

# POWER IN EMPLOYMENT RELATIONSHIPS: IS THERE AN IMBALANCE?

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## ABOUT THE AUTHOR

Geoff Hogbin became interested in the economics and politics of market regulations through his research into US farm subsidies as a student at the University of Chicago in the early 1970s. From 1974 to 1990 he was lecturer/senior lecturer in economics at Monash University, Melbourne. He has undertaken numerous research and consulting assignments relating to economic regulations and regulatory processes in various sectors of the Australian economy both at Monash University and, since 1990, as an independent consultant. His 1983 booklet, *Free to Shop*, published by the Centre for Independent Studies in Sydney, was influential in the debate that led to the substantial relaxation of restrictions on weekend and evening shopping hours in much of Australia.

In recent years, he has been reviewing the extensive economics literature on the consequences of labour and employment regulations in member countries of the Organisation for Economic Cooperation and Development, Latin America and elsewhere to assess its implications for labour market performance in Australia and New Zealand.



## EXECUTIVE SUMMARY

- There is a widespread belief, notably among lawyers and industrial relations specialists, that employment relationships are characterised by a systematic imbalance of power between employers and employees. This belief, which traces back at least to the early years of the industrial revolution, was reinforced and propagated by Karl Marx, who argued that employers could and would use their stronger bargaining power to drive wages to subsistence levels.
- The alleged power imbalance is central to the view that labour markets require special regulation. New Zealand's Employment Relations Act 2000 is based on the premise of an "inherent inequality of bargaining power in employment relationships".
- Most contemporary labour economists have a different view. Elementary economic analysis suggests that, as for other goods and services traded through markets, wages and other terms of employment are determined largely by supply and demand. There is no reason to suppose that the employer side of the market has inherent power over the employee side in determining wages and other conditions of employment. Several empirical observations support this analysis:
  - Far from falling to subsistence levels (the logical consequence of inherent power imbalance), real wages in modern economies have risen steadily over the last two centuries to levels that would have seemed incredible in the times of Karl Marx.
  - Aggregate labour income in modern economies accounts for around 65–75 percent of gross domestic product and is not higher in the more heavily regulated labour markets of the world. Indeed, it seems to be relatively higher in some of the most lightly regulated labour markets, such as the United States.
  - If employers had inherent power to set wages below the value of labour's contribution to production, then rates of return on capital should be higher in labour-intensive industries than in capital-intensive industries, but this is not the case.
  - If employees were disadvantaged by their allegedly weak bargaining power in labour markets, there are many other ways in which they could supply their labour to productive activities (for example, self-employment, independent contracting, labour hire companies, or workers' cooperatives). The fact that individual employment contracts have remained the dominant arrangement for over two centuries is compelling evidence that they deliver greater net benefits for most workers than any of these alternatives.
- At times there may be a sellers' or buyers' market for labour, due to supply and demand conditions, but this is so for other markets and does not reflect a systematic imbalance of the bargaining power of parties in employment relationships. As for

other markets, wage adjustments facilitate market 'clearance' and the attainment of full employment. Only if a job becomes non-viable is there a transient imbalance of power. The resulting contract terminations are essential to efficient allocation of labour in an economy.

- Clear recognition of the nature of employment relationships and *especially of the characteristics of the underlying employment contracts* is crucial to understanding how labour markets function and the effects of labour market regulations on labour market outcomes.
- An employment contract is largely a *relational contract* – an informally agreed set of terms and conditions and codes of conduct that frame the transaction between employee and employer (for example, skills to be deployed, level of physical and mental effort to be devoted to tasks, appropriate behaviour towards other workers and so on). These *relational terms* cannot be specified precisely and therefore can neither be effectively verified nor enforced by a third party – unlike the *formal terms* of an employment contract (wage rate, holiday entitlements and so on), which are verifiable and enforceable by a third party (for example, a court of law). The relational terms of an employment contract must therefore be self-enforcing.
- Compliance with the relational terms of employment contracts is crucial to the value of an employment relationship. The duration of most employment contracts is indefinite. However, both parties expect that if one believes the other is failing to perform in accordance with relational terms the contract will be terminated, thereby imposing termination costs on the other. Ultimately, it is the desire to avoid these costs that creates the incentives for both parties to comply with contractual terms, thus making the contract self-enforcing. Moreover, because both parties incur termination costs if an economically viable employment relationship is terminated, each has an incentive not to act capriciously.
- Labour markets, like the markets for most other goods and services, do not function as the textbook ideal of a 'spot market' in which rapid price adjustments ensure that prices for identical products are equalised throughout the market. However, the negative effects of labour market frictions must be evaluated relative to the positive consequences for employees of the low transaction costs of relational contracting. In a wide variety of circumstances relational contracting is cost-effective relative to formal contracting. It is pervasive in the supply of most kinds of goods and services, and crucial to the processes of efficient job matching and creative destruction that underlie the growth of modern economies.
- Three fallacious beliefs are widespread:
  - Employers have stronger bargaining power than employees because they generally have greater financial resources.
  - 'Take-it-or-leave-it' employment offers are evidence of the superiority of employers' bargaining power.

- The fact that employers have power to direct employees in undertaking tasks is evidence of their stronger bargaining power.

The report explains why these beliefs are unfounded.

- An understanding of the nature and role of relational contracting provides a framework for understanding why labour market regulations, either individually or in combination, often have the unintended consequence of reducing the welfare of workers. For example:
  - Regulations that increase the expected costs of labour market transactions impede the processes of job matching and creative destruction, thereby slowing improvements in productivity and, consequently, growth of real wages. For example, employment protection laws discourage people from starting new, innovative enterprises and from expanding existing enterprises.
  - Labour market regulations that undermine the self-enforcement properties of employment contracts increase the incidence of shirking and the cost of controlling it, both of which tend to reduce the value of employment relationships and real wages for *all* employees, including conscientious employees.
  - To the extent that labour market regulations increase rates of unemployment for particular types of labour, they systematically weaken the power of employees to enforce the relational terms of their contracts, thereby increasing the scope for unscrupulous employers to impose unreasonable demands on them. This is likely to be especially detrimental to low-skill employees.
- More generally, there is convincing evidence that misguided labour market regulations give rise to negative effects on employment (especially for youths and older workers); an increased incidence of long-term unemployment; the imposition of unwanted but unavoidable financial risk on workers; and reduced real incomes.
- Parties should be free to include negotiated provisions (for example, termination provisions) in employment contracts, but they should not be mandatory.
- A freely functioning labour market, conducive to full employment, provides effective protection for employees and employers alike against opportunistic exploitation by the other party. Employees derive power to constrain their employers' behaviour from their almost universal at-will termination right. Employment protection laws erode the power of employers to hold employees to contractual commitments, which in turn erodes the value of employment relationships and real wages.
- Labour market regulation should be neutral between individual and collective contracting. The argument that laws to encourage the formation of trade unions and strengthen their bargaining power are required to counteract the superior bargaining power of employers is not tenable.

- The common law provides protection for parties in interpersonal relationships, including employment relationships.
- Recognition that the marriage contract, another important form of relational contract, cannot be sensibly enforced by a third party has led most societies to abandon fault-based laws governing the termination of marriages. For the same reason, laws aimed at controlling explicitly the behaviour of parties in employment relationships should be abandoned.

# POWER IN EMPLOYMENT RELATIONSHIPS: IS THERE AN IMBALANCE?

## Introduction

The belief that there is an imbalance of power in employment relationships which gives employers an unfair advantage over employees has a long history. Although it preceded Karl Marx, it became influential through his writings and has remained widespread ever since. The New Zealand Human Rights Commission has expressed the belief succinctly:

... in reality the employment relationship is an ongoing human relationship unlike ordinary commercial contracts. It is based on an inequality of bargaining power between the competing interests of labour and capital.<sup>1</sup>

Managers of profit-maximising enterprises, especially, are considered by many people to have both the capacity and the incentive to exercise this power, with exploitation of workers an inevitable consequence. A natural and widely accepted corollary of this view is that regulation of employment relationships is a necessary corrective. In the words of the British labour law scholar, Sir Otto Kahn-Freund:<sup>2</sup>

The main object of labour law has always been, and I venture to say will always be, to be a countervailing force to counteract the inequality of bargaining power which is inherent in, and must be inherent in the employment relationship.<sup>3</sup>

Many others have regarded this proposition as simply and self-evidently true. Thus, the Employment Relations Act 2000 confidently aims "... to build productive employment relationships ... by acknowledging and addressing the inherent inequality of bargaining power in employment relationships". In an address delivered in 2000 in Hong Kong on New Zealand's place in the global economy, Finance Minister and Treasurer Dr Michael Cullen's explanation for replacing the Employment Contracts Act with the Employment Relations Act was that:

... it did not conform to basic ILO [International Labour Organisation] conventions and *because it failed to reflect the intrinsic imbalance in the worker-employer relationship* [emphasis added].<sup>4</sup>

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<sup>1</sup> Human Rights Commission (2000), para 1.4.

<sup>2</sup> Otto Kahn-Freund (1900–1979) fled Germany to England in 1933 and subsequently held chairs in law and legal studies at the London School of Economics, Oxford and Cambridge. He contributed extensively through public and professional appointments to industrial relations debate and practice in the United Kingdom and achieved international recognition through his comparative studies of relationships between law and societies.

<sup>3</sup> Kahn-Freund (1977), p 6.

<sup>4</sup> Speech reported at [www.beehive.govt.nz/ViewDocument.cfm?DocumentID=7242](http://www.beehive.govt.nz/ViewDocument.cfm?DocumentID=7242) (last accessed September 2005).

The New Zealand government's stance on the issue is reasserted in its 2002 report to the United Nations Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW).<sup>5</sup> Across the Tasman, Kahn-Freund's words are commonly cited by Australian legal scholars and experts in industrial relations as the authority for the propositions, first, that there is a pathological imbalance of power in employment relationships and second, that legislated constraints are a necessary corrective.<sup>6</sup> Assertions of power imbalance in employment relationships and the desirability of regulatory redress can be found readily in the legal and industrial relations literature of other countries. Aversion to 'at-will' employment contracts is characteristic of this literature.<sup>7</sup>

Generally, there can be little doubt that labour market regulations in New Zealand and other countries have been strongly influenced by (perhaps even largely based on) these widely held beliefs. Such regulations include minimum wage laws; employment protection (unfair or unjustifiable dismissal) laws; laws conferring on employees various entitlements such as paid holidays and sick leave; and laws that confer privileges on labour unions.

In contrast to those who hold to these beliefs, it is fair to say that the great majority of labour economists have a far more positive perception of relationships between employees and employers. Elementary economic analysis suggests that for so long as an employment relationship remains economically viable (in the sense that it produces value in excess of opportunity costs), both parties to the underlying contract have some degree of power to constrain the other to comply with the explicitly or implicitly agreed terms. This is conducive to efficient use of labour in production. If an employment relationship ceases to be economically viable (that is, the benefits to one of the parties fall short of the opportunity costs of maintaining it) then the power of one of the parties to influence the actions of the other vanishes. While this may be considered to constitute a state of power imbalance, it is symmetric (in the sense that either party's

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<sup>5</sup> Ministry of Women's Affairs (2002), pp 7, 77.

<sup>6</sup> Leading Australian labour law and industrial relations experts who use Kahn-Freund's words to support claims of an inherent power imbalance in employment relationships include Sydney University industrial law professor Ron McCallum (for example, McCallum, 1997, p 408); former senior deputy chairman of the Australian Industrial Relations Commission, emeritus professor Keith Hancock (for example, Hancock, 1999, p 79); and Breen Creighton and Andrew Stewart, authors of a leading Australian textbook on labour law (for example, Creighton and Stewart, 2000, p 4). Former secretary of the Commonwealth Department of Industrial Relations, Michael Costello, who has held a range of senior managerial positions in public and private sector organisations, asserted in a recent newspaper article that workers are in "... what is *intrinsically* a hopelessly unequal bargaining position" (Costello, 2005, emphasis added). Not all lawyers concur with the alleged inherent imbalance of power proposition. For example, University of Chicago law professor Richard Epstein has eloquently defended at-will employment contracts in numerous articles published since the early 1980s.

<sup>7</sup> The term 'at-will contract' originated in the United States and refers to a contract that can be terminated by either party 'for good reason, bad reason or no reason at all', a succinct characterisation which derives from *Payne v Western & Atlantic Railroad Company*, Supreme Court of Tennessee (1884), vol 81, pp 507, 523, 526-527.

power may vanish) and transient, and therefore cannot be considered an inherent imbalance. Moreover, it has the economically and socially desirable consequence of creating powerful and continuing incentives for people to allocate their labour and other resources to their highest valued uses. An employer's power to direct an employee in undertaking tasks might be regarded as constituting an asymmetry in power that is inherent in employment relationships. However, as discussed later, this power to direct is, for good reasons, ceded voluntarily by employees and cannot be considered pathological. It benefits both parties. In summary, while from an economics perspective the power of parties in employment relationships to influence each other's behaviour has important implications, most economists consider it neither inherently imbalanced nor a significant social problem. For example, it is difficult, if not impossible, to find reference to a systematic power imbalance in employment relationships in the encyclopaedic *Handbook of Labor Economics*, which comprises over 3,700 pages contributed by more than 80 invited specialists in the economics of employment and labour markets from many different countries.<sup>8</sup>

True, over recent years, a large volume of economics research throughout the world has focused attention on labour market frictions and their effects on the functioning of labour markets, notably their role in generating disparities in wages received by otherwise similar workers. However, this line of inquiry provides little if any support for the proposition that the consequences of market frictions can be corrected by regulation. Even proponents of the 'new monopsony theory'<sup>9</sup> are cautious in their evaluations of the detrimental effects of firms' discretionary power to set wages and, more importantly, in their assessments of the efficacy of regulatory correctives.<sup>10</sup> To the contrary, economic theory, supported by evidence from a range of countries, gives compelling reasons for believing that much labour market and employment regulation exacerbates labour market frictions with unintended, socially detrimental consequences, including lower employment and population ratios (especially for youths and older workers); an increased incidence of long-term unemployment; reduced real wages; and the imposition of unwanted financial risk on workers.<sup>11</sup>

Given the centrality of the alleged imbalance of power in employment relationships both to the debate on the merits of employment and labour market regulation and to understanding the consequences of such regulations, there is surprisingly little analysis of the issue in the literature of either law or economics. Clearly, to the extent that perceptions of power imbalance have contributed to the enactment of labour

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<sup>8</sup> Ashenfelter and Layard (1986), Ashenfelter and Card (1999).

<sup>9</sup> Monopsony power refers to the capacity of an employer to reduce wages below the value of an employee's marginal contribution to output because of constraints of various kinds (for example, workers' travel costs) on competition from other employers. Roughly speaking, monopsony in labour markets is regarded as of about the same economic significance as, say, the power of retailers to choose mark-up levels.

<sup>10</sup> See, for example, Manning (2003b), chapter 13.

<sup>11</sup> See, for example, Nickell *et al* (2005), Young (2003).

market regulations detrimental to people's welfare, there is far more at stake than mere academic curiosity. This paper sketches a framework for structuring and analysing power in employment relationships. The next section sets out basic facts about employment relationships and labour markets that provide perspectives for subsequent discussion. This is followed by an outline of the nature of employment relationships and the underlying employment contracts within profit-maximising productive enterprises. The sources of power in employment relationships are then examined. Against this background, some of the consequences of regulations ostensibly intended to alleviate the effects of the alleged power imbalance are then considered. The discussion relates only to individual employment contracts. However, it has obvious implications for regulations relating to collective bargaining for the supply of labour to productive enterprises.

## Perspectives on employment relationships

We begin with three points that give essential perspectives on employment relationships and the powers of parties to them.

First, almost all employment contracts between individuals and profit-maximising employers (hereafter individual employment contracts) in industrialised countries are at-will contracts – on the employee's side. With very few exceptions, an employee has the freedom to resign from a viable job for good reason, bad reason or no reason at all. Although the costs of hiring and training replacements can be substantial, in an overwhelming majority of cases employers are powerless to prevent job resignations – except by matching or bettering job offers. For example, of the 10.2 million people in Australia who worked in the year preceding February 2004, over 1.2 million or 11 percent were recorded as ceasing a job voluntarily during the year (Australian Bureau of Statistics, 2004, table 12). Although it can be difficult to distinguish between resignations and dismissals, clearly the costs to employers of voluntary resignations are not trivial. Similar data from industrialised economies suggest that voluntary resignations typically outnumber dismissals by as much as two to one, including dismissals from jobs that are no longer viable.<sup>12</sup> In summary, whereas in most countries there are mandatory restrictions of various kinds on an employer's power to terminate an employment contract, almost all employees can terminate at will. This is not to say that there ought to be restrictions on resigning from a job. Apart from the fundamental issue of whether such restrictions would be an intolerable violation of individual freedom, obliging unwilling workers to remain in jobs is unlikely to be consistent with profit-maximisation in the great majority of circumstances. But crucially, and central to later discussion, it is employees' ability to terminate at will that gives them the power to constrain their employers' behaviour.

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<sup>12</sup> In the year to February 2004, 657,000 people in Australia were estimated to have lost their jobs, but more than half of these job losses were either because the job was temporary or seasonal or because of illness or injury (Australian Bureau of Statistics, 2004).

Second, because of the likelihood that people's assessments of the fairness of employment relationships will be influenced by their perceptions of the division of the product of those relationships between employees and employers, it should be noted that in modern economies aggregate labour income (including the incomes of self-employed people) accounts for around 65–75 percent of gross domestic product (GDP), with the remaining 25–35 percent accounting for costs of capital and natural resources. Moreover, although for various reasons data on factor shares are not sufficiently precise to allow reliable international comparisons, there is little in them to suggest that employees in the more heavily regulated labour markets receive 'fairer' shares of national income. For example, data from the Organisation for Economic Cooperation and Development (OECD) show labour's share over an extended period in the lightly regulated US labour market to have been consistently higher than in most of the more heavily regulated labour markets of continental Europe (refer table 1).<sup>13</sup> Reynolds (1991, p 169) makes the further point that, if it were true that an imbalance of power in favour of employers enabled them to pay less than the value of labour's marginal contribution to production, then rates of return on capital should be higher in labour intensive industries than in capital intensive industries, a proposition for which there is no supporting evidence.

Third (and significant for the argument that follows) is the proposition that, in the absence of artificial constraints, people supplying labour to productive organisations will choose to do so through organisational forms and contractual arrangements that maximise their expected welfare. One such contractual arrangement is the individual employment contract. However, there is a range of feasible alternative ways of contributing labour to production, including through workers' cooperatives, independent contracting, communes, not-for-profit enterprises and publicly owned enterprises.<sup>14</sup> Also, instead of direct supply by individuals, labour can be (and is)

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<sup>13</sup> Intriguingly, Massachusetts Institute of Technology (MIT) economist Olivier Blanchard remarks on a "dramatic decline" since the early 1980s of 5 to 10 percentage points in labour's share in many countries in Europe (Blanchard, 2004, p 5).

<sup>14</sup> Legal and accounting services are commonly provided by partnerships that are, in essence, a form of worker cooperative. The existence of lumber and plywood worker cooperatives in the Pacific North West of the United States demonstrates that production in other industries could be conducted through this form of organisation. Worker cooperatives were the dominant (though relatively unsuccessful) organisational form for production in the former Yugoslavia. Supply of labour through independent contracting is, in principle, another feasible approach to organising cooperative production. Significant quantities of goods and services in modern economies are produced in non-profit organisations. There have been frequent attempts over several centuries to improve people's welfare by organising production through communal utopias but success, as measured by numbers of people choosing this form of cooperative production, has been very limited – aside from monasteries and convents. Centrally planned economies have been less successful in improving the welfare of working people than market-oriented economies. The implication to be drawn from these observations is that the contract of employment between a worker and a profit-maximising employer has not only survived but become the dominant contractual arrangement for organising cooperative production, presumably because workers perceive that it delivers benefits for them that are greater than (or at least equal to) the benefits from specialisation and cooperation delivered under other contractual arrangements.

Table 1: Average share of labour cost in total factor costs, national prices (selected countries, 1985 to 2001 inclusive\*)

<i>Country</i>	<i>Labour's average share (percent)</i>	<i>Range – 17 years (1985 to 2001 inclusive)</i>
Ireland	79.6	72.6 to 84.3
Canada	75.9	72.9 to 77.9
United States	75.3	72.5 to 77.9
Japan	72.6	68.1 to 77.4
Italy	71.9	69.7 to 75.0
United Kingdom	71.4	63.4 to 76.6
Belgium	70.1	66.2 to 72.4
France	69.7	68.0 to 71.9
Finland	69.4	57.3 to 71.7
Denmark	69.0	65.3 to 79.6
Greece	68.8	58.8 to 73.5
Sweden	67.6	57.4 to 75.6
Netherlands	67.4	64.8 to 70.3
Germany**	67.4	66.0 to 70.4
Spain	66.8	54.5 to 74.5
Australia	63.8	58.0 to 68.0

Source: OECD, data from OIisnet.

\* All countries for which there are data for at least the 17 years 1985 to 2001 inclusive, excluding Germany. By implication, the remaining share is the cost of physical capital, including land and natural resources. Although data for labour's share for New Zealand were not provided by the OECD, the Reserve Bank of New Zealand recently recorded labour's share as 71 percent of income GDP (Bollard, 2005).

\*\* Germany: data for 11 years 1991 to 2001 inclusive.

supplied to profit-maximising firms through labour unions or labour hire companies.<sup>15</sup> The important point is that the fact that the supply of labour through individual employment contracts has been, and remains, the dominant arrangement for cooperation in production is compelling evidence of its success, relative to the feasible alternatives, in delivering net benefits for most workers.<sup>16</sup>

There are numerous factors that contribute to the dominance of the individual employment contract for achieving cooperation in production. These include: creation of robust incentives to contribute physical and mental effort to production; creation of incentives to invest in human capital; economy in deployment and maintenance of scarce physical capital; specialisation in management; protection from the consequences of free-riding; and flexibility of labour allocation in response to innovations in products and

<sup>15</sup> The difficulties experienced by labour unions in surviving (recruiting members) without some form of legal privilege suggest that this mode of contracting to supply labour is not generally beneficial for workers.

<sup>16</sup> It is likely that the proliferation over recent decades in many industrialised countries of alternative forms of labour supply (such as independent contracting, labour hire companies, and casual and part-time employment) may be at least partly a manifestation of attempts by workers and employers to escape the consequences of regulations for which the perceived benefits fall short of the costs.

organisation of production. Two of these factors have implications for the analysis of power in individual employment relationships. The first, the role of the individual employment contract in creating incentives to contribute physical and mental effort to productive activities, is elaborated in the next section. The second is the role of individual employment contracting in mobilising and utilising information required for efficient matching of people with jobs. People are heterogeneous in aptitudes, skills, preferences for jobs, and so on. The skill requirements of jobs vary widely. Efficient matching of people and jobs is therefore a complex process. Individual employment contracting through labour markets mobilises, at low transaction cost, the idiosyncratic knowledge possessed by workers and employers that is required to achieve productive job matches. Young people, in particular, tend to change jobs frequently as they discover more about their aptitudes, abilities and work preferences and the characteristics of jobs.

The complexity of the process of efficient job matching is massively compounded by what Joseph Schumpeter termed the “creative destruction” that characterises the growth and development of modern economies.<sup>17</sup> New jobs are continually created by innovations in products and in the techniques and organisation of production, including the launching of new firms. At the same time, jobs are being continually destroyed as goods and services become obsolete, firms are reorganised or liquidated. To give an impression of the scale of job creation and destruction, Carroll *et al* (2002) report that between 1995 and 2001 in New Zealand 17.5 percent of the jobs in existence at the end of a year were created on average during the year and 15.3 percent were destroyed during the year. Rates of job creation and destruction are roughly comparable in other countries.

Labour mobility rates that take account of movements of workers into and out of jobs that remain in existence during a given year, in addition to jobs created and jobs destroyed, are, of course, considerably higher. For example, 2.1 million (21 percent) of the 10.2 million persons who worked at some time during the year ending in February 2004 in Australia either lost a job or left a job in that period, and roughly equivalent numbers would have moved into either newly created jobs or jobs vacated by others. These very high levels of labour mobility reflect people’s efforts to maximise the value of job matches and to reap the benefits of creative destruction through the resultant economic growth.

In summary, the flexibility and relatively low transaction costs of individual employment contracting are crucial to the complex process of efficient job matching that allows people to prosper in modern economies.

## Individual employment relationships and employment contracts

Like other commercial contracts, the overall purpose of an individual employment contract is to constrain the behaviour of the parties with the objective of maximising its combined value to them over time and, in particular, to deter one party from opportunistically taking advantage of the other. Employment relationships and the underlying contracts are frequently maintained over extended periods.

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<sup>17</sup> Schumpeter (1975) pp 82–85.

A distinguishing feature of employment contracts is that they can be characterised as *relational contracts*. Broadly, a relational contract is an informally agreed set of terms and an unwritten code of conduct that frames a transaction between two parties (Baker *et al*, 2002).<sup>18</sup> This contrasts with an *explicit* or *formal* contract that specifies the terms and conditions of a transaction in precise, verifiable terms (for example, contracts that cover the sale of property) and that are therefore enforceable by courts. Because *relational terms* in a contract are not specified in verifiable terms, they cannot be enforced effectively by courts.

Individual employment contracts can be regarded as relational contracts because the formal terms extend little beyond specifying the wage rate and a few entitlements. Yet each of the parties enters the relationship with a range of expectations and understandings on important matters such as: the skills to be deployed; the tasks the employee will be required to perform; procedures for assigning tasks; the amount of mental and physical effort to be devoted to tasks; prospects for promotion and future wages and benefits; opportunities to use initiative and to be creative; opportunities to acquire skills and experience; risks to health; the consequences of illnesses; conditions for severing the relationship (separation); financial risks; appropriate behaviour towards other workers and so on. These expectations and understandings are the essence of an individual employment contract but are simply too difficult (and therefore too costly) to specify *ex ante*, and consequently cannot be verified and enforced by courts. The unwritten terms of employment contracts vary widely to accommodate differences in jobs and the preferences and circumstances of the parties.<sup>19</sup>

In the case of another familiar relational contract, the marriage contract, governments have recognised the inherent difficulty of third-party enforcement of relational terms by introducing no-fault divorce.<sup>20</sup> In contrast, much of the legislation covering

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<sup>18</sup> Baker *et al* (2002), p 39, state that "Firms are riddled with relational contracts: informal agreements and unwritten codes of conduct that powerfully affect the behaviors of individuals within firms". While adoption of the term 'relational contract' has been promoted by Baker *et al*, it is probably yet to be regarded as generally recognised and accepted in economics. The relational elements of employment contracts are more commonly described as 'implicit contracts' in economics. However, as Baker *et al* (p 40, footnote 5) point out, 'relational' is an accepted term in the legal sphere and, importantly, avoids the connotation of vagueness that may be mistakenly associated with 'implicit'.

<sup>19</sup> While these aspects of employment contracts make them, as the Human Rights Commission observed, "unlike ordinary commercial contracts", relational contracts are by no means unique to employment relationships. According to Baker *et al* (2002), pp 39–40, "Business dealings are also riddled with relational contracts ... Whether vertical or horizontal, these relational contracts influence the behaviors of firms in their dealings with other firms ... Relational contracts within and between firms help circumvent difficulties in formal contracting (i.e., contracting enforced by a third party such as a court)".

<sup>20</sup> Nicholas Gruen has written: "Fault-based divorce sought to prevent 'unfair dismissal' from a marriage. In the 1970s we didn't suddenly become blasé about the suffering brought about by adultery and betrayal. But we did decide that legal fault-finding created more pain than it healed. Perhaps more important still we couldn't see much sense in forcing someone to stay in a marriage if they didn't want to be there. That's how I feel about unfairly dismissed workers. The boss has treated them with contempt. They'll be better off moving on". *The Courier Mail*, 27 July 2005.

employment contracts in industrialised countries rests on the fallacious proposition that court enforcement of relational terms is feasible.

An important implication of the fact that relational contracts cannot be effectively enforced by third parties (courts in particular) is that they must be *self-enforcing* in the sense that they must have in-built incentives for the parties to fulfil their contractual obligations. What makes a relational contract self-enforcing is that both parties expect to incur costs if they break a contract that remains economically viable. Ultimately, it is these *termination costs* that create the incentives to fulfil contractual terms (although it is important to recognise that eliciting cooperation and good performance from employees is a complex matter involving carrots as well as sticks).

### *Employee's termination costs*

The main termination costs expected by an employee in the event that the employer terminates a contract are the cost of searching for another job and the income forgone until a new job is found. Other costs the employee may incur include loss of value of reputation as a diligent worker in the event of dismissal for unsatisfactory performance (likely to be reflected in reduced future earnings) and perhaps relocation costs. Note, however, that these costs may be at least partly offset by redundancy payments or unemployment benefit payments. This presumably attenuates the power of employers over employees. The expectation of incurring termination costs creates incentives for employees to avoid dismissal by, for example, devoting acceptable levels of physical and mental effort to assigned tasks (not to shirk<sup>21</sup>) and to act in other ways in the employer's interest (for example, by safeguarding the employer's assets). Importantly, an employee's expected termination costs depend on the rate of unemployment – the higher the unemployment rate, the longer the period of unemployment the employee expects if the contract is terminated, and therefore the greater the termination cost.

### *Employer's termination costs*

In the absence of regulations, and assuming the need to fill the vacant position, the main components of an employer's expected termination costs are the cost of recruiting a replacement employee and the cost of training the replacement. Other

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<sup>21</sup> It should be noted that whereas in common usage the term shirk has connotations of turpitude, in this document shirk is used in a somewhat more morally neutral way to include behaviour in relation to productive activities which is less diligent than would be expected under higher-powered incentives. Shirking as used here is applied to physical effort, mental effort, alertness and other dimensions of quality of labour inputs, and might or might not be opportunistic or immoral. To illustrate, few people would regard a farmhand employed on a fixed-wage contract who pursued the onerous task of shearing sheep with less vigour than a person with a piece-rate contract to shear (that is, a fixed payment per sheep shorn) as either immoral or opportunistic. However, from our perspective the farmhand would be shirking if under stronger incentives he would shear more vigorously. Given the onerousness of the task of shearing, provided the farmhand's efforts were within the bounds of normality most people would consider the lower level of vigour to be a reasonable human response to the weaker incentive of a fixed-wage employment contract. On the other hand, in our usage there is an element of shirking in the behaviour of a piece-rate contract shearer who shears with less than due care in pursuit of greater output.

termination costs the employer may incur include mutually agreed or mandatory redundancy payments and, importantly, if the dismissal is perceived to be unfair, loss of value of reputation as a good employer. These costs create incentives for employers not to dismiss capriciously workers who are performing in accordance with their contracts. They also constrain an employer from demanding more from an employee than is implied in their employment contract – employers recognise that there will be a point at which an employee will choose to incur the costs of terminating a relationship rather than tolerate excessive demands. In summary, the capacity of each party to impose costs on the other makes employment contracting through profit-maximising enterprises self-enforcing. An advantage of this is that enforcement costs tend to be low.

Importantly, most employment contracts become more valuable over time as parties gain knowledge about job requirements and become skilled in accomplishing assigned tasks. The resultant increase in the value of the job match is referred to as a ‘match-specific rent’ – a return to the job match that exceeds the sum of the best outside offer open to the employee and best alternative use of the owners’ capital services supplied to the job match. Terminating a job match results in the loss of any associated match-specific rent, which, in turn, tends to increase termination costs for both parties. Thus the existence of match-specific rents strengthens the incentives for both parties to adhere to contractual terms, depending on their shares of the rent created in the ongoing job match. Finally, for perspective, it is worth noting that, measured by termination costs, an employer’s power to mistreat an employee is in most cases much weaker than the power of one partner in a marriage to mistreat the other.

### *Conditions for efficient contract termination: efficient separations*

When an employee terminates an employment relationship to move to another job, and the employer cannot profitably employ a replacement, a job is destroyed. Likewise, jobs are destroyed when employers dismiss employees who become redundant in the sense that the market wage has risen above the value created by the job. Such terminations are known as *efficient separations* because they offer a ‘free lunch’ – they raise the value of output of goods and services in an economy with no additional resource cost. For this reason, efficient separations are not prohibited by regulation in most countries, although in some employers are required to provide evidence that the jobs concerned are no longer viable. The incentive for one or other party to terminate an inefficient employment relationship is the essence of labour market flexibility and is one reason for the value – in productivity terms – and, therefore, dominance of individual employment contracts.

Termination of employment contracts that are no longer economically viable (that is, profitable) may be unpleasant but is nevertheless socially desirable – it is inherent to the Schumpeterian processes of creative destruction that continually shift resources to higher valued uses in response to the innovations in products, techniques and organisation of production that underlie the success of market-based economies.

## Power in employment relationships

Although there is no precise, comprehensive definition of power, in general terms it can be thought of as “the ability to impose one’s will on others, even if those others resist in some way”.<sup>22</sup> Power in interpersonal relationships derives from the ability of one party to impose costs on another.<sup>23</sup> The cost may be either pecuniary or non-pecuniary. A robber wielding a knife *derives* power to extract dollars from a shop owner from the ability to impose the non-pecuniary cost of injury or death. Parents may derive power over their children from their ability to impose the cost of withheld affection. The incentives to adhere to implicit terms of a relational contract can be thought of as the power of each party to constrain the behaviour of the other, which (as discussed earlier) derives from the ability of each to impose contract termination costs on the other. Note that power derives not from the imposition of costs but rather from the *perceived ability and willingness to impose costs* (that is, on the credibility of threats). Importantly, party A may have the power to constrain the behaviour of party B even if B can inflict greater costs on A (that is, B in some sense has more power). To illustrate, the United States has the weaponry to impose huge costs on North Korea, but because North Korea appears to have the capacity also to impose costs on the United States in retaliation (albeit smaller costs) the United States may not have the net power to force North Korea to comply with its wishes.

The notion of power as the ability to impose costs can be used to analyse power relationships between an employer and an employee in an employment contract. For our purposes, it is useful to distinguish between three phases in the contracting process:

- phase 1 contract formation;
- phase 2 enforcement of the ongoing individual employment contract over the life of the employment relationship; and
- phase 3 contract termination.

### *Bargaining power in contract formation*

The issue here is: does either of the parties have the power to impose costs on the other at the time the contract is agreed? As outlined above, employment relationships are continually forming as firms expand, start up and replace staff who leave, and are continually being broken as firms contract or cease operations and employees resign to go to better jobs, or for other reasons. An implication of this is that at any given time there is a substantial pool of people searching for jobs and a substantial number of

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<sup>22</sup> *Wikipedia*, ‘Power (Sociology)’, <http://en.wikipedia.org/wiki/> (last accessed September 2005).

<sup>23</sup> Barzel (2002), pp 17–19, has a pertinent, brief discussion of the concept of power.

employers wanting to fill vacant jobs.<sup>24</sup> Under these conditions, neither prospective employers nor job applicants are in a position to credibly impose costs on the other. An employer can decide not to hire a job applicant but cannot prevent a person from continuing to search for jobs. In particular, an employer who offers sub-market terms and conditions cannot prevent a worker from accepting an alternative job offering market terms and conditions. Likewise, a worker with an unrealistically high reservation wage cannot impose costs on employers who refuse to hire them. The employer will simply continue to search for an applicant willing to accept market terms and conditions.

Just as there is no inherent imbalance in bargaining power between consumers and retailers at the time a transaction is effected (because both parties have numerous other potential trading partners) so there is no inherent imbalance in the formation stage of employment contracting – at any given time there are numerous other buyers and sellers making offers in labour markets.

While the logic of this argument against an imbalance of power is compelling for economists, others find it difficult to accept. There seem to be several reasons for this.

One fallacious proposition is that employers have greater bargaining power because they typically have more financial resources. However, if this were true then the analogous argument for the product market should hold: retailers with more financial resources than consumers would have the power to coerce consumers into paying above market prices. There is no convincing evidence for this – large retailers are not in general more profitable than small retailers. A perhaps more persuasive counter-argument is that there is compelling evidence that large firms typically pay workers with similar characteristics substantially higher wages than small firms.<sup>25</sup> This clearly contradicts the argument that bargaining power in contract formation is positively related to financial resources.

Another common argument is that most jobs are offered on what amounts to be close to a take-it-or-leave-it basis, with employees playing little, if any, part in negotiating terms and conditions. This is taken as evidence that employers have the power to force their terms and conditions on employees. However, an important way in which a profit-maximising employer makes relational employment contracts self-enforcing is to signal to employees an assurance that they will not act opportunistically. One way of signalling this is to treat all similar employees equally and to establish a reputation for not reducing the terms and conditions of employment *after* an employment relationship has been formed. This effectively constrains an organisation to offer initial contracts with terms and conditions that it will not normally negotiate.

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<sup>24</sup> This is not so in cases of monopsony – where there is only one employer in a market for a particular type of labour. The market for nurses in an isolated town with only one hospital is often used as an example. Because situations in which a firm has significant monopsony power are rare, monopsony in labour markets is generally considered by economists to be of little practical significance.

<sup>25</sup> For example, Oi and Idson (1999) put the firm size/wage gap in the United States at 35 percent and observe that wage gaps of similar magnitude have been found in other countries and in earlier times in the United States.

### *Power in the ongoing employment relationship*

As long as a job is economically viable, each party to an employment contract has the capacity to impose costs on the other by terminating the contract. As discussed above, this makes employment contracts self-enforcing. Potentially, this gives each of the parties power over the other but it should be considered as enforcement power rather than bargaining power because it is used to induce adherence to formerly agreed contractual terms rather than to impose new contractual terms. Nevertheless, it seems likely that it is this source of power on the employer's side – the capacity to impose termination costs on employees – that people believe underlies the alleged inherent imbalance of power in employment relationships. However, for reasons outlined above, employers tend not to attempt to impose inferior terms after employment relationships are formed. An employer must keep in mind that an employee who believes they are being 'pushed too hard', relative to the implicitly agreed level of effort or other implicitly agreed terms, can resign, thereby imposing recruitment and training costs on the employer and, if the belief is justified, reputational costs as well. This tends to constrain employers from making excessive demands on employees.

Importantly, because separation imposes costs on *both* parties, they each have incentives not to exercise their power capriciously. This is so even if the costs that one party can impose are higher than for the other – both will suffer losses if a viable employment relationship is terminated. There is therefore no reason for believing that there is an inherent imbalance of power. Note, however, that an employer's ability to impose costs on an employee is positively related to the unemployment rate. This is significant, because regulations that have the unintended side effect of increasing unemployment also have the unintended consequence of increasing employees' termination costs, thereby giving employers more scope to abuse employees. Probably the most effective protection employees have from abuse by their employers is a labour market that keeps unemployment rates low.<sup>26</sup>

As noted earlier, the overall purpose of an individual employment contract is to constrain the behaviour of *both* the employer and the employee and, in particular, to deter one party from opportunistically taking advantage of the other. The essence of a continuing employment relationship is the stability of the underlying contract – broadly, for as long as the relationship remains economically viable, contractual terms and conditions either remain unchanged or change in accordance with prior expectations of both parties, for example changes over time in the wage or salary depending on factors such as performance, experience and seniority. The important point to recognise is that this contractual stability is *prima facie* evidence of balance in the power of the two parties in a continuing employment relationship to set terms

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<sup>26</sup> Envyng the performance of the UK labour market in recent years, the French weekly news magazine, *Le Nouvel Observateur*, is reported to have put this proposition nicely: "If you lose your job [in the United Kingdom] the economy guarantees you another" (*The Economist*, 14 May 2005, p 47). Unemployment rates in the heavily regulated French labour market have been in the vicinity of 10 percent for the past 20 years (roughly double those of the United Kingdom in recent years and much higher than the rates of around 2.5 percent in France in the 1960s).

and conditions of employment. In simple terms, were the power of the two parties not in balance then the terms and conditions of the contract would be changed (that is, the contract would be unstable). This point is fundamental.

Consider the implications of an *inherent power imbalance* that enabled employers to alter unilaterally the terms and conditions of continuing employment contracts. Exercising this power to reduce labour costs would necessarily increase an employer's profits (unless employees had countervailing power to withhold productive effort). If all employers were altruistic (in the sense of being willing to forgo profits to enhance employee welfare) then the assumption of power imbalance could conceivably be consistent with the observed stability of continuing employment contracts. However, if even some employers, in pursuit of higher profits, chose to exercise their power by unilaterally cutting wages or other terms of employment, the cost advantages available to these profit-maximising employers would enable them to drive the altruistic employers out of business. Thus, if power in employment relationships is inherently biased in favour of employers, only profit-maximising employers could survive. But, as Richard Epstein has forcefully argued, the logical consequence of this is that employment contracts would not be stable – wages (labour costs) would be driven inexorably to zero as employers acted to maximise their profits by continually exercising their inherent power to cut wages.

Let us assume we had an employer who was entitled to 'dictate' the terms of trade in the marketplace. What would we expect the contract to look like? The answer is that the employer would never stop pressing his advantage. If it turned out that the employer could dictate terms, why would he offer a wage of \$10 if he could drive it down to \$9; and why would he settle for \$9 if he could drive it down to \$8? The logic of a dictation, the logic of inequality of bargaining power necessarily says there is no reason for the employer to stop until he has extracted the last bit of advantage. That means, in effect, people are going to work for zero wages.<sup>27</sup>

Such a state of affairs is clearly contradicted by the evidence of contractual stability, and by the fact that real wages rise while profit rates (returns on capital) do not vary greatly over long periods. In short, if one believes that employers attempt to maximise profits then the alleged inherent bias in favour of them having the power to set contractual terms and conditions of employment in continuing employment relationships is simply not tenable.

This is not to say that the contracts underlying continuing employment relationships are continuously stable. Unanticipated changes in the supply of, or (often more obviously), the demand for, a particular type of labour change the relative bargaining powers of the two parties. For example, in the 1990s, a 'sellers' market', created by unanticipated demand, increased the bargaining power of employees with information and communication technology (ICT) skills relative to their employers, enabling the former to induce their employers to pay unanticipated salary increases. What caused the power relativities to change? Employees' bargaining power increased because strong

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<sup>27</sup> Epstein (1991), p 4.

external demand for their services reduced their cost of terminating an existing relationship, thereby increasing their confidence that demands for higher pay would not be countered by dismissal. Employers' bargaining power decreased because the increased cost of hiring replacements (higher termination costs) made it profitable to grant requests for higher pay rather than risk incurring the cost of terminating relationships. The resultant changes in terms and conditions (higher salaries) of ICT employment relationships tended to restore balance between demand for and supply of ICT skills and, concomitantly, balance in power relativities in ICT employment relationships. Of course, the higher salaries created incentives for people to acquire ICT skills, thereby subsequently shifting bargaining power back in favour of buyers of ICT skills. Indeed, the strength of the response to the high salaries in the late 1990s was such that the market for ICT skills turned into a 'buyers' market'.

These, however, were temporary shifts in power and not inherently imbalanced bargaining power. This example shows that bargaining power in labour markets plays the same role as bargaining power in other markets: adjusting to unanticipated changes in demand for or supplies of goods and services.

Lest all this seem too good to be true, attention should be drawn to other aspects of termination costs and empowerment of parties to employment contracts that have important (and somewhat less favourable) implications for employment relationships and the functioning of labour markets. First, the process of matching people to jobs is not instantaneous, nor can it be instantaneous if it is to be even tolerably efficient. A consequence of this is 'wage dispersion'. Contrary to the *unattainable nirvana* of a *perfectly* competitive labour market in which all employees with equal capabilities receive the same wage, there is ample evidence that wages for comparable workers vary depending on the industry and firm in which they are employed.

Although the reasons for this are far from completely understood, they can be sketched in broad terms. The productivity of job matches depends on resources devoted to the matching process. As noted earlier, it takes time for a person to search for a suitable job and time for an employer to find a person suitable for a job. An inevitable consequence of these labour market 'search frictions' is that at any given moment there will be a pool of people searching for jobs, some of whom will be unemployed and others with jobs in search of better ones. Similarly, at any given moment there will be a pool of job vacancies. This, combined with the costs to employers of finding and selecting job applicants and the costs to workers of job search,<sup>28</sup> creates scope for employers to adopt 'wage policies' and for employees to adopt 'job-search strategies'. For example, firm A might judge that its profits will be maximised by adopting a high-wage policy in the expectation that it will have the 'pick of the field' in matching its employees to job requirements, will fill vacant jobs quickly, and be in a position to demand strong performance from its employees. The underlying hope is that the higher-than-average productivity of its job matches (including greater-than-average employee effort) will more than compensate for its higher-than-average wage bill. Firm B, on the other hand,

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<sup>28</sup> Recall that these costs are the flip sides of termination costs.

might judge that the gain from a low-wage strategy will more than compensate for poorer matching (and therefore less productive job matches), delays in filling vacancies, and less employee effort.<sup>29</sup> Equivalently, workers face a trade-off between, on the one hand, more time and effort devoted to job searching and, on the other, the lower wages and other conditions of the job accepted. Because decisions on these trade-offs vary across employers and job seekers, wage dispersion is the ubiquitous outcome of the job-matching process in modern societies. The costs of searching for a job and of recruitment also contribute to wage dispersion by creating scope for firms to adopt different pay incentive structures and different internal promotion policies.

How should wage dispersion be interpreted? While it might be taken as an indicator of unfairness in the outcome of labour market processes, such an assessment must be balanced by proper recognition of the benefits of job matching through labour markets as manifested in the growth of real incomes over time in modern economies; the scope for people to use the labour market to move from low to higher wage jobs; the absence of efficacious alternatives to job matching through labour markets; and, above all, the processes of innovation and discovery that drive improvements in work productivity and work environments. There is no reason for believing that any particular wage policy per se gives a firm the capacity to exploit its employees (in the sense of ensuring that the firm consistently earns abnormally high rates of return on investments). Indeed, the evidence suggests that more profitable firms tend to pay higher wages (adjusted for worker quality).

A second issue arising from the power of one party to constrain the other party to comply with contractual obligations is that it may also be a determinant of the power to bargain for a share of any continuing match-specific rent created in an employment relationship. Again, this bears on assessments of fairness in employment contracting. If only because of its inherent specificity, rigorous measurement and analysis of the division of match-specific rents between employers and employees has proved to be extremely difficult. However, for the same reasons, the prospect of regulatory intervention (or third-party adjudication) to reliably improve social welfare by artificially determining the distribution of match-specific rents seems remote.<sup>30</sup> It is perhaps worth noting that research in recent years suggests that competition for labour supplies between firms resulting from on-the-job searches by employees is an important determinant of wages in ongoing employment relationships. This, in turn, suggests that the power of employers to capture match rents is, in practice, substantially constrained by the availability of labour market options external to the firm.<sup>31</sup> Again, the issue of the division of match-specific rents has been succinctly stated by Richard Epstein:

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<sup>29</sup> This discretionary power to set wages can be thought of as the counterpart of the power of retailers and other firms to trade off higher mark-ups over cost of sales against reductions in volumes of sales.

<sup>30</sup> These sentiments bear on assessment of the merits of regulations that confer bargaining power on labour unions.

<sup>31</sup> See for, example, Mortensen (2003), Cahuc *et al* (2005).

The question of inequality of bargaining power goes **not** to the issue of how you divide up the meat, **only** to the question of dividing up the gravy.<sup>32</sup>

Generally, in assessing the extent to which wage dispersion and the division of match-specific rents in the employment relationship might be a problem requiring regulatory amelioration, it should be recognised (as noted earlier) that, although there is a range of alternative organisational forms for realising the gains from division of labour and cooperation in production, the individual employment relationship continues to be dominant, presumably because it best serves the interests of large majorities of people who depend for income on sale of their labour.

Finally, as noted above, it seems likely that part of the reason for the belief that there is an inherent imbalance of power in employment relationships may relate to the more or less standard condition that the employee gives the employer the power to direct the employee's productive activity. This, however, increases the value of the employment relationship. For example, it avoids the costs of negotiating a new agreement whenever there is a need to reassign labour in response to new information or changed circumstances. As the owner, or agent of the owner, of enterprise assets and residual claimant to the value of an employment relationship, it is economically and socially efficient to give the employer the power of direction because they have the strongest incentive to devote effort to ensuring that the assets are used efficiently.<sup>33</sup> The power to direct *is* inherent in the employment relationship but to construe it as the capacity to impose unwanted terms and conditions (that is, an imbalance of bargaining power) is mistaken because it is ceded voluntarily by employees for a very good reason – it enhances the value they derive from their employment relationships.

### *Contract termination and power*

The capacity of one party to an employment contract to impose costs on the other depends on the job remaining economically viable. If an employment relationship ceases to be viable then the cost to one or other of the parties of breaking it falls to zero, and the contract will be terminated. On the one hand, if an employer cannot profitably match an employee's alternative wage offer, the employer's capacity to impose costs on the employee falls to zero – the employee resigns and the employer bears the cost of retraining a replacement plus the loss of whatever match-specific rent the relationship was generating at the agreed wage. This might be thought of as an imbalance of power – but it is in favour of the employee. The employer is not happy about finding and training a replacement. Recall that this is a common state of affairs – resignations typically outnumber dismissals by about two to one in most economies. This is part of the process of efficient job matching and the associated allocation of labour.

On the other hand, if the value of an employment relationship falls below the agreed wage, the employee's capacity to impose costs on the employer falls to zero. The

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<sup>32</sup> Epstein (1991), p 5.

<sup>33</sup> Milgrom and Roberts (1992), p 331.

employee becomes redundant and is dismissed by the employer, thereby imposing on the employee the cost of finding another job. Again, this might be thought of as an imbalance of power – this time in favour of the employer. The employee is not happy and their power to influence the employer's behaviour vanishes. Such situations are commonly identified in the legal literature as an imbalance of power in which the employee's vulnerability calls for legal protection. However, it is clear from the preceding discussion that it is impossible for a third party to assess performance relative to contractual understandings. Consequently, it is simply unrealistic to believe that satisfactory adjudication of a dismissal is feasible. Tacit acknowledgment of this is the emphasis placed on dismissal *procedures* as opposed to the substance of dismissals by labour market regulators. However, for a variety of reasons, 'procedural fairness' does not necessarily produce fair outcomes. For example, where information is costly, procedural rules may have the perverse effect of creating scope for opportunistic 'gaming' by one or other of the parties.

### *Concluding comment*

Relational contracts in general, and employment contracts in particular, do not always work perfectly. For example, if part of an employee's earnings takes the form of a future entitlement (seniority pay or long service leave), an employer may opportunistically dismiss an employee – which is why legislated entitlements are often detrimental to employee welfare. But attempts to improve welfare by regulation of labour markets must be based on a clear understanding of the nature of relational contracts and why they have become the dominant contractual arrangement for cooperating in production in modern economies.

### **Power imbalance and labour market regulations**

The preceding discussion bears on the issue of labour market regulation in two broad ways. First, it shows that the objective of regulating to redress the alleged imbalance of power in individual employment relationships is misguided. Evidence that certain labour market regulations have unintended consequences that are detrimental to workers is therefore not surprising. For example, there are increasingly convincing arguments, supported by statistical evidence, that in countries such as France, Italy and Spain, minimum wage laws, mandated entitlements and employment protection regulations interact to produce persistently high rates of unemployment (and especially long-term unemployment of low-skilled workers). Ironically, minimum wages effectively reduce the power of many less productive people over deployment of their labour to zero – by pricing them out of jobs.

The second broad way in which recognition of power in employment relationships as the capacity of one party to impose net costs on the other bears on labour market regulation is that it gives insights into reasons for regulatory failure. Consider a minimum wage, set above the market-clearing wage rate, thereby causing unemployment to be higher than otherwise. Because the higher unemployment rate increases the expected time an employee must search to find alternative employment, the expected cost to the

employee of dismissal by the employer increases. At the same time, because the pool of unemployed workers is larger, the expected cost to the employer of hiring a replacement falls. Both effects tend to undermine the power of an employee to induce the employer to adhere to the terms of the employment contract. This is scarcely profound – no more (but no less) than the common sense proposition that employers are more likely to mistreat their employees when rates of unemployment are high. This, however, is rarely, if ever, a consideration in determining minimum wages or mandated entitlements. Rather, to the extent that the problem of mistreatment of employees is exacerbated by higher unemployment, a likely regulatory response would be more stringent unfair dismissal regulation – the regulatory equivalent of a dog chasing its tail. That a freely functioning labour market, which keeps unemployment rates low, is the best protection employees have from abuse by employers (because it keeps the cost of escaping abuse low) seems to be rarely, if ever, recognised in regulatory proceedings.

A related insight is that unfair dismissal laws are likely to impose costs on more diligent workers. The reason is that they tend to undermine the effectiveness of the threat of dismissal as an instrument for controlling shirking. The resultant reduction in the expected value of employment relationships (and therefore wages) for all employees, including the diligent, is compounded by the increased cost of controlling shirking by other means, such as direct supervision. Remarkably, employment protection regulations may even be counterproductive – recent research suggests that increasing the ‘strictness’ of employment protection regulations in European countries *reduces* perceived job security for private sector workers, perhaps because it increases the expected duration of unemployment in the event of job loss.<sup>34</sup>

Finally, the general principle is that any regulation that reduces the capacity of one party to impose termination costs on the other undermines the enforceability of employment contracts and therefore also erodes the values of employment relationships and, ultimately, real wages of workers.<sup>35</sup>

## Conclusion

The capacity of one person to impose either pecuniary or non-pecuniary costs on another is a source of power for the one to change the behaviour of the other, even if the other resists in some way. Recognition of this allows systematic analysis of power relativities in individual employment contracts at the time a contractual relationship is formed; over the economic life of a contract; and at the time a contract is terminated. This analysis shows that the belief that power in economically viable employment relationships is inherently imbalanced in favour of employers is untenable. However, when an employment contract ceases to be economically viable (in the sense that it

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<sup>34</sup> Clark and Postel-Vinay (2005).

<sup>35</sup> Using US research as a benchmark, Charles Baird has suggested that the effects of New Zealand’s unjustifiable dismissal restrictions could include a decrease in real compensation to employees of 7 percent and a decline in overall employment of 1.5 to 3 percent (19,000 to 47,000 jobs, 1995 figures). See Baird (1996), pp vi–vii.

no longer produces value in excess of the productive opportunity costs of the two parties) the power of one party vanishes and the other will have an incentive to terminate the contract. Ephemeral power imbalances of this kind, and the resultant efficient separations, are essential to improving the productivity of job matches and to the processes of creative destruction that drive economic growth and improvements in living standards over time.

Although there are various arrangements under which people can choose to supply their labour to productive enterprises, the individual employment contract has remained dominant since the start of the industrial revolution. For this reason, there is a strong presumption that the great majority of people judge that it delivers superior net benefits relative to alternative contractual arrangements under which their labour could be supplied for production of goods and services. The efficacy of individual employment contracts is largely attributable to three factors.

First, employment contracts give each party power to compel the other to comply with relational terms – understandings and commitments made by both the employer and the employee that underpin willingness to supply productive effort but that are too difficult, and therefore too costly, to specify in terms that can be verified and enforced by third parties, such as a court. For this reason, employment contracts are considered to be self-enforcing contracts. Employees and employers alike derive power to enforce compliance with the relational terms from mutual recognition that each has the ability to impose termination costs on the other in the event of failure to perform in accordance with relational terms. Moreover, because both parties will incur costs if an economically viable employment relationship is terminated, each can be confident that the other's enforcement power will not be used capriciously. Compliance with these relational terms is essential to maintaining the productivity and harmony of job matches.

A second reason for the dominance of individual employment contracts is that one or other of the parties has a direct financial incentive to terminate an employment relationship if it ceases to be economically viable, in the sense that the value produced falls short of opportunity costs. Such efficient separations are essential to the labour market flexibility that underlies economic growth and drives increases in real wages for employees over time.

The third reason is related to the other two. Because the self-enforcement mechanism in employment contracts is effective and low-cost, transaction costs in labour markets based on individual employment contracting are relatively low. Again, this tends to improve the value of job matches both by reducing matching costs and facilitating the processes of creative destruction. In summary, the power of employees to constrain employers, and of employers to constrain employees, is crucial to the productive value of employment relationships and therefore serves the interests of people who depend for income on sale of their labour.

The flipside of this is that labour market regulations, either individually or in combination, that affect these power relativities often have the unintended consequence of reducing the welfare of employees. There are two main reasons for this. First,

regulations that increase the expected costs of labour market transactions impede the processes of job matching and creative destruction, thereby slowing improvements in productivity and, consequently, growth of real wages. For example, employment protection laws that increase the cost of terminating employment relationships can be expected to impede economic growth by reducing people's willingness to start new, innovative enterprises and to expand existing enterprises. Second, through their effects on the costs to employers and employees of terminating employment contracts, ill-conceived labour market regulations undermine the self-enforcement properties of employment contracts, thereby eroding incentives to comply with relational terms and, consequently, the productivity of employment relationships. For example, unfair dismissal laws tend to erode the power of employers to ensure that employees devote acceptable levels of physical and mental effort to assigned tasks. Because employers cannot measure effort precisely, and adjust the wages of individuals accordingly, any consequent increase in shirking is likely to erode labour productivity and real wages for all employees, shirkers and conscientious ones alike. Importantly, to the extent that labour market regulations increase rates of unemployment for particular types of labour, the resultant increase in employee termination costs shifts the balance of power in favour of employers, thereby creating scope for unscrupulous ones to impose unreasonable demands on their employees.

The obvious (and obviously important) conclusion is that lowering unemployment rates gives employees greater power to constrain their employers, even unscrupulous employers, to comply with relational terms in their employment contracts. Moreover, because of the inherent and insuperable difficulties in enforcement of the relational terms by third parties, directly empowering employees by keeping unemployment rates low is almost certainly more effective in protecting the interests of employees generally than either law or arbitration. Accordingly, further reforms to New Zealand's labour market and employment regulations aimed at removing regulation-created distortions to power relativities in employment relationships and minimising regulation-created labour market frictions can be expected to further reduce unemployment rates and keep them lower – with the added bonus of improvements in the *quality* of employment relationships. A key area of attention should be unjustifiable dismissal laws. Redress should be available in the event of so-called wrongful dismissal – dismissal in breach of contract – but otherwise employment should be held to be at will unless the parties to employment contracts include in them substantive or procedural provisions governing termination.



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