Liberating Labour

The Case for Freedom of Contract in Labour Relations

Richard A. Epstein

occasional papers

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Orders for publications and subscription enquiries should be addressed to:

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PO Box 92, St Leonards,
NSW 2065, Australia
Telephone (02) 438 4377
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Post Box 5776, Wellesley St,
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Telephone (09) 307 0933
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Foreword

This Occasional Paper springs from a CIS seminar that Richard Epstein gave in Auckland in July 1990. It was part of a speaking tour of Australia and New Zealand covering a wide range of issues such as professional liability, company law, natural resource management and comparable worth legislation.

The subject of this particular seminar was a timely one for both New Zealanders and Australians. Both countries then languished under regimes of labour law premised on concerns about 'exploitation' and 'unequal bargaining power' and the belief that labour was not, and could not be treated as, a commodity. The result in both cases was, in Professor Epstein's words, 'extraordinary bitterness, divisiveness and conflict' in employment relations, and the suppression of opportunities for the weakest members of the workforce. Both needed reminding of the opportunities and the mutual advantages associated with freedom of contract; that liberating labour was the key both to harmony in the workplace and to the prosperity of workers, especially the least advantaged of them.

In New Zealand at least, labour market law has since changed dramatically. The new Employment Contracts Act, implemented in May 1991, is founded, broadly speaking, on principles of freedom of contract. It abolishes compulsory unionism in favour of freedom of association, and removes the special rights and privileges that formerly gave unions the power to restrict entry into the labour market. It replaces old-style awards and agreements with employment contracts, to be freely negotiated and binding only on those who elect to be bound by them. For the first time in almost a century, workers and employers are being entrusted with the task of defining and managing their mutual relationships.

However, if the case that Richard Epstein makes here has been won in the broad sense, in some crucial areas his arguments are still poorly understood. The misapprehensions about 'unequal bargaining power' and 'exploitation' that he describes clearly remained in the minds of the Act's authors, with adverse effects. The process of negotiation remains regulated: employers and employees cannot, for example, elect to operate in either union or non-union shops. The terms of their contracts remain regulated: the Act requires all employment contracts to contain personal grievance and dispute procedures; and contracts-at-will, which Professor Epstein shows to be the basis of any free contracting regime, are effectively proscribed. Labour law remains outside the primary jurisdiction of the civil court system; instead, employment contracts come under the jurisdiction of a new Employment Tribunal and Employment Court. As Professor Epstein explains, such purported protections are likely to cost workers far more than they benefit from them.

In Australia, arguments for labour market reform have so far been focused on achieving 'enterprise bargaining': breaking down broad industrial and occupational awards to enable terms and conditions to be set at the level of the individual enterprise or workplace. This approach is at odds with true freedom of contract; instead, one 'preferred' form of mandated collective bargaining is simply replaced by another, with workers and employers still denied the freedom to choose other options. Decentralisation of collective bargaining is no guarantee against tyranny, barriers to entry and suppression of choice.

In both countries, then, Richard Epstein's demonstration of how a failure to understand the fundamental nature of employment relationships leads us to legal restrictions on opportunities and incomes, remains pertinent. So does his reminder that, to write 'good' labour law, we require an understanding, first of all, of the cooperative nature and wealth-creating power of market institutions, and of why the liberty of workers is necessary for these institutions to work. The focus of labour law would then be on the key elements, described by Professor Epstein, of self-ownership on the part of workers; contract law protections against duress, fraud, misrepresentation and the abuse of incompetence; and tort law protections against breach of contract. The practical guide to championing liberty that he offers in this paper will be a succinct and eminently useful resource for all those interested in labour market policy in Australia and New Zealand for some time to come.

Penelope J. Brook

About the Author

Richard Epstein is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago, where he has taught since 1972. Since 1985 he has been a member of the American Academy of Arts and Sciences and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the *Journal of Legal Studies* from 1981 to 1991, and is now an editor of the *Journal of Law and Economics.* His books include *Cases and Materials on Torts* (5th ed., 1990), *Takings: Private Property and the Power of Eminent Domain* (1985), and *Modern Products Liability Law* (1980). His book 'Forbidden Grounds: The Case Against Employment Discrimination Laws' is scheduled for publication in early 1992. His article 'Product Liability: An American Evolution Without a Stable Political Solution' was published in the Summer 1990 issue of *Policy.*

Liberating Labour

The Case for Freedom of Contract in Labour Relations

Richard A. Epstein

My topic is labour reform and liberating labour. It seems very clear that there has been a major transformation in systematic thought about labour reform. There was a time, a long time ago, when the basic common law principles of property, contract, and tort were thought sufficient to handle the many different kinds of labour relations.

Towards the end of the 19th century, starting perhaps in the 1880s and moving through World War I, these principles were displaced, first in Britain and New Zealand, and then, after the war, in the United States as well. Why did a system that held sway for so long go into such a profound period of eclipse? One possible explanation would be a political one. All these countries are now democracies. A crude estimate reveals that in each country there are more workers than employers. So, to the extent that the economic realm is dependent on the political realm, one would expect to see very powerful pressures moving in the direction of collectivism.

But that explanation is rather too facile. Employers, on the other side, have enormous advantages when they deal in political markets: their small numbers give them greater cohesion and they often are able to bring greater wealth to their political campaigns. So, if you are trying to understand labour reform as a simple clash of political wills, you cannot explain why the collectivist view triumphed so completely.

A more complex explanation contains another dimension. The state is made up not only of employers and employees. There are third parties, many of whom are uncommitted to one side or the other. These parties may well be lured by trading votes and tempted by coalition. But, in many cases, the uncommitted may respond to what they think to be the dominant and sound intellectual trends of the time.

In the British Commonwealth and the United States from the turn of the century to around 1950, the argument in favour of collective control over labour markets seemed more persuasive than the opposite argument at an academic and intellectual level. To understand the

overall situation, one has to go back to the arguments that were thought to be decisive, review them, and see what, if anything, was right about them and what was wrong with them.

Any kind of major and fundamental change in labour relations here in New Zealand, or anywhere else, is going to have to rest on intellectual foundations, which should be made as powerful and complete and accurate as rational thought can make them.

The easiest way to start the analysis of labour law is to begin with a simple development of the common law system, and its two cardinal principles applicable to labour relations. One was the principle of freedom of contract between employers and employees. This said, essentially, that the terms of a contract were to be determined by the private parties to each agreement as they saw fit. So long as there was no duress, so long as there was no fraud, no misrepresentation and no incompetence, any bargain was permissible.

The second principle was one of tort law which said that if a private contract had been concluded, no third party, such as a labour union, could knowingly induce one of the two parties to that relationship to breach it to the detriment of the other.

That is a very simple set of laws. If you were to try to inscribe it in the statute book today you could probably do so, not in volumes, but in pages: two or three would probably be sufficient to restore the basic legal position to what it was before 1900. Yet that simple edifice did not last, but was overwhelmed. What kinds of arguments turned the tide?

Power, Wealth and Monopoly

Let me review a couple of them. The first argument is that one cannot trust an ordinary contractual regime in a labour market because the result is eminently predictable and socially unfortunate. An employer is said to have great wealth and considerable cunning. An unorganised worker in a labour market is said to be possessed of neither. The contract, therefore, is said to have an inexorable and single result: the exploitation and domination of one class by the other, so that some form of equality imposed by law, some type of protection of employee interests, is necessary to redress the bargaining imbalance. Time after time, one hears complaints of exploitation and inequality of bargaining power as a major reason why labour negotiations cannot be left to the ordinary interplay of market forces.

In order to understand what is wrong about this conception, it is important to grasp exactly the way in which bargains work, and to

disaggregate two different conceptions that sometimes go under the name of market power. On the one hand, it could be said that market power is synonymous with wealth, On the other, it could be said that market power is synonymous with a lack of rivals on your side of the market. The first conception is mistaken, and the second is accurate. But they are often not distinguished carefully in debate.

As for the first of these two conceptions — wealth as power — there is an old joke that shows how wealth need not be an asset in market negotiations. It is short, so I will tell it in a sentence. The question is put: 'How do you make a Texas millionaire?' Everybody thinks hard, but the answer is easy: 'You start with a Texas billionaire!' The point of that bit of humour is that if you have a lot of money and do not know what you are doing with it when you enter a marketplace, you may easily lose it by trying to corner the silver market, Texas style, or by trying to engage in worthless real estate speculation. Wealth is not the same as acumen. People with lots of wealth and little acumen soon find themselves patsies for everybody else's blandishments and advances. That is a problem one has to face in negotiating with employment markets as well.

There is another way to raise the central point. Assume you have a perfectly rational employer who is out to, and can, maximise his gain through contracting. Assume also you have a worker whose income is relatively low. Under what terms should we expect to see the bargain take place? The modern theory of economics says the conception of 'exploitation' is misguided if it assumes that, after the contract is formed, the employer will be better off and the worker worse off than they were before the contract was concluded.

The explanation for that result is stunningly simple: why would anyone enter a voluntary arrangement that leaves him or her worse off than before the contract was formed? The basic intuition about contracts, at least within the framework of a market system, is that the metaphor of exploitation in many cases is misguided: that, in contrast, the right metaphor is one of mutual advantage through trade. The wealth of the two parties may be wildly unequal before the transaction starts, but to the extent that exchanges are undertaken, **both** sides will be able to advance. The great preoccupation with distributional concerns — who is going to get what out of the exchange — too often leads to suppression of the entire mechanism of exchange that is responsible for the basic creation of wealth.

So the idea of exploitation, if it is thought to be an analogy to theft and oppression, is a misguided one. The requirement for individual consent for labour contracts stands as a strong bulwark against any

form of exploitation.

But then it is also said that labour contracts are undermined by an inequality of bargaining power, closely associated with the idea of exploitation. That notion is wrong as well. The underlying reason is a bit formal and technical, but can be summarised in the following, fairly simple way.

Let us assume that we really believed there was an inequality of bargaining power. 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 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.

Of course, since these employers are so well endowed, the theory of dictation means when workers go into the product market to buy goods and services, they are going to have to pay an infinitely high price to acquire any goods, at least if product sellers also possess an inequality of bargaining power. There is, in a word, no stable or discernible equilibrium with wages for services or, for that matter, prices for goods.

The truth of the matter is that long before labour regulation we observed positive wages and limited prices with respect to goods. Indeed, what you earned was an effective limitation on what you could hope to purchase, that is, a budget constraint. So the idea of inequality of bargaining power, the idea of dictation as a means for employers to work oppression has to be wrong. What then does inequality of bargaining power mean? There is a better way to explain it. Many contracts between workers and employers endure over a long period of time. In many cases, the employer will have some special advantage from dealing with a familiar and trusted employee. By the same token, an employee will have an advantage from dealing with a familiar and trusted employer. Thus, even if you observe labour contracts terminable at will, it does not follow that they will be terminated as a matter of course at the end of each working day.

The question of inequality of bargaining power, then, is enormously technical. It essentially asks the question: when there are special gains from trade, that is, supra-competitive returns, to be shared by two individuals, who gets the lion's share: the employer or

the employee? The short answer is that nobody can be sure how the gains divide in this situation. But one thing is clear: you can count on both sides getting at least a competitive return, one for capital and the other for labour.

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. So if you are trying to figure out what is going on in labour markets, it is the second definition of market power — the lack of rivals — that is critical. There are very powerful forces in these marketplaces that determine what wages will look like. The key variable that ensures stability has nothing to do with muscle or oppression, but with thick (deep) markets on both sides of the transaction, with lots of employers competing and bidding up wages, and lots of workers, on the other side, bidding them down. Individual workers have to take wages offered to them, but individual employers have to face an equally demanding constraint. Whatever the market wage, an employer who offers anything lower, however rich he is, will find himself short of the employees necessary to keep on with the business.

Is Labour Above Commerce?

A further argument one hears in connection with labour markets is often put in heroic terms. It was embodied in the Clayton Act of 1914 in the United States and has been repeated throughout the Western world. The argument is that labour is simply not an article of commerce to be traded like any other.

There are some very great difficulties with this argument, some of which are descriptive and some normative. The first point is that, if labour is not an article of commerce, then what is it? One answer might be that labour is 'sacred': it's outside the mainstream of commerce, much like religious institutions. But such a regime would be ruinous, not only for future employers, but also for labouring men and women. For if labour is outside the scope of commerce, it cannot be sold on any terms at all, even those that give an employer a super-competitive return. Making labour sacred is to prevent it being traded at all. Yet no one thinks we're better off without any trading.

Descriptively speaking, this metaphor overstates the case. Everybody is willing to trade labour; the only question is: what are the terms on which it will be traded? It is clear that labour will be traded on terms different from other kinds of commodities mainly because people are willing to sell themselves, or their services, by the hour but

are not willing to sell themselves into slavery. In dealing with ordinary goods, however, with houses and other kinds of real estate, an outright sale that changes ownership from one side to the other is perfectly appropriate. One does not have to rely on external conceptions of what is and is not a commodity for trade to make a judgment that people acting in ordinary markets trade in labour on different terms from those on which they trade in goods and in land.

Normatively, once one decides that labour is something other than a commodity, what should one do? It is clear you are not going to keep labour off the market altogether. It is then possible to adopt only one response: you decide labour will not be traded in competitive markets, but will, instead, be traded in monopolistic markets, typically through a trade union that can bargain collectively on behalf of all workers in a firm or even an industry, including those workers who do not wish to join in but would rather bargain individually.

What are the consequences of not trusting competition to generate high wages and productivity? It is moving to another system, one with a single union and, in many cases — particularly in New Zealand with its national awards — a single organisation representing employers' interests as well. Here, two kinds of difficulties occur. One has to do with the bargaining problems that exist under a collective bargaining arrangement, and the other with certain kinds of protective legislation that may apply to all individual employees. Minimum-wage laws and unjust-dismissal laws are, perhaps, the most prominent examples of this sort of legislation.

Some Effects of Monopoly in Labour Markets

One of the things that characterise labour negotiations in any system of collective bargaining is extraordinary bitterness, divisiveness, and conflict. Is this kind of bitterness necessarily endemic to the relationship between employer and employee, or is it a function of the governing rules that structure the negotiations that take place? There is nothing about the employer-employee relationship that requires it to be resolved by bitter and divisive class conflict. The problem arises because monopoly positions are introduced by legislation on both sides of the market. Note the contrast. When you are dealing with a straight competitive situation, all employees take a market wage and all employers take that same market wage; the only choice either side has is to take it or leave it. There is no individual leverage that any party has, no political intrigue that any party could mount, to improve the position beyond what either party can get in ordinary market trans-

actions. But the moment there is a single employer bargaining agency and a single employee union, you have what is called a standard 'bilateral monopoly' situation. No one has 100 or 1000 people to choose from on the other side of the market: it is one against one.

Under this arrangement, there is no unique wage. The bargaining process could generate a wage as high as the monopoly wage, or it could generate a wage as low as the competitive wage, or the wage could fall anywhere in between. As a consequence, both sides have enormous incentives to spend real resources to achieve a solely distributional gain. What it gains, the other side loses. Indeed, even this scenario is too optimistic: since both parties incur the additional expenses of negotiation, the size of the total pie shrinks with each impasse.

Under this incentive structure, it is virtually impossible to have negotiations that are relatively non-problematic; rather, people on both sides engage in bluster and bluff and, in some cases, force or deception; and, in some cases, coalition or intrigue. The result is that you bargain with somebody whom you have every reason not to trust, an attitude as true on the one side of the market as it is on the other.

There is nothing inherent in the way labour works, nothing inherent in the way management works, that requires these kinds of personality traits to dominate contract negotiations. But if you put a pie of fixed size on the table and agree to divide it only if we can get the mutual consent of both parties, the division of spoils brings forth enormous efforts by labour and management alike to get the largest possible share for themselves.

The social consequences of this bargaining system are absolutely debilitating. In the first place, it is now impossible to distinguish between employers with special situations who might need one kind of labour and employers who need another. Everybody has to be bound by the same rigid system so that those people who wish to leave the standard agreement are forced to leave the market altogether. And any new firm that contemplates entering this market will be deterred because it will not see a smoothly flowing market in which wages go up and down with demand and price, much the way a flexible system of monetary exchange works in international markets. Sharp, discontinuous crises, such as strikes, can be replaced by smooth and continuous adjustments in wage levels.

Under the current system of rigid markets, however, the potential entrant will say, 'If this is the way the market works, why do I want to be part of it?' Foreign capital will stay away from New Zealand's shores and domestic people will choose to engage in forms of production,

such as independent contracting, that might be less efficient than the employment relationship but will be far less troublesome than the system of collective bargaining. Similarly, on the workers' side, there will be enormous amounts of tension because not all workers within a bargaining unit will be similarly situated. Some workers may want full-time employment and others part-time employment. Some may want extensive medical coverage but others may want other fringe benefits. When you negotiate standardised agreements, these individual variations in tastes and demand among workers cannot all be respected simultaneously. Not only will there be immense conflict between employee and employer under this monolithic structure but also major conflicts between different groups of workers.

And all the time we prop up, with public funds, a costly system that manages to get more and more dirt into the wheels of commerce. Inevitably the level of overall production falls systematically below what it could achieve under the alternative competitive scheme. The short-term gains that either management or labour gets from some particular bargaining ploy may loom large but, in the long term, the aggregate level of production and wages will fall to the detriment of labour and management alike.

Some Effects of Mandated Minimum Terms

The second problem that infects the present labour market has to do with mandated minimum terms of employment. At common law, the standard employment contract was at will: which meant that it could be terminated, as the saying goes, 'for good reason, for bad reason, or for no reason at all'.

Within the framework of modern labour negotiations, it is clear that this simple conception of what a contract is about is no longer permissible. Instead there is, by statute in New Zealand as in many other places, a law of unjust dismissal. The decision as to whether an employment contract shall be continued is no longer one to be determined by the parties and respected by the law. Instead, it's to be determined by the law and forced upon the employer and the employee whether they wish it or not.

Now, what kind of standards can the law create to tell us whether a particular dismissal or demotion is 'unjust'? Conceptually, it is pretty easy to see what has, in fact, proved the case: it will not be possible for any legislative body or any court to develop a standard that will be predictable and comprehensible. The explanation is simple. Descriptively, there is a diminishing rate of return to all things, including labour,

so if an employer hires 100 employees, the 101st may not be worth as much to him as the first. Yet the salary paid will be constant no matter how many employees are hired. Any rational employer not encumbered with the complexities of unjust dismissal law will decide, 'Look, I will hire employees up to the point where the last dollar spent is justified by the revenues I receive. As market conditions change and employees become unattractive to keep, I will fire them because their wages are going to cost me $100 and their value to me is only $90.'

If you are dealing with an unjust-dismissal law, you have to decide whether or not these constant marginal and incremental adjustments will be allowable. No court standing outside a contractual relationship has anything like the kind of detailed information necessary to decide whether the marginal benefits of hiring a given worker exceed or are exceeded by its marginal costs or how an employer ought to restructure his business to say how its decisions could be improved with respect to employment.

Since courts cannot make these marginal decisions on the question of redundancies they are apt to move to extreme positions. They insist that, with a case of redundancy, dismissal is justified only by showing that retaining the employee in the business will throw the firm into bankruptcy or insolvency. A decision like that may be a short-term victory for any given worker but its long-term consequences are as catastrophic for workers as a class as it is for management.

When courts say to a given firm that it cannot rationalise its workforce before falling into bankruptcy, workers must be kept on for fear of legal sanctions until the firm is bankrupt. Then, instead of dismissing a single worker, the firm may now be forced to let go an entire staff because there is no way to pay them. The judicial decision says, in effect, it is better to fire 100 workers later than one worker now. Therefore, by law, the system will create the very kinds of catastrophic failures that hurt workers and employers alike.

Will this legal intervention do any good for employees in their long-term job prospects? To answer this, it is essential to consider the way such a legal rule works, not only at the firing stage, but also at the hiring stage. An employer who knows that dismissal on grounds of redundancy will be impossible short of bankruptcy will be very reluctant to expand staff. Instead, the employer faced with increased demand probably will decide to engage in more capital-intensive activities or keep existing staff and expand overtime opportunities. By choosing thus, the employer is not going to face the same level of risk he would have if he had expanded staff, found it was a mistaken decision, and decided to release the new staff or indeed other

employees. So in an effort to preserve the job for one particular named individual, hundreds of other people seeking employment will not be able to obtain jobs. The law on dismissal will act as an effective deterrent to making new hires.

Discussion about legislation in New Zealand and the United States unfortunately places too much attention on the particular case — after the fact — and not enough attention on the long-term institutional incentives and disincentives that are thereby created before the fact.

Labour markets will always have their short-term casualties. There is no way you can run a system error-free. But it is an absolute delusion to think you can stop these errors by introducing a legal standard of unjust dismissal, which, even after the enormous amount of articulation within the legislature and courts, comes down to the question of whether or not this dismissal was 'reasonable under all the circumstances': a test that is profoundly useless with respect to the thousands of different circumstances to which it is said to apply.

By spending enormous sums of money to decide the outcome of a particular case, the law diverts much wealth from productive investments in capital and labour, investments that could expand the total amount of social opportunities available for everybody.

There is, in sum, a long-term lesson that can be gleaned by re-examining the way labour markets are regulated. The modern tendency is to look at individual cases of injustice and to argue that something has to be done by the state to make sure those cases are not going to occur. To plug a small gap, the law creates all sorts of rigidities which may themselves introduce many other kinds of injustices, some much worse than the original injustice.

Conclusions

There is no way to secure greater happiness and success for a society through rules that restrict the overall level of growth and productivity within the economy. There is no way that a system that produces less output, instead of more, can hope somehow to be clever enough, through administration and litigation, to figure out just that ideal distribution of wealth, so that a poorer society can direct its scantier resources to just those people who deserve it most.

In the end you have to return to a very different way of understanding labour relations, which is to recognise quite consciously that some degree of injustice is inseparable from the operation of all mass institutions. That being so, the best protection for individual workers is not the ability to sue an employer but rather to say: if I have

been wrongfully dismissed from one job, I will be able quickly to find another. Yet this will not be too common an occurrence, since the employer will have to pay for his error through lost reputation. Open labour markets are the greatest protection against individual injustice.

Unjust-dismissal laws, in general, are a mistake for they place too much weight on the so-called justice of individual cases and too little weight on the overall institutional structure. But in addition, unjust dismissal laws tie in an important way into the larger structural system of national awards. Because that bargaining structure blocks new entry on both sides of the market, it effectively curtails labour mobility. The foreclosure of new entry redounds to the disadvantage of people who lose jobs and then gravitate to unjust dismissal laws to forestall that possibility. Just as industry-wide bargaining and unjust dismissal laws rose together, so they should fall together.

Once, by law, you change the labour market in one dimension, the whole employment situation changes as well. If you can introduce competitive labour markets with multiple actors — unions, individual workers, and employers — then new entry and high mobility are best achieved, not by devoting your talents to a world of litigation and intrigue, but by devoting them to gainful exchange from trade. You can change your focus and change the direction of your labour market, so that even those who regard themselves as short-term losers from the deregulation of labour markets will, in the end, see themselves as long-term winners.

There will be an awkward transitional moment, of course, but if you persevere with what sound theory tells you is the right course of legislative policy, then you can go a very long way to liberating labour for the benefit of labour, management, and for the public at large.

Questions and Answers

Should workers in an enterprise be able to decide to bargain collectively and to make that universal; and should employers have the right to comment on how their workers bargain?

Epstein: Those are two essential questions, The basic position ought to be as follows: every individual should be able to control the offers he makes either to give or to receive employment. Nobody should be able to compel anybody else to accept an offer except those he finds in his own self-interest. Now, if this is the basic position, what does it say about the union situation? It says that (to take the easy case) if management and labour both agree that a closed shop is the preferable way of organising a particular plant, there is no principled objection against that.

I do not want to be understood as saying that union organisations have no useful function to perform within a plant. That strikes me as demonstrably false. There are many cases in which grievance procedures, for example, can only be effectively maintained if there is some professional on the other side of a dispute from an employer.

An employer who wants to attract labour may be quite willing to give a union some kind of a closed shop in exchange for other concessions not obtainable under the current system — as, for example, the right to choose which applicants join the union — that is, to have an employer sign off before memberships are going to be allowed. I am willing to let them do it.

Suppose we change the situation. Suppose the workers come amongst themselves and decide unanimously that they will only work in a plant in which the employer agrees to recognise them as a closed shop. I do not think they can, even with their unanimous consent, bind the employer to that arrangement. If the employer says, 'Look, I think the terms of trade are absolutely onerous and I do not want it', he can turn them down. If he wants to go so far as to say 'I do not want to have any union in my plant at all, and anyone who wants to join me has to abandon it', that is OK, too.

The result of this will be that a market will eventually emerge containing virtually all forms of labour organisation. There will be some closed shops with employers' consent, there will be some open shops in which some workers are members of a union with employer consent while other people will be hired without union affiliation, and there will be some other situations in which an employer will refuse to

hire any union member. The interesting thing is: what will wages look like under this distribution? You will not be able, as an employer, to maintain the third option of no unions by paying systematically below those your competitors pay. There soon will be competition, not only for wages, but for industrial forms. I cannot predict which way that competition will come out but I suggest that some workers are very comfortable with unions, other workers are very hostile to them, some are in between. Therefore, it is quite possible that three forms of industrial organisation will emerge simultaneously and persist over time.

The bottom line, therefore, is that there will be a much greater choice than there is under the current arrangement, where if you don't like what the national award stipulates you are out of luck, no matter which side of the market you are on. The basic answer to the question is that I would not have any preconception as to what form of market organisation will emerge; I would just stick to the original position of the individual worker having control over his labour and the employer having control over capital and then let them figure out what interactive patterns will take place. If there are thick markets, both sides will profit from the productive exchange and that probably should be enough to satisfy us all.

If individual workers should be allowed choice, should minority shareholders be allowed to set the overall approach of the firm?

Within any corporation, there is no standard form contract between majority and minority shareholders that tells you in principle what the allocation of power ought to be between the two sides. In some cases, you may have cumulative voting of a board of directors: that is, where you have ten votes, you may cast them all for a single director. In other cases you may wish to prohibit that by charter. In some cases, you can get buyouts with appraisal rights, in other cases not.

The two cases, corporations and unions, are exactly analogous: essentially, in a world without a union in place, you could get unanimous consent by all participants as to what the future contractual arrangements will be. So it is when you start a new corporation. There is nothing that tells you that all corporations ought to have the same internal governance structure; likewise, there's nothing that tells you all unions and all plants ought to have the same governance structure. Given what we know about the law of contracts, and patterns of contracting behaviour, we can be confident that an enormous variation across corporations and unions occurs for subtle reasons we do not fully understand. We should not push our luck and constantly try and

impose a monolithic structure in either of these markets.

I have taken very strong positions on the question of what sort of mandatory disclosure ought to be made with respect to new issues in the public market. I do not see any justification for a set pattern of disclosures, precisely because of the variations across corporations. So perhaps your question invites the following response: there is a lot with corporate and securities law that needs to be changed, just as there is with the current bilateral monopolistic bargaining structure in labour markets.

How do you deal with the short-term losers in the labour market, those who will end up as John Steinbeck predicted in his book about the American depression ***The Grapes of Wrath****?*

It is not at all clear what happens to short-term losers or indeed how you can identify them.

First of all, there will be some perceived short-term losers in every market because if everybody thought himself a winner from the dislocations that are otherwise going to take place, there would be no political opposition to it. The question then is how long you think the short-term losers will last. If you think these markets will be fairly slow to adjust to a new kind of environment, then maybe you ought to have a cash-transfer system or a slow, transitional introduction of the new rules so that people can adjust. My view, however, is that the transitional period will be very, very rapid and that the greatest protection short-term losers can have is entry of new employers, including new people from overseas, in the investment market to bid up demand for labour. In addition, you already have a social insurance system in place. I would rely on that, but certainly not expand it. Otherwise, I would not provide any special protection, because that protection will prevent people from making very quick searches for alternative employment.

Steinbeck was a great novelist, and *The Grapes of Wrath* is a powerful novel, but I have difficulty with treating novelists as arbiters of labour policy. Often they misunderstand the way these markets work. For example, in the 1930s a massive deflation threw the entire farm economy out of whack. The deflation substantially increased in real terms the size of the standard farm debt to the point that farmers could no longer carry them. The financial crunch led to the wholesale disintegration of that market. Yet you could read *The Grapes of Wrath* cover to cover without finding any explanation about the relationship between the deflation attributable to Presidents Hoover and Roosevelt, and the dislocation that took place in the farm labour market.

To repeat: the best thing to do with the short-term losses is to grin and bear them. Once people realise there is no going back, then, instead of trying to preserve the status quo, they will start scrambling for success in the new markets. These markets will be wildly different from any market you've otherwise seen.

Let me give you another analogy that helps you understand what labour markets are like and how they could be transformed. In the United States, both Chicago and New York have extensive housing rental markets. New York's is a rent-control market, which has powerful similarities to the way labour markets are organised in New Zealand. There is a rent control board that takes submissions from all landlords and all tenants, and imposes a structural settlement that tells landlords the allowable raises on annual rent. And it is an annual bloodletting. Every year the newspapers describe the way the system works: screaming and yelling until finally an award is struck. Housing supply is perpetually short; people spend hours, years, trying to plot a way to get a house in the New York market. Some landlords are thugs of the worst order; they have been known to burn people out of their units to sell them for condominiums.

In Chicago, however, nobody knows who is a landlord and who is a tenant. It is a completely unregulated market and apartments turn over frequently. Apartment leases end twice a year. People want to get a lease on July 1, they come into town on June 25, and nobody thinks twice about it. The landlords and tenants are the 'same' people in the two cities. Why do they behave like such crazed individuals in one place and like rational sober individuals in the other? It is because of the incentive structures imposed by the regulations on prices.

The moral is this: you cannot assume that if you deregulated your labour market domestically everybody would continue to behave the same old way when the incentives were totally different. People who for the longest time were always thinking about job security and retrenchment will now start to think about opportunity. Supply will start to flow in on both sides of the market, and, in the end, short-term losers will be swamped by the great long-term gain. I would not want to disturb that process by creating any extra palliatives; that will only introduce a scheme of mini-regulation that will expand until you are right back to where you started. The opportunity for a truly beneficial institutional change will have been lost.

In a free labour market, is it a legitimate function of government to make unemployment an economically viable alternative to employment?

That is a question about which I have had enormous amounts of uneasiness. Basically the problem is this: if you have a system of unemployment insurance, which promises individuals an amount roughly comparable to their wage, there's an enormous incentive not to work.

The hard question is whether a system of job incentives in the marketplace is compatible with the system of unemployment insurance in one form or another. I think there is a real tension there. Indeed, one of the problems about socialism in the welfare sector is that it will always undermine participation in the market. But current levels of welfare support have not induced people to quit unions in droves and go on the dole. Therefore, if as I suspect will be the case, you soon start to see wage levels rise with productivity, and you hold constant the level of unemployment benefits now available, you will create a larger gap between the market wage and unemployment support, resulting in a lower level of disincentives.

Deregulating the labour market is not simply a distributional play — you're not making employers $100 dollars, and employees $100 poorer. I have no particular interest in that kind of a scheme. What you are doing in effect is raising the level of effort on both sides. If that happens, and workers become better off in the long term, the incentives to get out of the labour market will be even weaker. Once you have achieved change in the labour market, then I think it's appropriate to see whether the system of unemployment insurance, medical benefits, and education benefits as provided in New Zealand is what you want, or whether these programs should be oriented along more market principles. But I would not want to link the two things together even as a matter of politics. If you do so, someone will say we cannot deregulate the labour market until we figure out the welfare system, and that's a sure recipe for paralysis.

The two issues are now relatively distinct; I think you ought to keep them that way and recognise that the short-term interactions are apt, for the reasons I just gave, to be more beneficial than harmful.

How does workers' compensation fit into a free market system and how does it compare with New Zealand's accident compensation scheme?

Let me give you in two minutes or less the thumbnail history of workman's compensation laws in England and the United States.

Back in the 19th century, the dominant law on employment at common law was as follows: workers took the risk of their employment and could not sue their employer unless they could show negligence, and very often it was impossible to do that. At the time those rules were dominant, there were in the mines and railroads in England, starting in the late 1860s, a fair number of voluntary workman's compensation plans organised jointly by unions and management. They decided that the basic structure that existed at common law was inefficient for at least some forms of work, and that it was possible to have a system that broadened the coverage to include any accident arising in the course of employment, so reducing the amount of awards paid in individual cases and the administrative cost, and leaving both sides better off than they were before. There was nothing intrinsically unstable about that system. It covered 25-35 per cent of the heavy industries, but did not penetrate the retail trades, largely because the accident levels were so low there that no one ever really worried about them.

What drove that system out was regulation: the Workman's Compensation Act in England in 1897 said that any private plan for workman's compensation had to meet the level of compensation required under the Act. But who has better information about the optimum level of compensation: the union and the employer getting together based upon what exists in the plan, or somebody in parliament? If you believed the latter, you would want to drive the plans out. And that's what they did. So, by 1905 or so, all the private plans in England had gone.

In the United States, the Wainwright Commission in 1910 in New York found, through an exhaustive investigation of the condition of workers' compensation in that state before the passage of the 1911 New York Compensation statute, huge numbers of major employers — B&O Railroad, General Electric, International Harvester — with voluntary plans of the same sort as in England.

There is no reason why this could not be done on a voluntary basis. Transaction costs between the parties are low; gains from trade are very high. It is clear today, even with heavy regulation on workman's compensation, still in many markets — mainly disability — voluntary compensation is provided above and beyond what the law requires. No reason it cannot happen here.

Now, what about the statutes? There are basically two tales of statutes under workman's compensation. One of them is moderately benevolent, and the other is totally destructive. The moderately benevolent program says: We have seen these voluntary plans and

they look pretty good. We are going to impose them on everybody and keep the levels of compensation reasonable. If you do that, and if the political process is attuned to what unions and workers and management want, for the most part everything is stable. At that point, you do not have any improvement over what a voluntary plan will give you but you do not have any enormous detriment, either.

On the other hand, if it turns out that politics get intense, as, for example, happened in my home state of Illinois in the mid-1970s, and somebody decides by statute to double the level of compensation in all relevant categories, it's a total catastrophe. So it's the usual result that one sees when you entrust the levers to monopolistic practices through government legislation. Things may go very well, and if they go very well, nobody notices. But when they go badly, legal intervention just blows the whole thing up and creates all sorts of dislocation.

In a systematic program that respects first principles, the best the state should do is to provide a standard set of default provisions with respect to workman's compensation. If your industry or your plant doesn't seem to fit this model, you can go back to some other system of insurance. That would work out surprisingly well. But the current system has very opposite results.

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Liberating Labour

The Case for Freedom of Contract in Labour Relations

Richard A. Epstein

Although the case against centralised wage-fixing has won increasing support in recent years, many reservations remain about allowing freedom of contract in labour markets and submitting labour contracts to the jurisdiction of the civil courts. The beliefs that labour is 'sacred' and that labour markets are inherently flawed by 'unequal bargaining power' have led to minimum-wage laws and unjust-dismissal laws whose effect is to reduce opportunities and incomes, especially for the most disadvantaged workers.

In this Occasional Paper, Richard Epstein argues that the law of contract operating in a competitive market economy offers the best possible protection for individual workers. 'If you can introduce competitive labour markets with multiple actors — unions, individual workers, and employers — then new entry and high mobility are best achieved, not by devoting your talents to litigation and intrigue, but by devoting them to gainful exchange from trade.'

Richard Epstein is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago, where he has taught since 1972. His books include *Cases and Materials on Torts* (1990), *Takings: Private Property and the Power of Eminent Domain* (1985), and *Modern Products Liability Law* (1980). His book 'Forbidden Grounds: The Case Against Employment Discrimination Laws' is scheduled for publication in early 1992.

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CIS Occasional Papers 36