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# Law-and-Economics Approaches to Labour and Employment Law

Stewart J. SCHWAB<sup>\*</sup>

*This article describes the distinctive approaches that law and economics takes to labour and employment law. The article distinguishes between ‘economic analysis of law’ and ‘law and economics’, with the former applying economic models to generally simple legal rules while the latter blends messier institutional detail with legal and economic thought. The article describes three eras of law-and-economics scholarship, recognizing that economics teaches that markets work and markets fail. Era One emphasizes that labour laws and mandatory employment rules might reduce overall social welfare by preventing a benefit or term from going to the party that values it most highly. Era Two emphasizes that labour and employment laws might enhance overall social welfare by correcting market failures arising from monopsony power, externalities, public goods, asymmetric information, information-processing heuristics, and internal labour markets. Era Three uses empirical methods to referee between markets-work and markets-fail approaches. The article argues that unequal bargaining power is not a standard market failure, because even powerful employers have a profit-maximizing motive to provide benefits, such as vacation or safety, that workers are willing to pay for.*

## 1 INTRODUCTION

Law and economics has been a distinct methodology within labour- and employment-law scholarship for nearly forty years, even though the field was one of the last areas of law to which law-and-economics scholars gave sustained effort. In this essay I describe some of its distinct features. Following this introduction, section 2 starts with terminology, including a possible distinction between ‘law and economics’ and ‘economic analysis’. It then sketches the history of law and economics generally, separating it into era one (markets work), era two (markets fail), and era three (empirical studies are needed to referee between eras one and two). These eras help explain why law and economics took a while to come to labour and employment law. Section 3 introduces a stylized example of mandatory vacation leave to illustrate economic analysis of employment law, and then describes the American tort of wrongful discharge in violation of public policy (WDVPP) to illustrate a grittier law-and-economics analysis of legal

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doctrine. Section 4 outlines some of the core concepts of the law and economics of labour and employment law. Section 5 briefly discusses the empirical turn in law-and-economics labour- and employment-law scholarship. Throughout, I will mainly refer to American law for examples – for the humble reason that American law is what I know best and therefore might be of most assistance to the reader, even though one of the attractions of economic analysis is that it can be applied across legal borders.

## 2 TERMINOLOGY AND BOUNDARIES

Let me start by defining the scope of the field.

### 2.1 LABOUR, EMPLOYMENT, AND WORKPLACE LAW

At its broadest, our subject matter includes all legal regulation affecting the workplace. This includes specific statutes like those prohibiting employers from discriminating against employees on the basis of race or sex (title VII), or laws mandating safety guards on workplace machines (Occupational Safety and Health Act), or laws regulating leave time (Family and Medical Leave Act). It also includes more general laws that have specific applications to workers, such as defamation law as it applies to employer reference letters, or the tort of intentional infliction of emotional distress as it applies to a boss berating a worker, or contract law as it applies to an employer failing to comply with its own employment manual.

Since around 1990, scholars and practitioners have distinguished between labour law and employment law. Before then, labour law was an umbrella term covering all laws regulating the workplace, although scholars focused on the laws regulating unions. Increasingly since 1990, ‘labour law’ regulates unions and ‘employment law’ comprises all the other laws regulating the workplace. With ‘labour law’ no longer covering the entire field, some scholars have suggested a new umbrella term of ‘workplace law’, but it seems this term is not yet as commonly used as the clunkier ‘labour and employment law’. I will be clunky in this essay.

Most readers of this journal have their own good grasp of the boundaries of labour and employment law (and if they lose sleep over holes in the fences, which Alan Bogg asserts they do not, I recommend his excellent essay in this issue on philosophical perspectives on labour law).<sup>1</sup> I will not further delineate the legal boundaries, but turn to the terminology of economic analysis.

<sup>1</sup> A. Bogg, *Labour, Love and Futility: Philosophical Perspectives on Labour Law*, 33(1) Int’l J. Comp. Lab. L. & Indus. Rel. (2017).

## 2.2 ECONOMIC ANALYSIS

There is considerable internal debate over what economics is.<sup>2</sup> Some say that economics is the study of how economies function at the individual and societal level. Others declare that economics is less about subject matter (the economy), than about how humans make decisions, particularly how they (would) make rational choices that maximize their welfare under conditions of scarcity. Many economists do not bother to define economics, whether viewed as a subject matter or a methodology, following the well-known 1930s economist Jacob Viner who supposedly said that ‘economics is what economists do’. As Backhouse and Medema sum up after quoting a cacophony of economists, ‘economics is apparently the study of the economy, the study of the coordination process, the study of the effects of scarcity, the science of choice, and the study of human behavior’.<sup>3</sup>

## 2.3 ECONOMIC ANALYSIS OF LAW, OR LAW AND ECONOMICS

These definitions of economics seem somewhat off point in describing economic analysis of law, and especially law and economics, terms I will distinguish shortly. Modern law and economics is often dated as beginning with Ronald Coase’s article on ‘The Problem of Social Cost’ in 1960<sup>4</sup> and Guido Calabresi’s article on ‘Risk Distribution and the Law of Torts’ around the same time.<sup>5</sup> Both articles analysed fundamental aspects of property and tort law.

Coase introduced law-and-economics analysis by assessing how rational actors would respond to a change in a specific law. In his famous example, Coase compared an enclosure versus a free-range law—that is, he compared how cattle ranchers and corn farmers would fare when the law required ranchers to pay damages to farmers for corn trampled by escaping cattle, versus when the law found the ranchers not liable. The resulting Coase Theorem declared that, when no transaction costs prevented ranchers and farmers from bargaining, the same amount of cows and corn would exist under either law. But Coase’s real message was the importance of studying transactions costs and how they inhibited efficient bargains.

Law and economics proceeded from this basic framework in many directions. It expanded in the scope of legal doctrines, from core private-law doctrines like contract, property, and tort law out to procedure, corporate law, constitutional

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<sup>2</sup> For a recent discussion, see R. E. Backhouse & S. G. Medema, *Retrospectives: On the Definition of Economics*, 23 J. Econ. Pers. 221 (2009).

<sup>3</sup> *Ibid.*, at 221, 222.

<sup>4</sup> R. H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960).

<sup>5</sup> G. Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 Yale L.J. 499 (1961).

law, and beyond – including rather late in the game, labour and employment law. Law and economics also expanded in methodological sophistication, from basic concepts like rationality and social efficiency to market failures arising from asymmetric information, public goods, and cognitive heuristics.

With a broad brush, one can paint three eras of law and economics. In the first era, scholars emphasized that markets work. A well-functioning market enhances trade so that resources go where they are most valuable, thereby maximizing social welfare. An efficient law bolsters or enhances the market, often by enforcing contracts, and the scholar's task is to analyse how a particular law enhances or inhibits market efficiency. In the second era, scholars emphasized that markets fail. Markets can have monopoly, limited-information, public-goods, or other problems that prevent resources from going to their most valued use, thereby creating inefficiencies. The role of law often is to reduce or correct market inefficiencies. These two eras often clashed with competing models showing that markets work and do not work. This led to a third era, empirical testing of economic models. Theory and counter-theory can only go so far, and facts on the ground are needed to resolve many debates about the effects of law.

#### 2.4 THE TIMELINE OF LAW AND ECONOMICS OF LABOUR AND EMPLOYMENT LAW

Law and economics was relatively slow to cover labour law, and even slower to cover employment law. A few scholars made forays in the 1970s, with more sustained analysis coming in the 1980s and later. This growth is illustrated by the various editions of Richard Posner's classic *Economic Analysis of Law*. Posner published his first edition in 1972. It was a tour de force demonstrating how economic analysis could be applied to specific doctrines in an amazing range of legal fields. Posner's first edition included a puny six-page 'Note on Labor Law' (out of 395 total text pages, or 1.5%), dealing only with labour unions as monopolies.<sup>6</sup> The second edition in 1977 expanded to a full eleven-page chapter (2% of the total text pages) on 'The Regulation of the Employment Relation', still mostly dealing with labour unions but also analysing minimum-wage, workplace-safety, and anti-discrimination laws.<sup>7</sup> By the latest edition in 2014, Posner's treatise had continued to expand the attention given to employment law both absolutely (thirty-six pages), relatively (3.5% of all pages), and in scope of topics, adding a discussion of employment at will, the labour-market failures for judicial law clerks, mandated benefits, and pension law.<sup>8</sup> Even by

<sup>6</sup> R. A. Posner, *Economic Analysis of Law* 133–138 (1st ed., Little Brown 1972).

<sup>7</sup> R. A. Posner, *Economic Analysis of Law* 239–249 (2d ed., Little Brown 1977).

<sup>8</sup> R. A. Posner, *Economic Analysis of Law* 427–462 (9th ed., Wolters 2014).

1990, enough scholarship existed that I could write a survey article on ‘The Economics Invasion of Labor Law Scholarship’.<sup>9</sup>

The early law-and-economics analysts focused on labour laws regulating unions. Perhaps they were slow to the field because, at first blush, in an era that emphasized that markets work and laws should promote efficiency, there seemed little to say about laws protecting unions and promoting collective bargaining other than that the laws were inefficient. Unions were viewed as monopolists restricting labour supply, doing their best (with the help of law) to raise wages above competitive levels. Like other monopolies restricting supply, unions inefficiently prevented mutually beneficial bargains between those workers willing to work at a lower wage (now unemployed by the union monopoly) and employers willing to hire at those lower wages.

Of course, a careful economic analysis can probe the consequences of specific labour-law doctrines, even accepting the basic premise that the law condones or even fosters monopoly unions. Work in the 1980s by Thomas Campbell<sup>10</sup> and Douglas Leslie<sup>11</sup> took this approach and usefully increased our understanding of secondary boycotts, appropriate bargaining units, and the like.<sup>12</sup>

The 1980s saw scholars apply the second-era theme of market failure to labour law. In particular, law-and-economics scholars applied the brilliant insights from labour economists Freeman and Medoff that unions had two faces (to paraphrase the title of their 1983 book).<sup>13</sup> One face was the traditional monopoly role whereby unions restricted labour supply, benefitting their members by raising wages but inefficiently limiting jobs. But the other face was an efficiency-enhancing role that emphasized that unions could enhance voice, solving public-goods problems in the workplace rather than relying on market-based exit. The workplace has many local public goods. A paradigm example is the factory line that can run at only one speed for all workers rather than be tailored to individual worker preferences. A union bargaining with management, representing the median worker, may reach a more efficient speed in ways that a non-unionized workplace, relying on exit of workers, cannot.<sup>14</sup>

Ironically, just as the academic economists and lawyers were exploring this efficiency face of unions, the economic clout of unions was plummeting. In the

<sup>9</sup> S. J. Schwab, *The Economics Invasion of Labor Law Scholarship*, in *Proceedings of the 41st Annual Meeting of the IRRRA* 236–242 (B. D. Dennis ed., 1989).

<sup>10</sup> T. J. Campbell, *Labor Law and Economics*, 38 *Stanford L. Rev.* 991 (1986).

<sup>11</sup> D. L. Leslie, *Labor Bargaining Units*, 70 *Va. L. Rev.* 353 (1984).

<sup>12</sup> For a more recent take, see M. L. Wachter, *The Striking Success of the National Labor Relations Act*, 37 *Reg.* 20 (2014).

<sup>13</sup> R. B. Freeman & J. L. Medoff, *What Do Unions Do?* (Basic Books 1984).

<sup>14</sup> See K. Dau-Schmidt, *A Bargaining Analysis of American Labor Law*, 91 *Mich. L. Rev.* 419 (1992) (exploring how various labour laws can help this efficiency-enhancing role of unions).

United States membership in the private sector plummeted from the 1950s high of 28% to the 1980s level of 20% to the nadir of 6% today. Unions and labour law may have an important efficiency-enhancing role in theory, but in practice it was swamped by other factors making private-sector unions of increasingly limited relevance. The continuing strength of public-sector unionism is its own topic of analysis for labour lawyers and economists. A core explanation is that governments are monopolies in their products, and unions can force a sharing of monopoly gains with their worker/members, thereby maintaining the support that is lacking in the private sector where globalization has demolished many product monopolies.

Law-and-economics scholars increasingly turned to employment law. Some used what I am labelling the era-one approach to show how background law could enhance the salutary effects of efficient markets. An example here is Richard Epstein's well-known defence of the at-will employment rule as helping sort workers into their most-productive positions.<sup>15</sup> In a nutshell, Epstein argues that the at-will rule allows employers to fire unproductive workers without the expense required in a just-cause regime, preventing inefficient shirking by workers, and that good workers are protected by the profit-maximizing incentives of employers to keep productive workers even if they could be arbitrarily fired. Other scholars used an era-two approach that justified law as overcoming market failures.<sup>16</sup> Among the many examples here are scholars suggesting that the anti-discrimination laws, even while interfering with employer freedoms, could enhance overall efficiency.<sup>17</sup>

More recently, employment law-and-economics scholars have turned to era-three empirical testing of hypotheses. Theory demonstrates how markets might work or fail, or demonstrates how laws might bolster market efficiency or are needed to correct market failure. But theory merely generates hypotheses. Data are needed to reject or not reject these hypotheses. To take just one example, many have hypothesized that the erosions of the at-will rule in various American jurisdictions have increased employer costs and thereby reduced employment. Autor et al. attempted to empirically test this hypothesis by comparing state employment rates over time with the adoptions of at-will exceptions, finding a

<sup>15</sup> R. Epstein, *In Defense of the Contract at Will*, 51 U. Chi. L. Rev. 947 (1984).

<sup>16</sup> See S. J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 Mich. L. Rev. 8 (1993); S. L. Willborn, *Individual Employment Rights and the Standard Economic Objection: Theory and Empiricism*, 67 Neb. L. Rev. 101 (1988).

<sup>17</sup> S. J. Schwab, *Employment Discrimination*, in *Encyclopedia of Law and Economics* vol. 3, 572–595 (Boudewijn Bouckaert & Gerrit De Geest eds, 3d ed., Edward Elgar 2000); R. H. McAdams, *Cooperation and Conflict: The Economics of Group Status Production and Race Discrimination*, 108 Harv. L. Rev. 1003 (1995); J. J. Donohue III, *Is Title VII Efficient?*, 134 U. Pa. L. Rev. 1411 (1986); S. J. Schwab, *Is Statistical Discrimination Efficient?*, 76 Am. Econ. Rev. 228 (1986).

moderate negative effect.<sup>18</sup> I leave to others (including the essay in this issue by Zoe Adams, Parisa Bastani, Louise Bishop, and Simon Deakin) to more fully analyse empirical studies of labour and employment law.<sup>19</sup> My major point here is to note that, while scholars of many methodological stripes are interested in the empirical turn in labour- and-employment-law scholarship, law-and-economics scholars are especially amenable to empirical legal studies.

## 2.5 CONTRASTING LABOUR ECONOMICS WITH LABOUR LAW AND ECONOMICS

Labour economists might smile or cringe (depending on their individual temperament) at my myopic dating of the labour-law-and-economics field from the 1970s. Labour economics was a well-established branch of economics for centuries before that. Indeed, one of the central insights of Adam Smith at the dawn of economics was about labour economics. In his famous pin-factory example, Smith emphasized the productivity advantages from specialization by workers in a factory setting. Some workers can specialize in the heads, others in the shaft, and overall they can produce many more pins than workers making the entire pin individually.<sup>20</sup> This is an economic study of labour markets, but not a study of labour law. Other labour economists, ranging from J.R. Commons to Hank Farber, do study the effects of law on labour markets. The range of studies on the effects of minimum-wage laws is a clear example.

No sharp line separates a labour economist from a labour law-and-economics scholar. The former usually has an office in the economics department of an arts and sciences college, and the latter in a law school. Labour economists are generally comfortable with crunching data to test hypotheses. Indeed, labour economists were among the first to apply modern econometrics methods to study their field. Some labour law-and-economics scholars have engaged in empirical studies, but not as extensively as labour economists. They almost surely have analysed labour- or employment-law doctrine in granular detail, while labour economists examine the law from a loftier viewpoint. But there is more to the distinction.

The distinction can be framed by contrasting the labels 'economic analysis' of employment law and 'law and economics' of employment law. Many scholars see no substantive difference between the two labels, and I confess I treated the terms as synonyms until learning of Geoffrey Miller's helpful distinction.<sup>21</sup> Economic

<sup>18</sup> See D. Autor, J. J. Donohue III & S. J. Schwab, *The Costs of Wrongful-Discharge Laws*, 88 Rev. Econ. & Stat. 211–231 (2006).

<sup>19</sup> See especially Z. Adams, P. Bastani, L. Bishop & S. Deakin, *The CBR-LRI Dataset: Methods, Properties and Potential of Leximetric Coding of Labour Laws*, 33(1) Int'l J. Comp. Lab. L. & Indus. Rel. (2017).

<sup>20</sup> A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* book I.1 (1776).

<sup>21</sup> G. P. Miller, *Law and Economics versus Economic Analysis of Law*, 19 Am. Bankr. Inst. L. Rev. 459 (2011).



analysis brings the principles and reasoning of economics to examine the effects of a law or legal doctrine. Law and economics, as the name suggests, combines both legal and economic modes of thought, and perhaps even prioritizes law by non-alphabetically listing it first. Law brings ‘the understanding of complex institutions, politics, and social policies’ to the analysis.<sup>22</sup> In our context, an example might be the comparison between Card and Krueger’s economic analysis of minimum-wage laws<sup>23</sup> and Shaviro’s law-and-economics analysis.<sup>24</sup> Prominent economists Card and Krueger empirically examined the unemployment and income-distribution effects of minimum-wage laws, including gathering their own data on fast-food restaurants in New Jersey and neighbouring Pennsylvania before and after New Jersey raised its minimum wage. Card and Krueger found that raising the minimum wage, contrary to the standard economic theory, often *increased* employment or had no effect. Shortly afterwards, prominent law professor Daniel Shaviro also assessed the minimum wage, using a framework that compares taxes, government spending, and regulation, and compares in detail minimum-wage laws and a host of tax and welfare policies including the earned income tax credit. Shaviro criticizes Card and Krueger’s conclusions,<sup>25</sup> but that is not the point of my distinction. Rather, my point is the difference in style and range of analysis brought to bear, ideally in a mutually reinforcing way. As Miller concludes in comparing the approaches (using a different example than Card/Krueger versus Shaviro), the law-and-economics methodology ‘makes the task messier and more complicated [than economic analysis] but also potentially richer and more revealing’.<sup>26</sup>

### 3 TWO EXAMPLES

A general discussion of the law and economics of employment law can quickly become overly abstract or general, so in this section I give two concrete examples to illustrate the style of thinking. The first is a simple, stylized sketch of workers and employers interacting over a wage-benefit package. It illustrates a basic economic analysis of mandatory vacation-leave law. The other example puts actual common-law cases of WDVPP into an economics frame, illustrating a law-and-economics analysis of employment law.

<sup>22</sup> *Ibid.*, at 460.

<sup>23</sup> D. Card & A. B. Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton University Press 1995).

<sup>24</sup> D. Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. Chi. L. Rev. 405 (1997).

<sup>25</sup> *Ibid.*, at 405, 406.

<sup>26</sup> Miller, *supra* n. 21, at 459, 465.

## 3.1 STYLIZED EXAMPLE OF ECONOMIC ANALYSIS OF MANDATORY VACATION LAW

Suppose a widget factory pays its workers wages and can also give paid vacation leave (perhaps responding to a legal mandate). The economic question is what amount of vacation is optimal – in the sense of maximizing total social welfare or, equivalently in this example, the welfare of workers as perceived by the workers themselves.<sup>27</sup>

In this stylized world, widgets sell for 1 each (the denomination can be dollars, euros, yuan, pesos, or whatever). If workers work year-round without vacation, each worker produces 900 widgets per week, or 46,800 widgets per year. See Table 1, row 0, columns 3–4 (ignore the salary and profits columns for a moment).

*Table 1 Stylized Example of Employer and Employee Valuation of Vacation Benefits*

(1) Weeks of Vacation	(2) Total Value of Vacation to Worker	(3) Weekly Output	(4) Annual Output: (3)x [52-(1)]	(5) Annual Salary: [Negotiated]	(6) Profits to Employer: (4)-(5)
0	0	900	46,800	35,000	11,800
1	2,000	1,000	51,000	36,000	15,000
2	3,200	1,000	50,000	34,900	15,100
3	3,900	1,000	49,000	33,800	15,200
4	4,400	1,000	48,000		

As the industrial engineers can show for this stylized industry, a week's vacation increases worker productivity by allowing healthful rest and recuperation. With a week of vacation, each worker produces 1,000 widgets during each working week, rather than merely 900 without a vacation, or 51,000 widgets per year. See row 1, columns 3 and 4. Thus, even accounting for the week without work, a week's vacation increases total productivity for the year.

Increasing vacation beyond a week does not further increase weekly productivity, however. With one or more weeks' vacation, workers produce the same 1,000 widgets each workweek. But workers want more vacation. Indeed, each worker would be willing to pay (or, equivalently, accept a lower salary) up to 1,200 for a second week of vacation, compared to their salary with a single week of

<sup>27</sup> For an empirical study of the tradeoffs between wages and vacation, see J. G. Altonji & E. Usui, *Work Hours, Wages, and Vacation Leave*, 60 *Indus. & Lab. Rel. Rev.* 408 (2007).

vacation—perhaps using this second week to visit their mother. Each worker also values a third week of vacation (to visit their uncle, say) at up to 700—not quite as much as they value the second week visiting their mother. A fourth week is still valuable (to visit their teacher, we teachers can hope), but marginally less valuable. No one in this widget industry has ever considered more than four weeks' vacation, so our chart stops there.

Now suppose the annual salary for Employer 0 (offering no vacation) is 35,000. Why this particular salary? For now we simply assume it comes from bargaining between employer and worker, and the exact amount is somewhat arbitrary. The employer is willing to pay this amount because it earns a profit (of 11,800) that it would not receive without the worker. Of course the employer would prefer a lower salary, just as the worker would prefer a higher salary, but the bargaining set it here. The worker is willing to work here because this is better than other available alternatives. Later we can discuss more precisely the important detail of how salaries are set, and in particular examine differences between a single, monopsonist employer and many competitive employers.

Let us compare Employer 0 and Employer 1. Employer 0's contract with no vacation is less efficient, because both employer and employee would prefer a contract calling for one week's vacation and a salary of 36,000. Workers prefer this, because it has a higher salary and more vacation. And Employer 1 also prefers it because profits are higher. Thus a law mandating one week's vacation improves efficiency by making both parties better off than a situation of no vacation. What an easy comparison—everything is higher with a one-week vacation mandate, including vacation length, weekly output, annual output, salary, and profit. Both parties directly benefit from a week of vacation. What an uncontroversial, efficient law! But what a trivial law, because both employer and worker would agree to one week of vacation even without a legal mandate.

Comparisons are slightly less obvious between Employer 1, offering one week of vacation, and Employer 2 offering two weeks of vacation. If the salary were to remain the same, the worker would prefer Employer 2, but investors would prefer Employer 1. A stalemate. But notice that the worker gains more by a second week of vacation (1,200) than the employer loses (1,000 in lost annual output). This allows for a trade that makes both parties better off. Compared to the Employer 1 contract, both employer and worker prefer a contract that reduces the salary somewhere between 1,000 and 1,200 and calls for two vacation weeks.

A law mandating that employers provide at least two vacation weeks again improves efficiency, but again the law is unnecessary. Both employer and worker would agree to a second week of vacation, even without the legal mandate. This time, the agreement comes not because both sides directly benefit from the extra

week of vacation. Rather, because gains exceed losses, the worker can compensate the direct harm to the employer by accepting a lower salary, and still be better off.

The comparisons change between Employers 2 and 3, because now the cost of the third vacation week (1,000) exceeds the value to the worker (700). The parties have no mutually acceptable deal with three vacation weeks that both prefer to two weeks. No salary/three-week-vacation contract exists that both employer and worker would prefer to their 34,900/two-week contract.

The law could still mandate three weeks of vacation, but that would be inefficient. The inefficient law makes workers (and employers) worse off, because workers would prefer a contract with less vacation and more pay, and employers are willing to offer that contract if the law did not forbid it. If a three-week law stays in place, Employer 3 will reduce salaries compared to Employer 2 by at least 1,000.

### 3.1[a] *Lessons*

What are the lessons from this stylized example of economic analysis of a mandated vacation law? First, notice the simplicity of the economic reasoning. Equating marginal cost and benefit is the concept lurking behind the example, but that jargon need not be express. This example is very much in the style of Ronald Coase's 1960 pathbreaking economic analysis of how farmers and ranchers would respond to laws allowing open range versus placing liability on cattle trampling crops.<sup>28</sup> Coase often explained his economic arguments through simple examples like this, and eschewed 'blackboard economics' or 'mathematical jargon'.

Second, 'value' is the key element in the illustration –with value being defined as willingness and ability to pay. For the employer, each week of vacation beyond the first costs 1,000 in lost output. Cost is the opposite of value, so the employer values each vacation week at -1,000 (i.e., the employer would be willing to pay up to a smidgen less than 1,000 in extra wages to avoid the worker taking another vacation week). For the worker, the value of each vacation week comes in the form of willingness to accept a lower salary. Later, when I discuss some of the subtleties behavioural economics has introduced to the economic analysis of employment law, we can examine how workers may react differently to giving up a week of vacation versus bargaining to get another week of vacation. This is often characterized as the difference between the maximum willingness to pay to get something versus the minimum willingness to accept to relinquish something. The current illustration finesses this willingness to pay/accept distinction by framing the labour market as having various employers offering different salary/

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<sup>28</sup> Coase, *supra* n. 4.

vacation packages to beginning workers, and workers gravitating to the package they most prefer.

Third, the example shows that an efficient employment contract maximizes the total valuation by both sides to the contract. In Table 1 above, the efficient contract is offered by Employer 2, maximizing the total value of vacation to the worker measured by the worker's willingness and ability to accept a lower salary (column 2) plus the total value of the output (column 4). Row 2 maximizes this sum. An efficient contract (the largest pie) can make both parties better off than any smaller pie, with an appropriate cutting of the slices.

Fourth, an efficient employment contract allocates each item to the party that values it most highly. Here, the two items are vacation weeks and money. Workers value week two of vacation more than employers do, while employers value weeks three and four more than workers do. So the efficient contract allocates vacation weeks one and two to the worker, and weeks three and four to the employer. However, no efficiency gains come from raising or lowering wages. Each side is willing and able to pay up to a dollar for a dollar, and thus each side values a dollar equally. No efficiency gains or losses come from making the wage higher or lower by itself, without trading off other items. (I assume here that the number of workers and weekly work hours are fixed.)

Fifth, the example shows that employers will sometimes provide benefits even without a legal mandate. Labour-law scholars sometimes overlook this simple point. Even with no statute mandating vacation, employers in our example willingly offer two weeks. It is often unnecessary for the law to mandate an efficient result.

Sixth, the example suggests only a limited role for law. This stark example makes a number of assumptions, including the core Coasean-world assumption that transaction costs are not large enough to prevent efficient bargaining. We are also assuming a background legal system that enforces employment contracts—so that workers get their wages and bargained-for vacation, and employers get the surplus profits. With these assumptions, an employment law mandating up to two weeks' vacation is trivially unnecessary, in that the parties would agree to the contract without the specific employment law. On the other hand, a law mandating 'overly generous' three or more weeks' vacation is not trivial but is inefficient, in that workers are worse off with the law than without it.

Finally, if we consider transactions costs, the role of law can be larger. An efficient law can reduce transaction costs by setting a presumption based on what most parties would want—a 'mimic the market' strategy. In our example, if law-makers are sure that two weeks is the optimal amount of vacation, they can mandate this level and save the parties the costs of bargaining over vacation pay. If workers and firms vary in their valuations, however, the law might do better by

creating a presumption of two weeks based on what most parties want, but allowing the parties by individual contract to agree to a different amount. By choosing what most parties want, this saves transaction costs for most parties. If the law-makers cannot determine what most parties want, another possible default rule could be based on relative transaction costs.

### 3.2 THE LAW AND ECONOMICS OF THE TORT OF WRONGFUL DISCHARGE IN VIOLATION OF PUBLIC POLICY

The prior example had highly stylized facts, ideal for economic analysis. Let me now describe the messiness of a common-law doctrine and see if a law-and-economics framework can help us understand it.

WDVPP is an American tort, arising from the backdrop of the American default rule of employment at-will. Law-and-economics scholars have debated the efficiency merits and demerits of the at-will rule.<sup>29</sup> I will not rehearse the arguments here, so for purposes of the illustration I will not attack the wisdom or efficiency of at-will employment by itself. Rather, I intend to briefly sketch cases in which employees asked courts for a tort exception to at-will employment. Courts sometimes adhered to the at-will rule and rejected their claims, but sometimes accepted the claims, creating the common-law tort of WDVPP. The question is whether we can give a law-and-economics account of this tort, explaining both the winning and losing cases.<sup>30</sup>

Consider these cases. In each case, the employment is at-will, which we can think of as an express agreement whereby the employer agreed to a higher wage in return for the legal right to fire for any reason without court scrutiny.

- (1) An employee is fired for refusing to commit perjury when the government investigates the employer for racketeering. Judgment: employee wins.
- (2) An employee is fired for absenteeism after being called for jury duty. Judgment: employee wins.
- (3) A bartender employee is fired for refusing to serve beer to an intoxicated customer. Judgment: employee wins.

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<sup>29</sup> See Epstein, *supra* n. 15; W. Kamiat, *Labor and Lemons: Efficient Norms in the Internal Labor Market and the Possible Failures of Individual Contracting*, 144 U. Pa. L. Rev. 1953 (1996); Schwab, *supra* n. 16, at 8; J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 1995 Wis. L. Rev. 837 (1995).

<sup>30</sup> For a more extensive analysis of this question, see S. J. Schwab, *Wrongful Discharge Law and the Search for Third Party Effects*, 74 Tex. L. Rev. 1943 (1996).

- (4) A sailor is fired for refusing orders to illegally dump bilge water into the harbour or for reporting the illegal dumping by co-workers. Judgment: employee wins.
- (5) A bank employee is fired for telling the bank's executives that the police are investigating his boss for embezzlement. Judgment: employer wins.
- (6) An employee is fired for punching back when a co-worker attacks the employee. Judgment: employer wins.
- (7) An employee is fired for showing up late for work after being in a car accident. Judgment: employer wins.
- (8) An employee is fired after her estranged husband beats her off-work, because the employer wanted to avoid dealing with the situation. Judgment: employer wins.

These are snippets from eight of the thousands of cases alleging WDVPP. Some observers find the court judgments to be a confusing cacophony. Worker-rights advocates root for the worker in each case. But some order is visible if we remember two principles of the law and economics of contracts and torts: First, contracting parties themselves are generally best able to assess their own interests and decide what employment contract furthers their interests, with the court's primary role being to enforce but not second-guess the parties' intentions. Second, a central purpose of tort law is to force parties to internalize the adverse consequences of their conduct on third parties.

The ordering principle, then, is whether the firing has direct third-party effects. Of course, every firing harms the employee and thereby harms society. But the harms to others are indirect, through the harm to the employee. We can assume that the employee considered the pros and cons to the employee of at-will employment when accepting the contract. Therefore a court will not step in and reset the bargain when the dispute is merely between employer and employee. But when the court sees direct harm to third parties from the employer curtailing the employee's actions, it upholds the employee's claim.

Third-party effects occur in cases (1)–(4). Not only does the firing harm the employee and the employee's family directly, but it also directly harms the rest of us by encouraging perjury, limiting the jury pool, increasing drunk driving, or polluting the harbour.

By contrast, cases (5)–(8) do not have direct third-party effects. The bank employer in case (5) may get less information about its workers, but the rest of us are harmed only if that harms the bank. Resolving a fight between co-workers incorrectly (case (6)) does not directly harm the rest of us. In case (7), the court considered that the employee in a car wreck risking dismissal by showing up late

for work might not seek immediate medical attention, and that delayed medical attention might increase medical bills that the rest of us subsidize. But this seems remote rather than direct. Even in the appalling facts of case (8), the rest of us are harmed by the battered wife being fired only through the harm to the wife, not direct harm to an outside-the-workplace interest.

This law-and-economics explanation of a tort doctrine is messier than the stylized economic analysis of vacation benefits presented earlier, and would be still messier if I discussed outlier cases. Its ordering principle distinguishes between private and public spats, itself a hugely controversial if not incoherent divide. The rule cannot explain every decision, but can help explain both employer and worker victories by focusing on the efficiency goals of tort law.

#### 4 KEY CONCEPTS IN THE LAW AND ECONOMICS OF EMPLOYMENT LAW

With the two illustrations in hand, let me make some more general remarks about the methodology of law and economics of employment law.

##### 4.1 THE RATIONALITY ASSUMPTION

Rationality is a core assumption of law and economics, as it is for economic analysis more generally. Economic models generally assume that actors know their preferences and make choices that maximize their overall welfare (synonymous with utility), based on these preferences. Be they individuals, corporations, labour unions, or whomever, actors respond to the law's sanctions like they respond to other constraints, by choosing actions that maximize their welfare subject to the constraint. The job of the economic analyst is to predict how rational actors will respond to a law (and, ideally, the analyst completes the job by testing empirically whether the prediction is correct—but more on empirical studies at the end of this essay). In our simple vacation example, we assumed that our worker knows how much utility he gets from a week's vacation and rationally chooses between vacation and the utility he would get from higher pay.

The rationality assumption is controversial and often misunderstood. Personal reflection shows that no one always rationally chooses actions that maximize their wellbeing. Greed, envy, lust, rage, and other passions block rational decision-making, along with limited information, biases, and heuristics. But economists do not view this as a fundamental criticism of their methodology. First, rational decision-making is a prediction that itself can be tested empirically. Economists generally admire parsimonious models with simple explanations, even when they do not capture every nuance or variation of human behaviour. Economists are



suspicious of ‘thick’ explanations that by trying to be all-encompassing create mushy stories that cannot be falsified. Second, economists have fruitfully studied passions and incorporated them into broader models of rationality, by showing how passions help humans maximize their long-run utility by, for example, using rage to convince others to keep their promises to the enraged actor even when it would not be rational in the short term for the enraged actor to retaliate.<sup>31</sup> Third, economists can incorporate insights from behavioural psychology (rebranding them as behavioural economics) to include rules of thumb and other heuristics as part of human decision-making.<sup>32</sup>

#### 4.2 MAXIMIZING SOCIAL WELFARE

Moving from the rationality assumption of individual decision-making, the next key concept of economic analysis is social efficiency. This is a subtle, slippery concept. A situation is efficient when, considering all the costs and gains to all actors, the net gain is maximized, or equivalently when the overall harm is minimized. In some situations, such as workplace accidents, it usually seems more useful to conceptualize the goal as minimizing the overall costs of accidents and avoiding accidents. In other situations, like most bargaining or contract settings where each party hopes to gain from the bargain, it seems more accurate to conceptualize the goal as maximizing the net gain to all parties. In either case, the gain or cost is from the actor’s own perspective as measured by the actor’s willingness and ability to pay for the item.

#### 4.3 POSITIVE AND NORMATIVE ANALYSIS

Many economists (but fewer law-and-economics scholars) say they are engaged in positive analysis rather than a normative assessment. Thus, when assessing a minimum-wage law, for example, they might say the law is inefficient or non-optimal, in that it prevents employment contracts between willing workers and employers at low wages, often increasing unemployment. Other economists suggest that minimum-wage laws can increase employment in markets where employers have significant monopsony power.<sup>33</sup> Ultimately, these are empirical questions that can and have been tested.<sup>34</sup> But my point here is that economists on both sides often

<sup>31</sup> See R. Frank, *Passions Within Reason: The Strategic Role of the Emotions* (W. W. Norton & Co. 1988).

<sup>32</sup> See C. Jolls, C. R. Sunstein & R. Thaler, *A Behavioral Approach to Law and Economics*, 50 *Stan. L. Rev.* 1471 (1998).

<sup>33</sup> See B. E. Kaufman, *Institutional Economics and the Minimum Wage: Broadening the Theoretical and Policy Debate*, 63 *Indus. & Lab. Rel. Rev.* 427 (2010).

<sup>34</sup> Card & Krueger, *supra* n. 23.

say they are not taking a normative position on the wisdom of the law, merely assessing its effects.

Non-economists are rightly sceptical. The very terms ‘optimality’ and ‘efficiency’ are loaded with normative connotations. Most law-and-economics scholars take a normative as well as positive approach, and applaud an efficiency-enhancing law and criticize an inefficient law, all else equal.

#### 4.4 UNINTENDED CONSEQUENCES

Law-and-economics scholars often delight in pointing out the unintended consequences of a law. In our stylized vacation-benefits example, we examined seemingly pro-worker laws mandating three vacation weeks – and why not four or five or twenty? The economics answer is that, whenever the costs to the employer exceed the gains to workers, mandating the benefit actually harms workers. The unintended consequence is the lower wage. Real world examples of unintended consequences might include the increased unemployment arising from minimum-wage laws or from laws requiring reasonable accommodation for workers with disabilities.

Other labour scholars too often ignore, the law-and-econ types think, these unintended consequences. Sometimes the ignorance comes from an (often unstated) assumption that employers will abide by laws without adapting their behaviour to ameliorate the laws. Sometimes the assumption is that exploitative employers have substantial amounts of money that they will simply give up when the law forbids or taxes a practice, rather than move to other activities.

#### 4.5 OVERALL SOCIAL WELFARE AND AGNOSTICISM AS TO WHO WINS

Most employment scholars believe they are championing workers, and use a methodology whereby the protection of workers is and should be the prime aim of employment law. As the prominent employment-law scholar Clyde Summers put it in applauding the rise of employment protections (while bemoaning the decline of collective bargaining): ‘if collective bargaining does not protect the individual employee, the law will find another way to protect the weaker party. The law, either through the courts or the legislatures, will become the guardian’.<sup>35</sup>

One problem with a law-protects-weak-workers framework is that it often seems unrealistic as a positive description of politics. Who creates the law, the weak or the strong? One possible answer is that workers are weak in economics

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<sup>35</sup> C. W. Summers, *Labor Law as the Century Turns: A Changing of the Guard*, 67 Neb. L. Rev. 7, 9–10 (1988).

but strong in politics, and that is why the law (based on one person one vote, with workers the most numerous voters) protects workers who are weak in the economic sphere (based on one dollar one vote, with capitalists or managers having more dollars). However, this still seems an unrealistic view of politics, where many decry the undue influence of money.

Supporters of the law-protects-weak-workers positive claim point to laws that seemingly favour workers, such as minimum wage laws. Even here, public-choice theorists might argue that these employment laws favour well-paid unionized workers who face less competition from lower-skilled workers, while harming those low-skilled workers who become unemployed after a minimum-wage increase.

The law-and-economics perspective takes greater issue with the normative premise of protecting weak workers, in that the protect-weak-workers premise has no limit. That premise can only say the law is good if workers get more; otherwise the law is bad. To return to our simple vacation example, a law-protects-workers approach would presumably push for as much vacation as possible. But does this mean three weeks is better than two, ten weeks is better than six, thirty weeks vacation is better than fifteen, or that fifty-two weeks vacation is the ultimate goal of employment law? At some point, workers have too much legal protection, but the law-favours-weak-workers approach has a hard time articulating that point, even conceptually.

Law-and-economics scholars use a different measuring rod, overall social welfare.<sup>36</sup> It thus can articulate the stopping point for protecting workers. The welfare of workers is important, but so is the welfare of consumers, children, retirees, investors, and other non-workers. Humans take on all these roles. Jobs, job growth, or protection of workers is not an ultimate goal of the good society, but merely an important means to the goal of improving overall social welfare. Even limiting the focus to the welfare of workers, the law-and-economics approach can articulate the normative limits of worker protection: as part of the goal of placing all items where they are most valued, the law should provide workers with all the vacation, safety, and other conditions that workers are willing to pay for (in a well-functioning labour market without market failures, a subject I take up soon).

#### 4.6 FOCUS ON MONEY AND COMMENSURABILITY

Many critics complain that law-and-economics scholars focus on money or material goods, ignoring issues of dignity, fulfilment, and self-worth that work can

<sup>36</sup> For a vigorous defence of law and economics' use of social welfare, see L. Kaplow & S. Shavell, *Fairness versus Welfare* (Harvard University Press 2002).

provide. This complaint misunderstands law and economics. Laws and economics counts as valuable anything that a worker values. For example, suppose a worker chooses job 1 over job 2, where both offer the same salary but job 1 offers more autonomy, dignity, or opportunity for meaningful work. The worker has revealed that he or she values the non-material aspects of job 1, and thus job 1 is more valuable. Indeed, many labour scholars have revealed that they prefer the (mostly non-material) benefits of their jobs rather than higher paying (but more onerous) law-firm jobs.

The law-and-economics approach does insist that everything has its price, including a fulfilling job. Every decision has pluses and minuses. Workers (like all economic actors) weigh and choose in every action they take. Even doing nothing (be it not going to college, declining a promotion, not moving to a new job with greater voice, not going to union-hall meetings, or whatever) is itself a decision. In the law-and-economics method, all things are commensurable. Law-and-econ scholars recognize these comparisons are often difficult, but it is what people do in their lives. To throw up one's hands and say the comparison cannot or should not be made denies what real workers do and must do every day.

The centrality of trade-offs in all aspects of life was emphasized by the Austrian school of economists. As Friedrich Hayek said, it is 'an erroneous belief that there are purely economic ends separate from the other ends of life.'<sup>37</sup> Corey Robben has nicely summarized Hayek's thinking about tradeoffs<sup>38</sup>:

Everything in life, and not just in the economy, is a trade-off. If I wish to devote myself entirely to philosophy, I must forgo the violin. I cannot be a child of God and a man of the world. Whatever we seek and care about in life requires a sacrifice from us: of time, effort, focus, and, most important, other options. That finitude we experience—that something can only be had at the expense of something else—is part of the human condition. This needn't be a source of sadness. For it is only through that sacrifice of ourselves, that enforced trade-off of other possibilities, that we learn what we truly believe and value.

Hayek recognized that trade-offs were as important for workers as consumers, and that some choice in jobs is critical so that a worker is 'not absolutely tied to a particular job which has been chosen for us, or which we may have chosen in the past'.<sup>39</sup> Hayek, of course, was railing against a planned socialist or fascist economy. He conceded that there is 'much that could be done to improve the opportunities of choice open to the people [as workers]. Here, as elsewhere the state can do a

<sup>37</sup> F. A. Hayek, *The Road to Serfdom* 89 (U. Chi. Press 1976) (originally published 1944).

<sup>38</sup> C. Robin, *White State, Black Market: The Capitalism of Clarence Thomas* 20 (unpublished manuscript Nov. 2016). See also C. Robin, *Wealth and the Intellectuals: Nietzsche, Hayek, and the Austrian School of Economics*, in *Hayek. Part V, Hayek's Great Society of Free Men: a Collaborative Biography* Ch. 4 (Robert Leeson ed., U. Chi. Press 2014).

<sup>39</sup> Hayek, *supra* n. 37.

great deal to help the spreading of knowledge and information and to assist mobility'.<sup>40</sup> I do not intend to push Hayek too far, for his influence on the law and economics of employment law has been, at most, deep background. His celebration of the wealthy<sup>41</sup> and his hostility to trade unions<sup>42</sup> in particular are not shared by many law-and-econ scholars. But Hayek's basic point that trade-offs between 'economic' and other items is central to understanding labour markets, and markets generally, is important. Law-and-economics analysis does not relegate itself to economic items or money alone.

#### 4.7 SCEPTICISM OF REGULATION

Some think that the law-and-economics approach is anti-regulation and anti-government, advocating for a laissez-faire approach to labour-market regulation. This characterization is understandable but unfair.

True, the law-and-economics approach criticizes some laws that purportedly favour workers. Which ones? The inefficient ones in which the costs to society (or to workers) exceed the gains to (some, or perhaps the same) workers. My stylized three-weeks-vacation law illustrates an inefficient regulation. Many economists think a USD 15 minimum wage would be another example of over-regulation. Most law-and-economics analysis of this type is stage-one, emphasizing the power of markets and the harm of over-regulation.

But law-and-economics endorses much employment regulation—namely, the regulation that promotes overall efficiency. Generally, law-and-economics scholars endorse laws that correct market inefficiencies.

A further irritation even here is that law-and-economics scholars warn against the Nirvana fallacy that compares the inefficient messiness of a real market with the idealized intervention of a costless legal regulation, rather than the real-world messiness of government regulation.<sup>43</sup> But this warning is apt, and often ignored by labour-law scholars. Under-regulation (for example, the at-will rule) leads to bad consequences in the real world, but so does over-regulation (for example, a

<sup>40</sup> *Ibid.*, at 95.

<sup>41</sup> See Robin, *supra* n. 38.

<sup>42</sup> B. Jackson, *Hayek, Hutt and the Trade Unions*, in *Hayek. Part V, Hayek's Great Society of Free Men: A Collaborative Biography* Ch. 5 (Robert Leeson ed., U. Chi. Press 2014).

<sup>43</sup> R. H. Coase, *The Firm, the Market, and the Law* 24 (U. Chi. Press 1988) ('the existence of "externalities" does not imply that there is a *prima facie* case for governmental intervention, if by this statement is meant that, when we find "externalities", there is a presumption that governmental intervention (taxation or regulation) is called for rather than the other courses of action which could be taken (including inaction, the abandonment of earlier governmental action, or the facilitating of market transactions)').

just-cause rule that in practice means that incompetent or ill-willed workers cannot be fired).

#### 4.8 MARKET FAILURES

Labour markets fail in a variety of ways. Much of the most interesting law-and-economics scholarship shows how employment laws can correct these market failures. The stories of market failure are often more complicated than the stories of well-functioning markets. Let me briefly tick off several ways labour markets can fail, and how regulation can correct the market.

##### 4.8[a] *Monopsony Power*

Markets work best when they are competitive, having large numbers of sellers and buyers who are individually too small to affect the market price. A product market is inefficient when it has a single monopolist seller or a few oligopolist sellers. Specifically, a monopolist no longer acts as if it can sell an unlimited quantity at the going market rate. Rather, it recognizes that it must lower the price to sell more. To maximize profits, a monopolist reduces the quantity sold, thereby keeping the price high. Monopolistic competition is an intermediate case where several firms sell similar but not identical goods. In this case also, prices are set higher than competitive levels, which is inefficient in that some consumers value the good more highly (its marginal benefit) than the (marginal) cost of producing it, and yet the resources go to a less valuable product.<sup>44</sup>

For labour markets and other input markets, the mirror of a monopolistic producer is the single, monopsonist employer buying labour. Unlike an employer in a competitive labour market, who can attract an unlimited number of workers at the competitive wage rate, the monopsonist recognizes it can only attract more workers by raising the wage. In the economist's diagram, the monopsonist employer faces an upward-sloping supply curve of labour. To maximize profits, the monopsonist hires fewer workers at a lower wage compared to the competitive equilibrium. This is inefficient because workers who would be more productive in this industry than elsewhere, and who are willing to work at a wage the employer could earn profits from, are turned away. In such situations, a mandatory minimum wage might induce employers to hire more, rather than fewer workers.<sup>45</sup>

<sup>44</sup> See H. R. Varian, *Microeconomic Analysis* 52–54 (W.W. Norton 1978).

<sup>45</sup> D. Card & A. B. Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* xi (Preface to 20th-Anniversary ed., 2016) (noting that 'just about every introductory economics textbook describes the static monopsony model of the labor market, which has similar implications for the

Economists have debated the prevalence of monopsony.<sup>46</sup> The remote logging camp or company town are clear examples, but relatively rare in modern industrial economies. Undoubtedly more common is monopsonistic competition.

#### 4.8[b] *Externalities, or Third-Party Effects*

An externality occurs when the workers and employer do not consider all the costs and benefits of their agreement on others. My discussion of the tort of WDVPP illustrated a legal doctrine designed to control externalities. The employer and employee had agreed to at-will employment without considering the effect that agreement might have on third parties or the public at large who are denied a full jury pool, or a non-polluted harbour.

Transaction costs create externalities. As Coase showed in his famous article, with zero transaction costs all persons possibly affected by a worker's or employer's actions could bargain for a different employment agreement that considered their interests. This is the same idea as saying that, with zero transaction costs, all pedestrians put at risk by a speeding car could bargain with the car to slow down, thereby having the driver internalize all costs of speeding. But the Coasean world of zero transaction costs is not our world, as Coase himself emphasized.<sup>47</sup> Some labour-law regulation, such as the requirements to collectively bargain in good faith, can be seen as trying to reduce the transaction costs of collective bargaining in order to promote efficient bargains.<sup>48</sup>

#### 4.8[c] *Public Goods in the Workplace*

Some goods, called public goods, benefit other workers when given to a single worker. Consider dangerous cotton dust in a factory. Reducing dust for one worker reduces it for all. The level of safety is a public good. Individual bargaining tends to produce inadequate levels of safety. Suppose one worker values lower cotton dust, in the sense that she is willing to accept lower wages for the increased safety. She could individually ask the employer, but a problem arises. If the request works, every worker benefits from the cleaner factory air. But if the employer

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dynamic search model that we emphasized as an explanation for many of our findings [that a minimum wage can increase employment]).

<sup>46</sup> See B. E. Kaufman, *Labor's Inequality of Bargaining Power: Myth or Reality?*, 12 J. Lab. Res. 151, 156 (1991) (arguing that 'historical evidence demonstrates that monopsony conditions, at least broadly defined, were relatively prevalent in early twentieth-century labor markets').

<sup>47</sup> See Coase, *supra* n. 43, at 174 ('The world of zero transaction costs has often been described as a Coasian [sic] world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave.')

<sup>48</sup> See S. J. Schwab, *Collective Bargaining and the Coase Theorem*, 72 Cornell L. Rev. 245, 266 (1987).

instead retaliates by firing the worker, the harm from speaking up falls on the worker alone. The individually optimal strategy may be to stay quiet and hope someone else sticks their neck out and complains. But this may lead to safety not being provided even when workers are willing and able to pay for it. Workplace-safety laws may be needed to mandate more efficient levels of safety and other workplace public goods.<sup>49</sup>

#### 4.8[d] *Asymmetric Information*

Market failure can also arise when employers have less information than employees, or vice versa, creating adverse-selection problems. For example, consider two types of workers. Each is equally productive in the workplace, but type-1 workers have families with expensive health-care needs. Type-2 workers have families with less expensive health-care needs. All workers value employer-provided health insurance, in the sense that they are willing to accept lower wages that reflect the costs of insuring their type of family. The workers know which type they are, but employers cannot tell them apart. In this 'lemons' market, an employer who offers its workers health-insurance benefits at an average wage reduction will see type-1 workers flooding to apply, with the employer's overall health costs exceeding the wage reductions. The result is that type-1 workers may not get any insurance, even when they value the insurance at more than it would cost employers to provide it to them. An employment law mandating that employers provide health insurance (or government-provided insurance) may reduce this adverse-selection problem and be more efficient than an unregulated labour market.<sup>50</sup>

#### 4.8[e] *Limited Information and Information-Processing Heuristics*

Psychologists have long understood that people have difficulty assessing the risk of low-probability events or events far in the future. Unfortunately, workers often face low-probability events (such as contracting cancer from workplace exposure to benzene) or events with payoffs far in the future (such as a pension). As a result, the labour market might under-produce these goods, in that workers would be willing to pay for the safety or the pension if they accurately assessed the costs and

<sup>49</sup> See R. Edwards, *Rights at Work: Employment Relations in the Post-Union Era* (Brookings Institution 1993).

<sup>50</sup> See C. Jolls, *Accommodation Mandates*, 53 *Stan. L. Rev.* 223 (2000); L. H. Summers, *Some Simple Economics of Mandated Benefits*, 79 *AEA Papers & Proc.* 177 (1989).



benefits. A law mandating a certain level of benzene or pension payments may increase workplace efficiency.

Many economists blanch at such laws because they smack of paternalism. Who is better positioned to understand whether a worker is better off with higher wages or more safety, the worker or the government? If the government is confident it is better able to assess these choices, then who cares about the paternalism charge. But often the government is confident in general, but less sure that its choice is superior to the worker's choice in every situation.

The answer might be a nudge rule, as Thaler and Sunstein have advocated in coining this type of law.<sup>51</sup> A nudge rule is not a mandate, but a default rule that a worker can countermand. The default is set at what the rulemaker believes is most appropriate for the worker, considering all the costs and benefits. For example, consider two rules surrounding employee pension contributions. The laissez-faire rule calls for no wage deduction into an employee's defined-contribution retirement account unless the employee specifies how much, up to say 5%, should be deducted. It turns out in practice that many employees under such a rule save very little for their retirement. The nudge rule, by contrast, requires that 3% of wages be taken out and placed in the employee's retirement account, unless the employee specifies that more or less be taken out. It turns out in practice that employees save much more under this nudge rule. Such a nudge rule may be more efficient (in the sense of maximizing overall welfare for more workers in the balance between current and retirement pay) than either a laissez-faire rule or a mandatory 3% contribution rule.<sup>52</sup>

#### 4.8[f] *Internal Labour Markets*

Many workers are in long-term career relationships with their employer. They join an employer in one of its entry-level jobs and work their way up the internal promotion ladder. Careers at IBM or DuPont were classic examples of these internal labour markets. Many of the checks on exploitation that external labour markets provide—most importantly, the ability of workers to quit and employer to fire if things get bad—are weaker in career employment. The career employee has obtained firm-specific knowledge and established firm or community roots that are less valuable elsewhere, locking the employee and employer together. Wachter has explored the implications of internal labour markets for labour and employment

<sup>51</sup> See generally R. H. Thaler & C. R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (2008).

<sup>52</sup> B. C. Madrian & D. F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. Econ. 1149, 1150 (2001).

law.<sup>53</sup> He sees a great role for unions to enforce the internal workplace norms of fair play, but finds only a limited role for employment laws that can improve the efficiency of internal labour markets. Almost by definition, no contract can specify the details of this long-term relationship, so Wachter concludes that courts are poorly equipped to intervene. I have suggested that courts might usefully step in to police the opportunism dangers that workers face near the end of their career, especially if their compensation exceeds their end-career productivity, but courts should not step in mid-career.<sup>54</sup>

#### 4.9 UNEQUAL BARGAINING POWER

The major overarching purpose of most employment laws, in the eyes of most employment-law scholars, is to counteract bad market outcomes caused by unequal bargaining power.<sup>55</sup> While some highly skilled workers such as experienced CEOs have considerable bargaining power, most workers are individually weak. In the law-and-economics approach, by contrast, unequal bargaining power plays a more limited role. Unequal bargaining power by itself does not create inefficiencies, because workers without bargaining power can still receive those goods for which they are the highest valued user. Thus, while many analysts think of unequal bargaining power as a market failure, I discuss it separately (but immediately after my discussion of market failures).

Unequal bargaining power is a notoriously slippery concept. Some years ago Duncan Kennedy brilliantly dissected some of its conflicting meanings, arguing that ‘there is little behind the notion [of unequal bargaining power] in the way of an intelligent analysis of the general problem of equality, let alone the problem of the quality of life under our form of capitalism’.<sup>56</sup> Some equate unequal bargaining power with take-it-or-leave-it offers written by a large corporation, perhaps a monopolist, and foisted upon many weak consumers. Other conceptions add that the item is a necessity in short supply. Workers employed by large corporations fit this image. They struggle to find work, especially in times of high unemployment,

<sup>53</sup> See M. L. Wachter, *Neoclassical Labor Economics: Its Implications for Labor and Employment Law*, in *Research Handbook on the Economics of Labor and Employment Law* (Cynthia L. Estlund & Michael L. Wachter eds, Edward Elgar 2012).

<sup>54</sup> S. J. Schwab, *supra* n. 16, at 8.

<sup>55</sup> See G. Davidov, *A Purposive Approach to Labour Law* 52 (Oxford 2016) (“While the language of market failures is gaining some ground in recent years [ ... ], the view that is still by far the most widely accepted, throughout the world, is that which explains labour law by reference to “inequality of bargaining power”).

<sup>56</sup> D. Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 Md. L. Rev. 563, 620 (1980).

and rarely negotiate over terms. Guy Davidov has succinctly summarized these ideas in the labour context:

The term ‘inequality of bargaining power’ seems to suggest that even though an employee should get a certain wage, she is willing to work for less. Or otherwise accept terms and conditions that she would not have accepted if she had more bargaining power. Otherwise put: this concept suggests that the employer usually has the power to determine the wage and the terms of employment, while the employee usually faces a ‘take it or leave it’ choice, and often has to take an unfavourable offer to make a living. But in what sense can we say that the employee ‘should’ have received more?<sup>57</sup>

In short, Davidov says that unequal bargaining power can be a ‘shorthand for the existence and prevalence of market failures’.<sup>58</sup>

It is unclear that take it or leave it, or big against small, implies either market failure or unequal bargaining power. Consider consumers buying cereal at the grocery store. Consumers cannot bargain individually, but few doubt that they can get any type of cereal – sugared, healthy, with or without nuts – that they are willing to pay for. Even monopolists have incentives to respond to customer wants. If cereal producers can make money by catering to a certain type of consumer, they will offer that brand. Similarly, a monopsonist employer has incentives to cater to employee needs or desires.

Bruce Kaufman is the law-and-economics theorist who has most systematically discussed the implications of unequal bargaining power in labour markets, especially from an institutional perspective. He also posits the major source of unequal bargaining power with monopsony and related market imperfections. Kaufman defines unequal bargaining power as the power of an employer (or symmetrically, but rarely in practice, the power of an employee) to ‘set non-competitive wages or conditions’, a power that arises when employers are not the wage takers of competitive-market theory but face upward-sloping labour supply. Upward-sloping supply arises from fewness of firms, limited worker mobility, or differentiated workers. This occurs with monopsony, a well-recognized type of market failure creating inefficiencies.<sup>59</sup>

<sup>57</sup> G. Davidov, *supra* n. 55, at 52.

<sup>58</sup> *Ibid.* Davidov continues that unequal bargaining power can also refer to the fact that ‘due to the previous allocation of resources in society, [an employee] has to accept the first offer made to her—unlike the employer, she does not have the ability to wait (or ‘hold out’ of the market) for any significant period.’ *Ibid.*, at 53. Davidov also explains that ‘[a]n entirely different meaning does not concern bargaining over the terms of the contract, but rather refers to the existence of subordination—the agreement of the employee to submit herself (to some degree) to the control of the employer’.

<sup>59</sup> B. E. Kaufman, *Labor Law and Employment Regulation: Neoclassical and Institutional Perspectives*, in *Labor and Employment Law and Economics* 3, 15–16 & 30–33 (Kenneth G. Dau-Schmidt, Seth D. Harris & Orly Lobel eds, Edward Elgar 2009).

I agree that monopsony power is a market failure that allows employers to reduce wages below competitive levels. That is why I examined it first in the earlier discussion of market failures. But I would define unequal bargaining power somewhat differently than equating it with an employer facing an upward-sloping supply curve for labour.

I define bargaining power as the relative gain from trade that goes to a particular party. Parties enter contracts, including employment contracts, because each side prefers the contract to the next best alternative, and thus gains something from the contract. If the employer has great bargaining power, most of the gain goes to it and little to the worker.

Return to our stylized example of vacation pay. Week 2 of vacation costs the employer 1,000 in lost production, but the worker values it at 1,200 – meaning the worker would be willing to give up to 1,200 in wages. An employment contract with two weeks' vacation increases total value by 200. How much of the gain goes to the employer versus the employee depends on the relative bargaining power. If the employer has great power, wages will fall by almost 1,200. If the employer has little bargaining power, the wage will fall by barely 1,000.

Bargaining power is related to the economic concept of 'rent'—which for labour markets can be defined as the difference between the actual wage and the employer's or worker's next best alternative. Suppose a widget worker's next best alternative is as a farmer making 100 (often termed the reservation wage). The additional revenue an employer can get from this widget worker (the marginal revenue product) is 200. Thus, as I have defined this situation, the worker is willing to work here for any wage more than 100, and the employer is willing to hire for any wage lower than 200. Suppose the parties settle on  $x$  between 100 and 200, which depends on the relative bargaining power. The employer's rent from this transaction is  $200-x$ , and the worker's rent is  $x-100$ . The greater the employer's/employee's rent, the greater its relative bargaining power.

In this conception, bargaining power can arise even in competitive markets. In the standard competitive supply-and-demand model, everyone but the last (marginal) worker is paid more than their reservation wage and less than their marginal revenue product, creating rents on both sides.

The key question is whether an employer's greater bargaining power leads to inefficient labour markets. More specifically, will an employer's bargaining power prevent workers from getting all the terms and conditions that they value more than the employer does? The answer, in general, is no.

In asserting this, I sharply distinguish the wage (or, more generally, the overall cost to the employer of the employee's compensation package) from the particular terms and conditions of employment—ranging from vacation to safety levels to workplace voice to dignified work. The employer with bargaining power has the

ability and profit motive to lower the compensation package. Thus, in the standard monopsony model the compensation and employment level is inefficiently low.

But the employer does not have a similar profit incentive to lower every workplace benefit. Quite the contrary. Given a particular overall compensation cost (which the employer with bargaining power will drive low), the employer wants to provide the mix of wages and benefits that employees value most highly. By providing this surplus-enhancing benefit, the employer can exploit workers all the more, by enlarging the pie and using its huge bargaining power to cut an even larger slice for itself. In other words, large employer bargaining power does not imply that the labour market will not give workers value-enhancing benefits. In our vacation example, even a monopsonist will offer a second week of vacation, reducing the wage by nearly 1,200, and increasing its profits compared to offering only a single vacation week.

Some readers might be wondering how this assertion fits with the well-accepted notion that monopolies are inefficient. True, a monopsony labour market with one employer and many workers hires inefficiently few workers. Unlike an employer in a competitive labour market, who can hire as many workers as it wants at the competitive compensation level, the monopsonist employer is not a 'compensation taker'. Rather, the monopsonist employer recognizes that it must raise compensation if it wants to hire more workers. The monopsonist maximizes profits by keeping compensation below competitive levels, even at the cost of hiring fewer workers. The low compensation discourages some workers from working in this industry even when they are more productive here than elsewhere. These workers are not willing to work at the low monopsony compensation but would be willing to work for a higher compensation that the employer could still find profitable, but for having to raise compensation for all others. In technical terms, these workers are willing to work for compensation less than their marginal revenue product in this industry, but the monopsonist will not hire them if it requires raising compensation for all.

Once the monopsonist has set the size of its workforce (below the efficient number) and its overall level of compensation (below the competitive level), it still has a profit-maximizing incentive to provide the efficient wage/benefit combination to workers. A monopsonist loses profits if it fails to provide benefits that its workforce is willing to pay for. Better to reduce wages still further (even below the low level a monopsonist offers without benefits) by adding benefits that workers value. There is no necessary connection in the economics of labour markets between bargaining power and the failure to provide benefits.

## 5 THE EMPIRICAL TURN

Perhaps my major point has been to emphasize that the law-and-economics approach is not inherently against legal regulation of labour markets. Economists have two lessons: labour markets work, and labour markets do not work. Labour and employment laws can enhance efficiency by bolstering the smooth operation of markets and by correcting market failures. The law-and-economics method provides a perspective or framework for assessing when employment laws are likely to enhance or inhibit efficient markets, though ultimately these are empirical questions.

Economists have increasingly emphasized empirical analysis in recent decades.<sup>60</sup> As Card and Krueger recount,<sup>61</sup> in many economics articles from the 1970s and 1980s ‘the empirical analysis was clearly secondary to the main theoretical point of the paper’. This began changing in the late-1980s,<sup>62</sup> and labour economists were leaders in emphasizing empirical, data-crunching methods to test hypotheses, ranging from the unemployment effects of minimum wage laws to the determinants of retirement age.

The empirical mindset within the legal academy is more recent, although its antecedents go back to the legal realists 80 years ago or more. But today law scholars from various perspectives are turning towards empirical studies for guidance.<sup>63</sup>

Empirical evidence is particularly salient for law-and-economics scholars analysing employment laws, precisely because of how easy it is to point to theory and counter-theory suggesting that a legal doctrine promotes or inhibits efficiency. What is needed, by both law-and-economics and other employment scholars, to move our understanding forward is a willingness to make falsifiable arguments, an interest in figuring out whether the argument is true or false, and a healthy indifference to whether the ultimate conclusion on a particular point favours labour or management. Let the data speak.

I leave to other essays in this conference issue a fuller discussion of empirical methodology in labour and employment law, and simply say that the law-and-economics methodology applauds the empirical turn.

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<sup>60</sup> See D. S. Hamermesh, *Six Decades of Top Economics Publishing: Who and How?*, 51 J. Econ. Lit. 162 (2013).

<sup>61</sup> Card & Krueger, *supra* n. 45.

<sup>62</sup> See J. D. Angrist & J.S. Pischke, *The Credibility Revolution in Empirical Economics: How Better Research Design is Taking the Con out of Econometrics*, 24 J. Econ. Perspectives 3 (2010).

<sup>63</sup> See M. Heise, *An Empirical Analysis of Empirical Legal Scholarship Production, 1990–2009*, 2011 U. Illinois L. Rev. 1739 (2011).

## 6 CONCLUSION: ONE VIEW OF THE CATHEDRAL

Economic analysis can apply to everything, far beyond conventional markets with money prices. Supply and demand in the criminal market, the marriage market, and the market for legislation are standard fare. The imperial nature of economic analysis can understandably irritate outsiders.

Most law-and-economics scholars, however, appreciate the sub-title of one of Guido Calabresi's most famous articles, *One View of the Cathedral*.<sup>64</sup> The law-and-economics lens gives a valuable perspective, but it is only one view. As Dean Calabresi explains, quoting an earlier Yale Law Dean, the law-and-economics perspective is just one of many ways to analyse law. The impressionist Claude Monet provided over thirty paintings of the cathedral at Rouen, in different lights and hues. To understand the cathedral, one cannot look at just the perspective from one painting. So too with the law and economics of labour and employment law.

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<sup>64</sup> G. Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972).