why they were not studied until recently in law and economics – most of these situations are resolved very quickly in practice. An employer would say to an employee, 'I'm giving my new workers X, but you are a little better, so I'm giving you an X + 2 percent wage increase'. The employee quickly agrees and they go about their business.

It is conceivable in some settings that a systematic argument could be made that one or the other side is likely to garner most of the surplus, but I have yet to discover any powerful or determinate theory to support such a conclusion. So, in this model, some inequality of bargaining power does exist, but we do not know where it is located. The worst thing we could do as regulator is to stipulate, for example, a minimum wage increase for the employee in an effort to guarantee their share of the gain. Let that number be set at 5 percent, when the maximum wage increase that is feasible to the employer is 4 percent, and we have one less job, to the benefit of neither side. The clear maxim is let the surplus fall where it may, so long as competitive forces offer some external constraint on its division.

Contracting at will

A common tactic of those who seek to find inequality in the labour market is to focus on the particular terms of a contract and declare that they are so one-sided there must have been improper use of market advantage to obtain them. This query leads me to a popular topic which is whether, in dealing with labour relations, we ought to have any affection for the traditional contract at will. This somewhat artificial legal contrivance is a situation in which there is perfect legal symmetry between the two sides. An employer may hire, fire or retain a worker for good reason (which is, of course, virtuous), bad reason (which is, of course, terrible), or no reason at all (which turns out to be a little bit crazy). Likewise, the worker may take, leave or retain a job for good reason, bad reason, or no reason at all.

In the light of this formal equality, how should we think about the manifest insecurity of workers who could be stripped of their employment and left in a vulnerable situation? I think the first question to ask is whether people would rationally enter a legal arrangement that could have such consequences. I think that they can. Knowledge of transaction cost economics makes me reluctant to say that such a contract should be regarded as presumptively off-limits, or that protection is needed such as through a public service system with permanent employment or by means of an unjust dismissal law. The symmetries are real. Many employees exercise their right to quit. They would be affronted at the idea of having to appear before a public agency to prove they had good cause for taking another job, and that it was in the social interest that they be allowed to do so when it is shown that this move has disadvantaged their current employer. If this were required, there would be enormous administrative rigidities and a whole series of fanciful stories. Everybody would be constantly forced to explain why their own assessment of their situation and interests should be upheld by public officials who knew nothing about them. Exaggeration will be the order of the day on all sides. If we were to ask workers whether they would only take on jobs if they were able to quit for a good reason, I suspect most would stare blankly and respond, 'of course I will only quit if I have a good reason – but you can trust me to make that judgment myself'. Thus we have the birth of the intuitive Hayekian, who knows the strength of their own local knowledge even if they doubt that others have the same comparative advantage.

All this is not to say that the at-will rule always works best, even at the option of employees. The absence of a 'for cause' requirement on the employee side gives rise to a certain kind of opportunism. If a seasonal harvest worker is able to quit at will one week before the annual harvest takes place, leaving crops to rot in the field, the worker has a decisive advantage over the employer. The appropriate response, however, is not regulation but negotiation. Wages, or other terms of employment, can be adjusted to get around the difficulties associated with the contract at will. One solution might be to say to the employee, 'you will receive room and board until the end of the harvest season, but you will not be paid until the harvest has finished. That way, if you quit, we have enough money in the bank to hire substitute labour'.

And what happens on the other side? 'For cause' requirements imposed on employers who wish to terminate a worker's contract are enormously problematical. Often, the single most important element of the employment relationship – not only the dynamics between the employer and the employee, but also among co-employees – depends on soft facts that matter a lot in practice but are almost impossible to describe after the fact in a neutral fashion to third parties – local knowledge all over again.

In my own brief experience as an (interim) university dean I found that inter-employee relationships were the single most important factor I had to deal with. In the absence of someone in a position of authority exercising a relatively strong hand, able staff cannot be protected from less able staff. I have no doubt that this same issue arises in settings where multiple employees report to a single employer. The possibility of unsatisfactory relationships among employees creates the genuine danger of sending the entire organisation into a tailspin. In handling these situations I was constantly being reminded that I could not just dismiss somebody from their job. However, when I talked to the employees who were supposedly protected from the at-will rule, I discovered a new employer duty that I had never realised existed. That is the duty to dismiss. Staff members in key administrative positions would say, 'unless you get rid of that person I will not stay here because my situation is intolerable'. This shows why the level of discretion associated with the contract at will can be required. It supplies the only effective remedy for heading off or resolving potentially hazardous inter-employee disputes. The symmetry argument is not a silly formalistic notion; rather it is rooted in workplace realities, realities that become more evident as we move to situations where many workers report to a single manager.

Nor does the contract at will exhaust its strength in dealing with lower-level employees. As one ascends the employment ladder to managerial ranks, it is clear that many relationships rely on the contract at will, even when there is no indication of any inequality of bargaining power. It is very common for senior managers in large firms to be employed under at-will arrangements. Neither they nor the firm would have it any other way; logically, if they wanted increased protection, the firm would offset the risk of facing a difficult

dismissal situation by insisting on a pay cut. Indeed, the only privileged individuals I know who are systematically employed on a different basis are people like myself: academic professors who get tenure. Tenure may well be a justifiable institution – it was, after all, voluntarily created – but it does pose enormous dangers of sub-optimal effort by academic staff who are partly immunised from any employer sanction.

Looking at the full range of voluntary employment arrangements including the contract at will, I do not think you can argue that any of them gives rise to obvious forms of inefficiency. In fact, they seem to operate very well. They do not provide evidence that there is anything wrong with the unfettered operation of the labour market.

The behavioural economics critique

Thus far I have offered a standard analysis of the underlying situation that assumes some degree of rational action on the part of all actors. However, that assumption does not enjoy the status of a necessary truth. Indeed, recently, behavioural economists have taken an interest in exploring these matters from a rather different perspective. The insight that this hardy band of analysts offers is not one of bargaining inequality in the Marxist sense of an employer having inexhaustible market power to force wages down to subsistence levels. Rather, behavioural economists point out that not all people are good at making the calculations necessary to enter into agreements that make them better off. The principle of mutual advantage that normally drives voluntary exchange cannot work, it is said, when people involved in these transactions are subject to a variety of biases that lead to systematic flaws in their decision making.

If this theory of human capabilities is true, it is so for people on both sides of the market. Employers and employees will be subject to unconscious impediments to making rational decisions. If both are subject to the same difficulties, why would protection be extended to one side and not the other? Moreover, although people certainly make mistakes when they enter into employment relationships, they are at least cognisant of the fact that they are ignorant about how things will work out. People know when they are in over their head, which is one reason why they hire others to do their taxes. So, for workers, an advantage of a contract at will – or any fixed-term employment

contract – is that, by preserving the quit option, they are able to adjust their situation in the light of experience, even if they could not predict in advance what would happen to them. Rational labour decisions should not be seen as a one-time choice that may lead either to success or disaster. Rather, employment relationships at will allow constant modifications over the life of an agreement. Even when the parties to them cannot figure out in advance what is in their interests, the feedback mechanisms are direct and powerful, and will prompt them to make adjustments that move them closer to a more desirable state of affairs.

Indeed, putting behavioural economics aside, employment relationships – whether at will or otherwise – never take the form of contracts in which all contingencies are covered. Both sides build in a lot of flexibility at the front end. The success of these relationships depends on the way people adapt and respond to new information. If we took the view that all individuals behaved like dyed-in-the-wool Hobbesians, then allowing that degree of slippage in contracting would count as a colossal blunder. But, here again, we have to keep things in perspective. Any political system involves huge numbers of actors, and thus can be destabilised by the actions of a tiny fraction of them. The situation is dangerous even if most people are good sorts who will not push every advantage to the limit. Yet employment relationships do not raise that sorry prospect. Even if we cannot choose our fellow citizens one at a time, we have far more choice over our trading partners, in labour markets as everywhere else. So if you have some confidence in the character of the person with whom you do business, then allowing discretion comes at a much lower cost. Of course that decision can backfire in some highly visible contexts. But, by the same token, it tends to work well in many others. The sign of a successful labour market is not conspicuous bluster that could lead to strike action. It is non-dramatic and constructive cooperation that produces positive results even though it attracts no public attention.

Labour markets are not special

If these arguments are correct, it follows that when it comes to employment arrangements, the classical liberal argument in favour of competitive markets holds. Monopoly is not a serious problem in today's labour markets where both workers and firms are mobile. However, two other issues should be considered.

The first is the possibility of incompetence, force and duress. If labour markets looked like those that involved treatment for patients with serious mental illness, no one would say that trust and confidence could smooth the way for all concerned. But the contrast between healthy workers and unwell patients should be clear enough. Although there may be some irregularities in labour cases, an *ex ante* prohibition will be inefficient compared with *ex post* relief that would allow a party to prove irregularity in the drawing up of the contract. This is not a setting where we need protections like doctrines of informed consent that are used in a medical context.

The second problem concerns externalities or harms to third parties. These can be real: if someone is leading lions on a leash down a busy city street, the risks to others are extreme. However, for the most part, labour relationships in a competitive market have *positive* externalities and therefore do not raise any need for legal redress. A successful employment contract makes both sides better off than before. Each will have larger stores of wealth and therefore larger levels of satisfaction or utility. Hence they will have increased ability and means to enter into positive deals with other parties. It would be nice to subsidise these transactions, save that we would have to tax other like transactions to do it. As in so many other cases, we let the positive externalities take care of themselves.

So, in the end, it is back to basics: just remember that if you can reduce the level of friction in transactions you will be able to increase the velocity of voluntary exchanges. In turn, this will generally increase overall welfare levels. It is simply an application of the insight of the Coase theorem that the nearer transaction costs get to zero, the better off trading partners will be. Whereas many markets, such as those for land use and intellectual property, will not allow you to get these costs very close to zero, the labour market is not such a case. When considering regulation it is perhaps the best candidate for adhering to the principle that the first thing to do is do no harm at all.

A practical context: New Zealand employment law

Let me briefly put this discussion into a practical context. I was involved in some of the work leading up to the passage of the Employment Contracts Act of 1991. It is often claimed that that legislation was advantageous to employers.

I am an academic – and an employee – with no such covert motive. My goal is to maximise the sum of consumer and producer surplus, employer and employee surplus. It would be very irresponsible to support legislation that made employers richer at the expense of employees. The goal should be to create a system of *ex ante* opportunities from which both sides will be able to profit through voluntary exchange.

How would this play out in practice? If you had a highly unionised workforce with strong monopoly protections – as New Zealand did – the elimination of those privileges might mean that unionised workers' wages would slide until improvements in productivity drove them up. Of course, the transitional problem accounts for the fierce political resistance to change. However, that is not a reason to regard the legislation as unjust. Quite the opposite, the legislation serves to reveal the artificial nature of the previous state of affairs.

The second question is did the legislation work in practice? I believe the 1991 Employment Contracts Act revealed unions to be less attractive to workers in the long run, even if they could secure some redistribution in favour of their members. Unionisation necessarily creates a divide between management and labour, which makes it harder to share the confidential information within the firm with those who have loyalties to another organisation. The upshot is that unions have a long-term consequence of *reducing* social mobility by making it harder for their members to make it into the management ranks.

In addition, these union arrangements could not survive if employees could be dismissed at will. The necessity of some kind of a for-cause regime has additional inefficiencies of its own. Unions of course develop grievance procedures to enforce this for-cause regime. However, one has to be very cautious in thinking that this grievance machinery counts as an argument against at-will contracts. People dismissed unjustly under this system may experience personal and psychological setbacks. But even a regime that allows for personal grievance procedures can result in harsh decisions. People will always point to hard cases with any system. It is far more instructive to estimate, in fairly cold and calculating terms, whether those mistakes are going to occur

with greater or lesser frequency under one system or another. Employers who know they cannot dismiss someone without showing just cause are unlikely to take the risk of hiring a person with a spotty employment history. Ironically, re-contracting will be easier for people with reputational problems in a contract-at-will universe than in a labour market with extensive protections. Although a contract-at-will regime may mean dismissals are somewhat more frequent and perhaps more traumatic in some cases, it will make re-contracting easier.

Of course you do not have to stay in this contract-at-will world simply because of a lack of regulations. Many firms have contracts at will as a matter of law, but they also have very complicated internal review procedures to decide on salaries, promotions, dismissals, grievances and similar matters. Other firms, for good reasons, do not have such procedures. If all of this occurs voluntarily, what will be gained by imposing restrictions on how business is conducted? A rule that supplants something that is done voluntarily will seldom come out right in all circumstances. The voluntary system may require that you do A, B and C. The mandatory system will oblige you to do B, C and D. You know that A is better than D, whereas the government does not – but you cannot escape the requirement it lays down. Indeed, with unions, the problem is more acute, because the basic decision to require firms to deal with them means that modifications of a labour agreement work on many dimensions at once. The betting is that the new configuration will result in inefficient practices. The best way to prevent exploitation of workers is to allow for ease-of-entry by new firms, and that, ironically, is something that regimes of compulsory unionisation frustrate.

The final issue I touch on is the shift from the Employment Contracts Act 1991 to the Employment Relations Act 2000 and recent amendments to it. I do not believe the changes help workers from the *ex ante* perspective. With globalisation, the gains from monopoly unionisation are sharply curtailed by the prospect of entry in goods markets. Because unions work by engaging in acts of redistribution – exercising market power – rather than improving productivity, they make local industries more vulnerable to external competition. Without a tariff wall, imported goods will undersell those that

are domestically produced. For domestic firms to succeed, a cartel mentality bent on achieving monopoly wages and obtaining a larger slice of a given pie must be abandoned in favour of a production mentality focused on the efficient operation of firms. The protection against imports has to come from better goods at lower prices than foreign competitors', with the assistance of transport costs.

Given all these considerations, it seems clear that competitive markets, which operate well for goods and services, work just as well for employment relationships. So long as the law of large numbers holds, there will be mistakes in individual cases under any system. However, we must keep our eye on the main point, which is that the additional churning and transaction costs created by protectionist employment law will result in divisive behaviour, not in productive gains that can be socially shared. One of Nobel laureate George Stigler's famous remarks was that allocative gains will, in the long-run, swamp redistributive victories if markets are allowed to operate. That holds as true in labour law as anywhere else.

Questions

Why do you think the notion of unequal bargaining power has persisted? When it was invented by Karl Marx and other economists it made a bit more sense because of one-factory towns and relatively little worker mobility. Today, the world is vastly different. Both firms and workers are far more mobile. Wages are higher and conditions are better. If employers did have inexhaustible bargaining power we would expect the opposite to have occurred. It seems the simplest of fallacies to debunk, so why are discussions such as this one still necessary?

I think a lot of the fervour among adherents to the principle of unequal bargaining power in the labour market has diminished. There is less support for the view that employers are a deadly opposition to be fought at all costs. That vision may still resonate with those who have no direct connection with labour markets – such as those in the academic world. But a lot of people have moved on to realistic assessments of their current prospects.

Most workers recognise there are two ways to improve their position. The first is to lower unit costs. This can be achieved by increasing efficiency. Workers, employers and other parties all benefit. However, workers may also improve their position by restricting competition. There will be uncertainty about whether cost reductions or entry restrictions would yield a higher personal rate of return for the worker. After repeated efforts to reduce costs, restraining competition will start to look more appealing. As long as cartelisation is available as a legal option, people will seek to use it. Therefore, I believe labour unions should be subject to the same kind of restraints as industrial organisations, including antitrust laws. With trade barriers falling, support will grow for employment regimes based on freedom of contract. That is a positive trend.

The evidence suggests there will not be an enormous revitalisation of unions in New Zealand. Dismantling the old system made it impossible to reassemble parts of it. The transaction costs of forming a union are high. The gains to individuals from joining unions are much smaller than they have ever been. Once workers see how business proceeds in non-unionised firms, they will be reluctant to try to turn the clock back, even if the law is structured to facilitate a return to the earlier union era.

The contrasting objectives of employers and employees lead to an appearance of conflict. Increasing self-employment and independent contracting would make employers' and employees' interests coincide. However, commentators, including labour lawyers and policymakers, dislike such developments. Why is that?

Usually, the shift toward independent contracting is not for the reasons you have described. Rather, it is the result of an effort to avoid regulation that increases the cost of the employment arrangement relative to its next best alternative. If employees can unionise in monopoly ways and independent contractors cannot, employers will obviously attempt to shift their labour mix accordingly. However, this can be inefficient. Think of employees as holding a creditor position – like debt holders – while the employer has an equity position. Creditors are more immune from market shifts than people holding equity. Wages are relatively sticky: they will not move up or down very much according to short-term changes in market conditions. The employer carries the risk. When employees become independent contractors, their risk profile changes. They become like holders of equity. There are ways to reduce the risk. Most people who set up independent firms only do so if they have confidence that they have a secured long-term contract (not an ownership or an employment relationship) that will cushion the volatility they would otherwise face.

I believe policy should remain silent on whether it is better for people to become entrepreneurs, independent contractors or workers. It is regrettable to note, however, that a strong labour movement, backed by statutory privileges, will tend to force people into riskier employment positions. This is another reason why regulation should not be considered only in the particular cases where it would work for the good. Instead, one must consider from an *ex ante*

perspective whether regulation would change the mix of market participants. In this case, regulation that increases unionisation may lead to more independent contractors, each with a higher risk of going bankrupt and perhaps having other negative consequences for society. Quantifying such matters is very difficult. However, the doctrine of internal relations that says everything is connected with everything else definitely applies in labour markets.

You mentioned that with globalisation the ability of unions to extract monopoly rents is diminishing. Is there a connection between firms' interests in forms of protection that allow them to increase prices and reduce output, that is, to exercise market power, and labour market regulations that privilege collective bargaining and unions?

Yes, and it is a long-term, well-understood phenomenon. Unions and manufacturers in the United States steelmaking community come together with appalling solidarity to keep out cheap imports from abroad. An important objective of unions is to create local monopolies in product markets by lobbying legislators to restrict foreign trade. Such protectionism is deplorable, whether employers or unions are responsible for promoting it.

Another argument – which I do not believe is very strong – is that there are firm-specific situational monopolies capable of exploitation. This goes back to the Ricardian theory of rents. Suppose you have a coal mine where all of the coal is close to the surface. Your competitors' coal is deeper. You will have site-specific rents because you can extract the coal at a lower cost and you will be able to cover more than your marginal cost of production. An interesting practical example of this situation comes from the United States, where the United Mine Workers' Union had a national agreement that set base wage rates while simultaneously in local agreements it tried to extract site-specific rents from particular mines. That is why it has been so difficult to maintain peaceful labour relations in the industry.

With the monopoly power of unions diminishing, unless it is propped up by the government, their new functions will largely involve organising and coordinating training, 'upskilling' and the like. As a matter of comparative advantage, there is no reason why a union is better suited to this role than a for-profit company providing training services. Unions have to make one size

fit everybody because workers have limited resources to invest in training operations. In the absence of training tailored to individual needs, everybody would be suspicious they were getting a raw deal. However, if education is sold not as a bundled good but as a separate good, the problem diminishes. Suppose an industry will only last another 10 years. Independent, secondary markets will prove more adept at handling the re-education of workers. One person could learn computer programming, another could train in financial analysis, and a third could study law. If each person goes their separate ways, that will be more efficient. If a union does not know an employee's specific skills, other than those associated with membership of their current union, it will be at a systematic disadvantage.

In the private sector, most workers today will not be able to justify the heavy front-end investment in training associated with membership of a monopoly union. If people are going to be working in half a dozen different industries over the next 25 years, what would be the point of paying for a union training programme when the expense must be amortised over a few years? Unions will die a natural death in the private sector unless governments do foolish things that carry an enormously high cost to everybody. It is striking that New Zealand's current Labour-led government is not making large leaps backward on trade liberalisation. Instead, progress will simply be slow compared with the ideal course, which would be to move quickly to zero tariffs on all imported goods and zero subsidies for all exported goods, combined with less labour market regulation.

Currently in New Zealand, most employees who want a job have one. This means they control the risk and cost of changing that job. Most employers are small businesses and they find looking for new talent difficult, partly because of our demographics and skill shortages. A problematical employee is in a powerful position vis-à-vis an employer – especially one who may not be a disaster, but is a square peg in a round hole. Do you agree that, in this situation, employers hardly enjoy unequal bargaining power?

Bargaining power is essentially a matter of alternative opportunities. You have basically described a reasonably healthy labour market. If people are looking for jobs while they are employed, there will be offers from new employers and

counter-offers from those who want to keep them. A labour market characterised by full employment provides the best protection for all workers by comparison with employment protection rules that only benefit some at the expense of others.

Taking up a behavioural economics theme, a great problem in analysing labour relations is that horror stories get immense publicity but relationships that are working well – where the employee receives a raise or a new job – seldom get reported. However, there are thousands of good-news stories for every tale of horror. If you want to figure out the general effect of various arrangements, the single most important thing to do is to count events. If you compare messy dismissals with sensible employment exits (resignation to take a new job, for example), you will find that contracting at will produces many more sensible exits than painful dismissals.

The rhetoric in New Zealand seems much more subdued today than it was in 1990. At that time there was impassioned support for retaining compulsory unionism and national awards, and even for pay equity legislation. Today, only a few diehards hanker for a return to the sort of suicidal activity associated with the old system, although it is bizarre to hear that your government is still toying with pay equity legislation. The 1991 Employment Contracts Act should have gone further, but it was a great advance and it did not cause the sky to fall in, as union leaders predicted.

Union activity typically involves redistribution, and often leads to production losses through inefficiencies and disruption. In the end, it is impossible to redistribute what is not produced. If that is understood as the key principle of social action, the aim must then be to ensure private manoeuvres are for socially beneficial initiatives such as productivity improvements, cost reductions and innovation rather than excluding competition and reducing workplace flexibility. To the extent that unions accept the case for competition in all markets, renounce claims for union privileges and focus on productivity improvements and wealth creation, employers will welcome them with open arms.

This lecture, Is There Unequal Bargaining Power in the Labour Market?, was delivered in Wellington on 2 August 2004 at the offices of Chapman Tripp Sheffield Young, Wellington.

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Contents

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He has been a member of the American Academy of Arts and Sciences since 1985 and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the *Journal of Legal Studies* from 1981 to 1991, and as editor of the *Journal of Law and Economics* from 1991 to 2001.

His books include *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 7th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure, communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

Introduction

Geof Shirtcliffe,
Chapman Tripp Sheffield Young

It is a great pleasure to welcome professor Richard Epstein. He is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago. Since 2000, he has been the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution. Before joining the University of Chicago Law School he taught at the University of Southern California.

Professor Epstein is a man who leaves in his wake a string of inferiority complexes with his daunting curriculum vitae that includes books, articles and lectures on all manner of subjects. I heartily recommend people with a problem of over-confidence to perform a Google search on Richard's website. Once they have found his homepage, they will feel much more normal within two minutes.

Professor Epstein will address the question, 'Is there unequal bargaining power in the labour market?'. Frankly, I would have thought the answer was self-evident. As in other markets, there is and often has been unequal bargaining power in the labour market in the sense that supply and demand are not always in balance. In New Zealand over the past 15 years or so there has been two distinct periods. When unemployment was high in the late 1980s and early 1990s, there was unequal bargaining power on the side of employers. In more recent years, and particularly in today's tight labour market, the inequality has changed to favour employees. I am sure these curious developments will be further elucidated by professor Epstein.

Is There Unequal Bargaining Power in the Labour Market?

Introduction

The question to which this paper is devoted contains a latent ambiguity that Geof Shirtcliffe has brought out in his brief, but pointed, introduction. Usually, a discussion on this theme will focus on the extent to which employers enjoy market dominance. However, as Geof indicated, the balance of advantage can go in both directions. You can easily have unequal bargaining power in favour of workers – presumably subject to the same objections associated with fairness and resource allocation that are brought against regimes of employer domination. In New Zealand and elsewhere supporters of the status quo may labour to defend the current legislative fix under the illusion of perfect equality. However, in a more open debate, the real question might be whether elements of employment law unfairly penalise employers rather than employees.

Before examining the claims of unequal bargaining power in a New Zealand context, I would like to look at the principles that will assist us to understand and evaluate the overarching argument in defence of this commonly accepted viewpoint. If the fatal phrase 'inequality of bargaining power' had never been coined, how would we analyse the operation of labour markets? I start with an assumption that there is no coordination between sellers on one side of the market, or buyers on the other. Then, by relaxing that assumption, I examine how the labour market would operate with coordinated efforts on one side or both. After going through this process, I ask whether the notion of inequality of bargaining power retains any credence as an explanatory or normative tool, even though its political and rhetorical influence is enormous.

At this point, the discussion turns toward simple economics, for which I make no apology. Generally, I find today's economists are too worried about complicated problems that cry out for mathematical solutions that prove some complex 'existence theorem' of which the content may be known only to the gods in heaven, but which elude us mere mortals on earth. However, economics should not be a branch of recreational mathematics. I believe the priority should be to understand the basic phenomena that have greater and more immediate institutional importance in contexts that truly matter to the well-being of any society. The labour market is such a phenomenon.

There is an advantage to being determinedly simple-minded about matters like this. It is important to get the first approximations right and worry about refinements later. That is what I plan to do in this paper. I take the two paradigm cases first, and then introduce a degree of complexity to see how the results change.

Competition in the labour market

Some would say a competitive labour market demonstrates a high level of social efficiency because it is characterised by misery on both sides of the transaction. Employers complain, 'this is a terrible, dog-eat-dog world. If I lower wages by a cent, I can't get a single taker among workers. And if I raise wages by a cent, then my business goes under'. Before playing the violins for the employer, it should be noted that, in this uncoordinated market, workers are just as miserable. They say, 'if we make a wage demand a cent above the competitive price, employers won't accept it. And if the demand is a cent too low, we can't make ends meet'.

Looked at from the perspective of either group, this situation appears pathological. It is easy to make predictions that such a baleful situation is unsustainable. But these appearances mislead. From a broader societal perspective, it is enormously positive. Neither side has any degree of market power; nobody can change prices and retain the worker or the job. In effect, there is a unique price equilibrium, which means the number of transactional obstacles that lie in the path of agreement will be small. Because everybody will instantly converge on this ideal competitive wage, the amount of joint productive gain will be high while the transaction costs are low. It is a sign of

social health when transaction costs are low relative to the number of transactions that are consummated. It is a delusion that has afflicted many 'progressive' writers to think that haggling over the price of a cow across the farmyard fence represents some economic Shangri-La. But it is exactly the reverse, unless the bargaining process is treated as some kind of consumption good instead of the economic cost that it truly represents. Smooth and rapid transactions are the end that market participants seek.

How then is that desirable state of affairs achieved? Once again it is back to basics. The competitive labour market should be thought of in terms of the traditional intersection of supply and demand. If there is a labour shortage, employers will bid up the price, drawing forth extra workers to take jobs. If there is an abundance of labour the opposite will occur, as workers leave their jobs to pursue other options. By allowing the free movement of price and quantity, powerful forces will result in a convergence at the optimum level. In this type of market, any transactions worth undertaking will take place. If prices are raised or lowered by government fiat, then we shall all pay a high price: certain kinds of gainful transactions would be precluded.

The single most important thing to understand about the operation of a standard labour market is that it is immensely boring. It does not present any difficult transactional problems or generate negative externalities that require government control. Compared with network industries or intellectual property, dealing with labour markets appears a piece of cake, so long, at least, as we have the courage to leave well enough alone.

Coordination in the labour market

If we relax our assumptions and allow coordination to take place, employers could associate through trade associations while workers could join trade unions. We do not have to refer to inequality of bargaining power to see that our previously happy story evaporates. The moment coordination is allowed, actors on one side or the other will move wages away from the competitive equilibrium.

Generally, people are suspicious of monopolies because they recognise that the equilibrium reached in a typical case is inferior to that reached through

competition. In a labour market, workers fortunate enough to organise a monopoly will have incentives to constrain the supply of labour and seek higher wages. The private gain from pushing wages above competitive levels would be smaller than the social losses suffered by employers and third parties, such as unemployed job-seekers and consumers (including employees of other companies) who use the products of the firm.

A zero transaction cost model has some plausibility in a competitive market, but less if a monopoly is present. There will be political jockeying to decide who is accepted as a member of a union and who will be excluded. To maintain its monopoly, the union must appeal to the state to prevent new entry by excluded workers, because their uncontrolled actions would return the price to the competitive level.

The same results would occur if employers were organised and workers were not. An effort to lower wages would cause a reduction in labour supply. There would be constant manoeuvring and cheating by employers in the fashion of all cartels. Some would honour the agreements, while others would hope that their cheating would go undetected. More likely than not, the large number of players would be unable to resist the persistent efforts to return to the competitive equilibrium.

If both sides are allowed to establish strong bargaining power by combining forces it will create a bilateral monopoly situation. There is no determinate wage or quantity of work to be done, a huge amount of negotiating will take place, but relatively few stable bargains will emerge. It may well be the case that we should prefer the unfairness of having a monopoly on only one side of the market. Even if someone does not like the skewed distributional consequences from having such a monopoly, third parties would be left better off. The creation of a bilateral monopoly introduces the risk of massive instability that could close down an entire business: witness the shutdowns that occur from time to time in the airline industry and professional sports, where a bargaining impasse leads to strikes with strongly negative third-party effects. The theory of 'countervailing power' popularised a long time ago by John Kenneth Galbraith is suspect precisely because it overlooks these systematic consequences.

Analysing bargaining power

If the goal is to maximise productivity with minimum transaction costs, it is clear that the competitive situation will work best. So why is inequality of bargaining power even worthy of serious discussion? There are two approaches to this question. The first relies on a belief that, in my view, takes us nowhere. The second is important when more complicated labour markets, in which workers and employers are not homogeneous, are considered.

The exploitation hypothesis

The approach that does not work particularly well hypothesises that, in a competitive situation, one side has an advantage caused by size, net worth, experience or some other factor that allows it to push wages to a point that makes the other party unhappy with any agreement that emerges from this process. This hypothesis is closely associated with the Marxist notion of exploitation. In this version employers use their bargaining power to keep pushing wages down. If this were true, labour markets would be no different from theft, because we would have a situation in which one party won and the other lost, losing perhaps even more than the winner gained. Something would have to be done to stop contracts from being made, given that they would, by assumption, lead social institutions into a downward spiral.

However, an attempt to identify the equilibrium conditions in this situation will not find any that survive analysis. If you held inequality of bargaining power independent of the market structure, you would continue exercising it to the point where the other side had abjectly to surrender. The only equilibrium position I can envision is where employers receive an infinite amount of labour for a zero wage. Why would any employer, with this advantage, settle for anything less advantageous? Yet a pattern of zero wages exists in no labour market.

Historically, employer cooperation has been an important issue. Antitrust laws apply but in many settings they have little application, even if on the books. Labour markets tend to be thick and diverse. Mechanics, for example, are not restricted to working in one trade but can work in many different trades. The concentration sometimes seen in product markets is not generally

a feature of labour markets. Therefore, it seems much more important to stress the alternatives available to both sides and examine whether, and if so how, people on one side of the market are able to cooperate with one another. The exploitation model is a dead end because it cannot explain any features that we see in labour markets, most obviously the spirited competition that takes place at every level for honest, able and ambitious workers who are the heart and soul of any business, large or small. Managers who work under the illusion that they possess this enormous bargaining power will learn to their personal regret how wrong their world view is.

Bargaining over rents

A second, and more sensible approach to the subject becomes possible, however, when we reject the useful but artificial assumption of perfect homogeneity in the marketplace. Just think of the easy cases in which that assumption is routinely violated. When a new position in a firm opens up, many potential applicants will apply. But even if they were all identical at the outset, that condition would not last long. While on the job each worker builds up specific human capital. When the question of contract renewal, advancement or promotion arises, there will be room for bargaining on both sides precisely because of the individuation that has taken place.

It is easy to imagine a situation where a worker would stay in a role if offered a 2 percent wage increase while the employer would be prepared to pay up to 10 percent more to retain that employee. Somebody has to decide how to divide the spoils between the two sides. In these circumstances, the measure of inequality of bargaining power comes down essentially to who is likely to get more than 50 percent of the difference. An immense number of games or theoretical complexities could be identified, but virtually nothing can be done to eliminate the difficulties of figuring out who gets how much. The process may yield an ambiguous result, but the theory could never tell you in advance what that would be. After all, in this simplest of examples, I simply chose two numbers. Yet, in any real-world setting, I would have no idea what the reservation prices were on either side, or even if the parties knew their own reservation prices or had some sense of the other player's. These are all guesses on my part, rather

than precise knowledge. Even if the parties had that information in digestible form, it is highly unlikely that any third party could figure out in advance what tactics they would adopt or what the outcome of their negotiations would be.

Typically – and I suspect this is why they were not studied until recently in law and economics – most of these situations are resolved very quickly in practice. An employer would say to an employee, 'I'm giving my new workers X, but you are a little better, so I'm giving you an X + 2 percent wage increase'. The employee quickly agrees and they go about their business.

It is conceivable in some settings that a systematic argument could be made that one or the other side is likely to garner most of the surplus, but I have yet to discover any powerful or determinate theory to support such a conclusion. So, in this model, some inequality of bargaining power does exist, but we do not know where it is located. The worst thing we could do as regulator is to stipulate, for example, a minimum wage increase for the employee in an effort to guarantee their share of the gain. Let that number be set at 5 percent, when the maximum wage increase that is feasible to the employer is 4 percent, and we have one less job, to the benefit of neither side. The clear maxim is let the surplus fall where it may, so long as competitive forces offer some external constraint on its division.

Contracting at will

A common tactic of those who seek to find inequality in the labour market is to focus on the particular terms of a contract and declare that they are so one-sided there must have been improper use of market advantage to obtain them. This query leads me to a popular topic which is whether, in dealing with labour relations, we ought to have any affection for the traditional contract at will. This somewhat artificial legal contrivance is a situation in which there is perfect legal symmetry between the two sides. An employer may hire, fire or retain a worker for good reason (which is, of course, virtuous), bad reason (which is, of course, terrible), or no reason at all (which turns out to be a little bit crazy). Likewise, the worker may take, leave or retain a job for good reason, bad reason, or no reason at all.

In the light of this formal equality, how should we think about the manifest insecurity of workers who could be stripped of their employment and left in a vulnerable situation? I think the first question to ask is whether people would rationally enter a legal arrangement that could have such consequences. I think that they can. Knowledge of transaction cost economics makes me reluctant to say that such a contract should be regarded as presumptively off-limits, or that protection is needed such as through a public service system with permanent employment or by means of an unjust dismissal law. The symmetries are real. Many employees exercise their right to quit. They would be affronted at the idea of having to appear before a public agency to prove they had good cause for taking another job, and that it was in the social interest that they be allowed to do so when it is shown that this move has disadvantaged their current employer. If this were required, there would be enormous administrative rigidities and a whole series of fanciful stories. Everybody would be constantly forced to explain why their own assessment of their situation and interests should be upheld by public officials who knew nothing about them. Exaggeration will be the order of the day on all sides. If we were to ask workers whether they would only take on jobs if they were able to quit for a good reason, I suspect most would stare blankly and respond, 'of course I will only quit if I have a good reason – but you can trust me to make that judgment myself'. Thus we have the birth of the intuitive Hayekian, who knows the strength of their own local knowledge even if they doubt that others have the same comparative advantage.

All this is not to say that the at-will rule always works best, even at the option of employees. The absence of a 'for cause' requirement on the employee side gives rise to a certain kind of opportunism. If a seasonal harvest worker is able to quit at will one week before the annual harvest takes place, leaving crops to rot in the field, the worker has a decisive advantage over the employer. The appropriate response, however, is not regulation but negotiation. Wages, or other terms of employment, can be adjusted to get around the difficulties associated with the contract at will. One solution might be to say to the employee, 'you will receive room and board until the end of the harvest season, but you will not be paid until the harvest has finished. That way, if you quit, we have enough money in the bank to hire substitute labour'.

And what happens on the other side? 'For cause' requirements imposed on employers who wish to terminate a worker's contract are enormously problematical. Often, the single most important element of the employment relationship – not only the dynamics between the employer and the employee, but also among co-employees – depends on soft facts that matter a lot in practice but are almost impossible to describe after the fact in a neutral fashion to third parties – local knowledge all over again.

In my own brief experience as an (interim) university dean I found that inter-employee relationships were the single most important factor I had to deal with. In the absence of someone in a position of authority exercising a relatively strong hand, able staff cannot be protected from less able staff. I have no doubt that this same issue arises in settings where multiple employees report to a single employer. The possibility of unsatisfactory relationships among employees creates the genuine danger of sending the entire organisation into a tailspin. In handling these situations I was constantly being reminded that I could not just dismiss somebody from their job. However, when I talked to the employees who were supposedly protected from the at-will rule, I discovered a new employer duty that I had never realised existed. That is the duty to dismiss. Staff members in key administrative positions would say, 'unless you get rid of that person I will not stay here because my situation is intolerable'. This shows why the level of discretion associated with the contract at will can be required. It supplies the only effective remedy for heading off or resolving potentially hazardous inter-employee disputes. The symmetry argument is not a silly formalistic notion; rather it is rooted in workplace realities, realities that become more evident as we move to situations where many workers report to a single manager.

Nor does the contract at will exhaust its strength in dealing with lower-level employees. As one ascends the employment ladder to managerial ranks, it is clear that many relationships rely on the contract at will, even when there is no indication of any inequality of bargaining power. It is very common for senior managers in large firms to be employed under at-will arrangements. Neither they nor the firm would have it any other way; logically, if they wanted increased protection, the firm would offset the risk of facing a difficult

dismissal situation by insisting on a pay cut. Indeed, the only privileged individuals I know who are systematically employed on a different basis are people like myself: academic professors who get tenure. Tenure may well be a justifiable institution – it was, after all, voluntarily created – but it does pose enormous dangers of sub-optimal effort by academic staff who are partly immunised from any employer sanction.

Looking at the full range of voluntary employment arrangements including the contract at will, I do not think you can argue that any of them gives rise to obvious forms of inefficiency. In fact, they seem to operate very well. They do not provide evidence that there is anything wrong with the unfettered operation of the labour market.

The behavioural economics critique

Thus far I have offered a standard analysis of the underlying situation that assumes some degree of rational action on the part of all actors. However, that assumption does not enjoy the status of a necessary truth. Indeed, recently, behavioural economists have taken an interest in exploring these matters from a rather different perspective. The insight that this hardy band of analysts offers is not one of bargaining inequality in the Marxist sense of an employer having inexhaustible market power to force wages down to subsistence levels. Rather, behavioural economists point out that not all people are good at making the calculations necessary to enter into agreements that make them better off. The principle of mutual advantage that normally drives voluntary exchange cannot work, it is said, when people involved in these transactions are subject to a variety of biases that lead to systematic flaws in their decision making.

If this theory of human capabilities is true, it is so for people on both sides of the market. Employers and employees will be subject to unconscious impediments to making rational decisions. If both are subject to the same difficulties, why would protection be extended to one side and not the other? Moreover, although people certainly make mistakes when they enter into employment relationships, they are at least cognisant of the fact that they are ignorant about how things will work out. People know when they are in over their head, which is one reason why they hire others to do their taxes. So, for workers, an advantage of a contract at will – or any fixed-term employment

contract – is that, by preserving the quit option, they are able to adjust their situation in the light of experience, even if they could not predict in advance what would happen to them. Rational labour decisions should not be seen as a one-time choice that may lead either to success or disaster. Rather, employment relationships at will allow constant modifications over the life of an agreement. Even when the parties to them cannot figure out in advance what is in their interests, the feedback mechanisms are direct and powerful, and will prompt them to make adjustments that move them closer to a more desirable state of affairs.

Indeed, putting behavioural economics aside, employment relationships – whether at will or otherwise – never take the form of contracts in which all contingencies are covered. Both sides build in a lot of flexibility at the front end. The success of these relationships depends on the way people adapt and respond to new information. If we took the view that all individuals behaved like dyed-in-the-wool Hobbesians, then allowing that degree of slippage in contracting would count as a colossal blunder. But, here again, we have to keep things in perspective. Any political system involves huge numbers of actors, and thus can be destabilised by the actions of a tiny fraction of them. The situation is dangerous even if most people are good sorts who will not push every advantage to the limit. Yet employment relationships do not raise that sorry prospect. Even if we cannot choose our fellow citizens one at a time, we have far more choice over our trading partners, in labour markets as everywhere else. So if you have some confidence in the character of the person with whom you do business, then allowing discretion comes at a much lower cost. Of course that decision can backfire in some highly visible contexts. But, by the same token, it tends to work well in many others. The sign of a successful labour market is not conspicuous bluster that could lead to strike action. It is non-dramatic and constructive cooperation that produces positive results even though it attracts no public attention.

Labour markets are not special

If these arguments are correct, it follows that when it comes to employment arrangements, the classical liberal argument in favour of competitive markets holds. Monopoly is not a serious problem in today's labour markets where both workers and firms are mobile. However, two other issues should be considered.

The first is the possibility of incompetence, force and duress. If labour markets looked like those that involved treatment for patients with serious mental illness, no one would say that trust and confidence could smooth the way for all concerned. But the contrast between healthy workers and unwell patients should be clear enough. Although there may be some irregularities in labour cases, an *ex ante* prohibition will be inefficient compared with *ex post* relief that would allow a party to prove irregularity in the drawing up of the contract. This is not a setting where we need protections like doctrines of informed consent that are used in a medical context.

The second problem concerns externalities or harms to third parties. These can be real: if someone is leading lions on a leash down a busy city street, the risks to others are extreme. However, for the most part, labour relationships in a competitive market have *positive* externalities and therefore do not raise any need for legal redress. A successful employment contract makes both sides better off than before. Each will have larger stores of wealth and therefore larger levels of satisfaction or utility. Hence they will have increased ability and means to enter into positive deals with other parties. It would be nice to subsidise these transactions, save that we would have to tax other like transactions to do it. As in so many other cases, we let the positive externalities take care of themselves.

So, in the end, it is back to basics: just remember that if you can reduce the level of friction in transactions you will be able to increase the velocity of voluntary exchanges. In turn, this will generally increase overall welfare levels. It is simply an application of the insight of the Coase theorem that the nearer transaction costs get to zero, the better off trading partners will be. Whereas many markets, such as those for land use and intellectual property, will not allow you to get these costs very close to zero, the labour market is not such a case. When considering regulation it is perhaps the best candidate for adhering to the principle that the first thing to do is do no harm at all.

A practical context: New Zealand employment law

Let me briefly put this discussion into a practical context. I was involved in some of the work leading up to the passage of the Employment Contracts Act of 1991. It is often claimed that that legislation was advantageous to employers.

I am an academic – and an employee – with no such covert motive. My goal is to maximise the sum of consumer and producer surplus, employer and employee surplus. It would be very irresponsible to support legislation that made employers richer at the expense of employees. The goal should be to create a system of *ex ante* opportunities from which both sides will be able to profit through voluntary exchange.

How would this play out in practice? If you had a highly unionised workforce with strong monopoly protections – as New Zealand did – the elimination of those privileges might mean that unionised workers' wages would slide until improvements in productivity drove them up. Of course, the transitional problem accounts for the fierce political resistance to change. However, that is not a reason to regard the legislation as unjust. Quite the opposite, the legislation serves to reveal the artificial nature of the previous state of affairs.

The second question is did the legislation work in practice? I believe the 1991 Employment Contracts Act revealed unions to be less attractive to workers in the long run, even if they could secure some redistribution in favour of their members. Unionisation necessarily creates a divide between management and labour, which makes it harder to share the confidential information within the firm with those who have loyalties to another organisation. The upshot is that unions have a long-term consequence of *reducing* social mobility by making it harder for their members to make it into the management ranks.

In addition, these union arrangements could not survive if employees could be dismissed at will. The necessity of some kind of a for-cause regime has additional inefficiencies of its own. Unions of course develop grievance procedures to enforce this for-cause regime. However, one has to be very cautious in thinking that this grievance machinery counts as an argument against at-will contracts. People dismissed unjustly under this system may experience personal and psychological setbacks. But even a regime that allows for personal grievance procedures can result in harsh decisions. People will always point to hard cases with any system. It is far more instructive to estimate, in fairly cold and calculating terms, whether those mistakes are going to occur

with greater or lesser frequency under one system or another. Employers who know they cannot dismiss someone without showing just cause are unlikely to take the risk of hiring a person with a spotty employment history. Ironically, re-contracting will be easier for people with reputational problems in a contract-at-will universe than in a labour market with extensive protections. Although a contract-at-will regime may mean dismissals are somewhat more frequent and perhaps more traumatic in some cases, it will make re-contracting easier.

Of course you do not have to stay in this contract-at-will world simply because of a lack of regulations. Many firms have contracts at will as a matter of law, but they also have very complicated internal review procedures to decide on salaries, promotions, dismissals, grievances and similar matters. Other firms, for good reasons, do not have such procedures. If all of this occurs voluntarily, what will be gained by imposing restrictions on how business is conducted? A rule that supplants something that is done voluntarily will seldom come out right in all circumstances. The voluntary system may require that you do A, B and C. The mandatory system will oblige you to do B, C and D. You know that A is better than D, whereas the government does not – but you cannot escape the requirement it lays down. Indeed, with unions, the problem is more acute, because the basic decision to require firms to deal with them means that modifications of a labour agreement work on many dimensions at once. The betting is that the new configuration will result in inefficient practices. The best way to prevent exploitation of workers is to allow for ease-of-entry by new firms, and that, ironically, is something that regimes of compulsory unionisation frustrate.

The final issue I touch on is the shift from the Employment Contracts Act 1991 to the Employment Relations Act 2000 and recent amendments to it. I do not believe the changes help workers from the *ex ante* perspective. With globalisation, the gains from monopoly unionisation are sharply curtailed by the prospect of entry in goods markets. Because unions work by engaging in acts of redistribution – exercising market power – rather than improving productivity, they make local industries more vulnerable to external competition. Without a tariff wall, imported goods will undersell those that

are domestically produced. For domestic firms to succeed, a cartel mentality bent on achieving monopoly wages and obtaining a larger slice of a given pie must be abandoned in favour of a production mentality focused on the efficient operation of firms. The protection against imports has to come from better goods at lower prices than foreign competitors', with the assistance of transport costs.

Given all these considerations, it seems clear that competitive markets, which operate well for goods and services, work just as well for employment relationships. So long as the law of large numbers holds, there will be mistakes in individual cases under any system. However, we must keep our eye on the main point, which is that the additional churning and transaction costs created by protectionist employment law will result in divisive behaviour, not in productive gains that can be socially shared. One of Nobel laureate George Stigler's famous remarks was that allocative gains will, in the long-run, swamp redistributive victories if markets are allowed to operate. That holds as true in labour law as anywhere else.

Questions

Why do you think the notion of unequal bargaining power has persisted? When it was invented by Karl Marx and other economists it made a bit more sense because of one-factory towns and relatively little worker mobility. Today, the world is vastly different. Both firms and workers are far more mobile. Wages are higher and conditions are better. If employers did have inexhaustible bargaining power we would expect the opposite to have occurred. It seems the simplest of fallacies to debunk, so why are discussions such as this one still necessary?

I think a lot of the fervour among adherents to the principle of unequal bargaining power in the labour market has diminished. There is less support for the view that employers are a deadly opposition to be fought at all costs. That vision may still resonate with those who have no direct connection with labour markets – such as those in the academic world. But a lot of people have moved on to realistic assessments of their current prospects.

Most workers recognise there are two ways to improve their position. The first is to lower unit costs. This can be achieved by increasing efficiency. Workers, employers and other parties all benefit. However, workers may also improve their position by restricting competition. There will be uncertainty about whether cost reductions or entry restrictions would yield a higher personal rate of return for the worker. After repeated efforts to reduce costs, restraining competition will start to look more appealing. As long as cartelisation is available as a legal option, people will seek to use it. Therefore, I believe labour unions should be subject to the same kind of restraints as industrial organisations, including antitrust laws. With trade barriers falling, support will grow for employment regimes based on freedom of contract. That is a positive trend.

The evidence suggests there will not be an enormous revitalisation of unions in New Zealand. Dismantling the old system made it impossible to reassemble parts of it. The transaction costs of forming a union are high. The gains to individuals from joining unions are much smaller than they have ever been. Once workers see how business proceeds in non-unionised firms, they will be reluctant to try to turn the clock back, even if the law is structured to facilitate a return to the earlier union era.

The contrasting objectives of employers and employees lead to an appearance of conflict. Increasing self-employment and independent contracting would make employers' and employees' interests coincide. However, commentators, including labour lawyers and policymakers, dislike such developments. Why is that?

Usually, the shift toward independent contracting is not for the reasons you have described. Rather, it is the result of an effort to avoid regulation that increases the cost of the employment arrangement relative to its next best alternative. If employees can unionise in monopoly ways and independent contractors cannot, employers will obviously attempt to shift their labour mix accordingly. However, this can be inefficient. Think of employees as holding a creditor position – like debt holders – while the employer has an equity position. Creditors are more immune from market shifts than people holding equity. Wages are relatively sticky: they will not move up or down very much according to short-term changes in market conditions. The employer carries the risk. When employees become independent contractors, their risk profile changes. They become like holders of equity. There are ways to reduce the risk. Most people who set up independent firms only do so if they have confidence that they have a secured long-term contract (not an ownership or an employment relationship) that will cushion the volatility they would otherwise face.

I believe policy should remain silent on whether it is better for people to become entrepreneurs, independent contractors or workers. It is regrettable to note, however, that a strong labour movement, backed by statutory privileges, will tend to force people into riskier employment positions. This is another reason why regulation should not be considered only in the particular cases where it would work for the good. Instead, one must consider from an *ex ante*

perspective whether regulation would change the mix of market participants. In this case, regulation that increases unionisation may lead to more independent contractors, each with a higher risk of going bankrupt and perhaps having other negative consequences for society. Quantifying such matters is very difficult. However, the doctrine of internal relations that says everything is connected with everything else definitely applies in labour markets.

You mentioned that with globalisation the ability of unions to extract monopoly rents is diminishing. Is there a connection between firms' interests in forms of protection that allow them to increase prices and reduce output, that is, to exercise market power, and labour market regulations that privilege collective bargaining and unions?

Yes, and it is a long-term, well-understood phenomenon. Unions and manufacturers in the United States steelmaking community come together with appalling solidarity to keep out cheap imports from abroad. An important objective of unions is to create local monopolies in product markets by lobbying legislators to restrict foreign trade. Such protectionism is deplorable, whether employers or unions are responsible for promoting it.

Another argument – which I do not believe is very strong – is that there are firm-specific situational monopolies capable of exploitation. This goes back to the Ricardian theory of rents. Suppose you have a coal mine where all of the coal is close to the surface. Your competitors' coal is deeper. You will have site-specific rents because you can extract the coal at a lower cost and you will be able to cover more than your marginal cost of production. An interesting practical example of this situation comes from the United States, where the United Mine Workers' Union had a national agreement that set base wage rates while simultaneously in local agreements it tried to extract site-specific rents from particular mines. That is why it has been so difficult to maintain peaceful labour relations in the industry.

With the monopoly power of unions diminishing, unless it is propped up by the government, their new functions will largely involve organising and coordinating training, 'upskilling' and the like. As a matter of comparative advantage, there is no reason why a union is better suited to this role than a for-profit company providing training services. Unions have to make one size

fit everybody because workers have limited resources to invest in training operations. In the absence of training tailored to individual needs, everybody would be suspicious they were getting a raw deal. However, if education is sold not as a bundled good but as a separate good, the problem diminishes. Suppose an industry will only last another 10 years. Independent, secondary markets will prove more adept at handling the re-education of workers. One person could learn computer programming, another could train in financial analysis, and a third could study law. If each person goes their separate ways, that will be more efficient. If a union does not know an employee's specific skills, other than those associated with membership of their current union, it will be at a systematic disadvantage.

In the private sector, most workers today will not be able to justify the heavy front-end investment in training associated with membership of a monopoly union. If people are going to be working in half a dozen different industries over the next 25 years, what would be the point of paying for a union training programme when the expense must be amortised over a few years? Unions will die a natural death in the private sector unless governments do foolish things that carry an enormously high cost to everybody. It is striking that New Zealand's current Labour-led government is not making large leaps backward on trade liberalisation. Instead, progress will simply be slow compared with the ideal course, which would be to move quickly to zero tariffs on all imported goods and zero subsidies for all exported goods, combined with less labour market regulation.

Currently in New Zealand, most employees who want a job have one. This means they control the risk and cost of changing that job. Most employers are small businesses and they find looking for new talent difficult, partly because of our demographics and skill shortages. A problematical employee is in a powerful position vis-à-vis an employer – especially one who may not be a disaster, but is a square peg in a round hole. Do you agree that, in this situation, employers hardly enjoy unequal bargaining power?

Bargaining power is essentially a matter of alternative opportunities. You have basically described a reasonably healthy labour market. If people are looking for jobs while they are employed, there will be offers from new employers and

counter-offers from those who want to keep them. A labour market characterised by full employment provides the best protection for all workers by comparison with employment protection rules that only benefit some at the expense of others.

Taking up a behavioural economics theme, a great problem in analysing labour relations is that horror stories get immense publicity but relationships that are working well – where the employee receives a raise or a new job – seldom get reported. However, there are thousands of good-news stories for every tale of horror. If you want to figure out the general effect of various arrangements, the single most important thing to do is to count events. If you compare messy dismissals with sensible employment exits (resignation to take a new job, for example), you will find that contracting at will produces many more sensible exits than painful dismissals.

The rhetoric in New Zealand seems much more subdued today than it was in 1990. At that time there was impassioned support for retaining compulsory unionism and national awards, and even for pay equity legislation. Today, only a few diehards hanker for a return to the sort of suicidal activity associated with the old system, although it is bizarre to hear that your government is still toying with pay equity legislation. The 1991 Employment Contracts Act should have gone further, but it was a great advance and it did not cause the sky to fall in, as union leaders predicted.

Union activity typically involves redistribution, and often leads to production losses through inefficiencies and disruption. In the end, it is impossible to redistribute what is not produced. If that is understood as the key principle of social action, the aim must then be to ensure private manoeuvres are for socially beneficial initiatives such as productivity improvements, cost reductions and innovation rather than excluding competition and reducing workplace flexibility. To the extent that unions accept the case for competition in all markets, renounce claims for union privileges and focus on productivity improvements and wealth creation, employers will welcome them with open arms.