The Market For Employment

CIS Policy Monographs 27

The MARKET for EMPLOYMENT

GERALD GARVEY

THE CENTRE FOR INDEPENDENT STUDIES

1994

Published May 1994 by

The Centre for Independent Studies Limited

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National Library of Australia

Cataloguing-in-Publication Data:

Garvey, Gerald.
The market for employment.

Bibliography
ISBN 0 949769 94 0

1. Industrial relations – Australia. 2. Labor market – Australia.
I. Centre for Independent Studies (Australia). II. Title.
(Series : CIS policy monographs ; 27).

331.0994

© 1994 The Centre for Independent Studies
Printed by Alken Press Pty Ltd
Production and design by Heather Clements.

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Foreword

Australia's labour market remains highly regulated. It is, in the eyes of many, a 'special case'. In most economic relationships, the parties are free to make mutually advantageous exchanges. In the labour market, however, employers and employees are constrained by a wide variety of Commonwealth and state regulations. The federal government's Industrial Relations Reform Act *1993,* by putting into place still more 'safeguards' of the interests of workers, extends this Australian tradition of controlling the employment relationship from above.

In *The Market for Employment* Gerald Garvey argues for seeing the employment relationship as a market exchange. As with any voluntary exchange, employers and employees will only strike an agreement when it involves gains for both parties. They, and not a legislator or industrial relations commissioner, are in the best position to know what kind of employment agreement best suits their particular circumstances.

Garvey agrees with opponents of labour market deregulation that the labour market is 'different'. The long-term relationship between employers and employees, the need for training, and a range of other factors distinguish the labour market from the spot markets for commodities. But it is still a market. None of the distinctive features of the employment relationship are inconsistent with the market model. Employers and employees are still capable of working out what kind of bargain is to their mutual benefit. Indeed, the complex nature of the employment relationship makes it all the more desirable that its terms be negotiated freely.

Garvey's treatment of the subtleties of the employment relationship may come as a surprise to those quick to caricature labour market deregulation as 'textbook' economics bearing no relationship with the real world, or 'industrial relations realities'. The so-called textbook model provides solid foundations on which to add insights into the particular nature of the employment relationship. The end result is an analysis of the employment relationship much more in tune with 'workplace realities' than is the current industrial relations system.

Labour market reform is essential to Australia's future. Gerald Garvey's The Market for Employment helps us understand why change is so important, and the nature of the required reforms.

Greg Lindsay

About the Author

Dr Gerald Garvey is a member of the Department of Economics in the Faculty of Economics and Commerce at the Australian National University. From 1987 to 1993 he was at the University of New South Wales' Australian Graduate School of Management. His research on financial and labour markets, and the internal structure of business firms, has been published in such journals as the *Journal of Labor Economics, Journal of Business, Journal of Financial Intermediation, Journal of Economic Behaviour and Organization, Economic Letters, Journal of Corporate Finance, Research in Finance,* and *International Review of Economics and Finance.* He has served as a consultant to the New South Wales and Victorian Treasuries, the Australian Stock Exchange, and the New Zealand Commerce Commission. His current research interests include problems of corporate governance and their effect on a firm's labour force, and the financing of on-the-job training programs.

Acknowledgments

This monograph is based on a report for the Business Council of Australia, and their permission to use material from the report is gratefully acknowledged. Useful suggestions were provided by Michael Angwin, Bob Drago, Peter Hartley, and an anonymous referee.

Chapter 1

Introduction

Whether or not economics deserves the title 'queen of the social sciences', its influence on major policy areas such as tariff reform and competition policy is beyond question. More modest initiatives, such as the one to end the monopoly of the legal profession over conveyancing, also reflect the fundamental insight that competition between persons and organisations leads to lower prices and a better match between the needs of the consumers and sellers of the service. There is also a powerful moral argument in favour of this 'deregulationist' position: the current monopoly bestows privileges on a few members of the community and arbitrarily disadvantages both consumers and those who are denied the opportunity to provide conveyancing services.

The debate over labour market regulation seems uniquely impervious to the insights provided by economics in general and even to the specialist field of labour economics. The simple and powerful idea that an employer and employee should be free to make agreements on whatever terms they find mutually agreeable is generally set aside by invoking concerns about 'fairness' and 'unequal power'. Even those who advocate a decentralisation of the current system to encourage enterprise bargaining stress the contribution that such arrangements would make to something called 'national competitiveness'. Basic economic principles indicate that although competitiveness will be enhanced by allowing greater freedom to exchange labour services, competitiveness is not a legitimate goal. The goal is to allow persons to enhance their own standards of living, as they see it, through mutually beneficial exchange. To do otherwise ignores the fact that an employee will accept employment only on terms advantageous to himself, and violates fundamental principles of individual liberty and human rights.

Why then has economics had so little influence in the area of labour market reform? A public choice approach directs our attention to the powerful and concentrated interests that derive special benefits and privileges from existing arrangements. But the ability of 'vested interests' to retain their privileges depends, in part, on the ease with which the public can be misled into believing that the current system of labour market regulation is more beneficial to workers than a system

that allowed greater freedom of contract. This monograph attempts to raise the costs of such deception. Its primary target is the argument that labour is somehow different from the other 'commodities' that people trade, and that the differences justify the suspension of individual liberties that characterise the Australian labour market. The summary dismissal of Brook's (1990) timely and cogent analysis of labour market deregulation in New Zealand by McCallum (1992:297) is a case in point:

> Brook sets out her free market model for dealing with labour relations. The marketplace should govern the free exchange of labour, as well as decisions about investment and the purchasing of goods and services. Employment contracts should be between individual employees and their employers. Any laws which are perceived as giving trade unions advantages must be repealed. As I believe that the marketplace for human capital cannot be equated with the market for investments and for goods and services, I disagree with her approach.

This monograph makes three essential points in response. First, textbook microeconomics does indeed treat labour markets as essentially identical to those for commodities. Although the textbook treatment certainly does not capture all the richness and detail of the employment relationship, it makes the key point that **all markets involve the mutually voluntary exchange of rights between human beings.** Mutually voluntary exchange necessarily involves a gain for both parties. The employment relationship merely refers to the exchange of a particular set of rights.

Second, the past 30 years have witnessed an outpouring of theoretical and empirical research that explicitly recognises the fact that the employment relationship involves a particularly complex bundle of rights, and that the exchange can take place over many years. This research has greatly enhanced our understanding of such issues as career structures, the exercise of authority of 'managerial prerogative', and the contribution made by unions. Although such features of the employment relationship appear inconsistent with an idealised spot market for labour services, they actually serve to support rather than to restrict exchange. Thus freedom of contract does not imply an institution-free labour market. Rather, institutional structures develop to support exchange.

Third, an understanding of the complexities and idiosyncrasies of the employment relationship in no way justifies the coercive features of the Australian approach to the labour market. Nor do proposals

advocating enterprise bargaining necessarily fare much better. The arguments for allowing individuals free choice over the terms under which they work, including the right to join or not to join a trade, industry, or enterprise union, become more and not less compelling when account is taken of the unique problems and opportunities presented by the market for employment.

Part One of this monograph reviews the major insights of the standard textbook approach to the labour market. Part Two presents the findings of recent research into the special problems encountered in the exchange of labour services, and into the way private contractual arrangements overcome these problems. Part Three assesses the role of unions and government intervention in the context of recent approaches to the market for employment.

PART ONE

Insights from the Textbook Model

Chapter 2

People Trade Rights, not 'Commodities'

The model that dominates most microeconomics textbooks is widely criticised and equally widely misunderstood. Its fundamental purpose is not to shock readers with stark assumptions about atomistic competition between self-interested persons. The model simply provides a precise analytical exposition of Adam Smith's 'invisible hand' insight (Demsetz, 1982; Coase, 1992). In the context of the labour market, the invisible hand leads employers to look out for the interests of employees and vice versa. Employers and employees are seen as engaging in mutually gainful exchange. By conceiving the world of employment as a market, rather than as a production plant or perhaps an extended family, the model focuses attention on exchange and away from features such as domination, exploitation, and 'fairness' of outcomes. The economic approach to labour emphasises the mutually gainful, positive-sum features of employment, rather than the negative-sum, redistributive focus that is inherent in traditional Marxist and related 'political' approaches to the workplace.

All Services Are Human

The other distinguishing feature of the textbook economic model is that labour services are not treated as fundamentally different from other goods and services. Labour inputs are sold by their owners (employees) to the users (employers) for a mutually acceptable price, that is, a price that gives the seller at least as much as his next-best opportunity, but which does not exceed the value of the service to the employer.

This disembodied treatment evokes the common objection that labour is provided by human beings whose feelings, goals, aspirations, self-esteem, and so forth, are at stake. How can labour be analysed like other inputs such as land or financial capital, or like commodities such as apples and oranges? On closer inspection, this objection proves largely devoid of content. First of all, it implies that other inputs are **not** fundamentally human. In fact, **all** economic decisions are made, and all profits and losses are borne, by human actors with feelings, goals, aspirations, likes, dislikes, family and religious values, and so on. To distinguish between the essential humanity of labour as opposed to, for example, financial capital, is to deny that those who sell financial

capital (investors) are human and make choices. The investor parts with hard-earned savings for a prospective return, and a worker parts with time for a wage, salary, and/or career path. 'Mechanical' inputs embody the labour and capital of other people. Commodities, machines and labour services are all traded by people.

The apparent difference between labour and other goods or services is also unduly magnified by the abstract treatment of the 'commodities' that are exchanged, What is bought and sold in markets are bundles of **rights.** To take a trivial example, when I purchase an apple from my grocer, he confers upon me certain rights of consumption. I do not purchase the right to propel the apple through my neighbour's window, and in Singapore I would be wise not to leave any part of the apple on a sidewalk. The purchase of a home generally confers rights of exclusive occupancy, but not the right to make unlimited additions to the structure or to sell liquor or food on the premises. The exchange of labour services clearly involves a complex bundle of rights and expectations on the part of both employer and employee. So it is with many other goods and services we exchange. The contribution of modern labour economics, summarised in Part Two, is to focus on the particular set of rights and expectations exchanged between employers and employees, Financial economics focuses on the rights and expectations that are exchanged between different investors and the companies in which they invest. The generic textbook model is given empirical content by specifying the precise set of rights to be exchanged.

Once we have defined the set of rights under exchange, the remaining input into any economic model is the price. In most economics texts the price of labour is rather cavalierly termed the 'wage rate', but this term should be understood as anything that demanders (employers) provide to employees to induce them to devote their time and energy to the employer rather than to an alternative pursuit (whether that alternative consists of working for another employer, working for oneself, returning to school, going on the dole, embarking on a life of crime, or whatever). Thus 'wages' should be understood as referring to money payments made at the time the employee joins the firm, as well as payments made later on in the career or even after retirement. Also included are non-pecuniary forms of compensation such as a safe and pleasant workplace, medical and dental coverage, or training programs. If workers have a political bent or a taste for such things as wage justice, then an egalitarian workplace can be part of their compensation! Organisations such as Greenpeace receive a great deal of highly skilled labour at low pay, precisely

because they confer other benefits on those who contribute. Frank (1991) provides more systematic evidence on this form of compensation. He found, for example, that the median respondent in a survey of Cornell University graduates would have to be paid US$15,000 annually extra to be willing to work as an advertising copy writer for Camel Cigarettes, as opposed to the charity fund The United Way.

The next step is to distinguish between the buyers and sellers of labour services, that is, between the demanders and the suppliers in the labour market. Demanders in the labour market are termed 'employers'. At a high wage level, only those employers who value the particular type of labour most highly will be willing to 'buy'. Other employers will either substitute into other inputs (including other types of labour as well as capital goods), will go out of business, or will not bother to enter into production in the first place. As the wage falls, those employers who were already hiring some workers will find it profitable to expand production and also to make more intensive use of the now cheaper input. Furthermore, some of those employers who were not willing to hire any of the particular type of labour at the high wage rate find it profitable to do so as the wage falls.

This is the essence of a 'downward-sloping demand curve' for labour. It simply reflects the decisions of employers who have some interest in profits. We need not assume that they are all strictly rational profit-maximisers. All that is required is that employers have some concern for their bottom line, and that they not be entirely unable to alter their production and marketing strategies and technologies as wage conditions change. When employers can easily respond to wage changes, we say that their demands are elastic, that is, very responsive to changes in the cost of labour. When employers are locked in to the uses of particular types of labour, we say that their demands are inelastic, that is, not very responsive to changes in the price of labour. The ultimate in demand inelasticity occurs when employers actually 'need' a particular form of labour. This means that they will continue to hire the same amount no matter how high the wage goes.

A completely inelastic demand curve is essentially a theoretical curiosity or a 'limiting case' (Heyne, 1991, calls it a 'mythical beast' in his best-selling text). Nonetheless, the perfectly inelastic case implicitly underpins much of the Australian approach to wage-setting in its focus on employers' 'ability to pay' (meaning, presumably, that companies will hire the same amount of labour, regardless of the wage, so long as they are solvent). It is also the view taken whenever a central authority speaks of increasing mandated wage levels to improve the lot of the worker. As soon as it is recognised that demand is at all elastic, this

view must be amended to one of improving the lot of only those workers who remain employed after the wage increase. Moreover, the effect of mandated minimum wage rates is blunted if workers can compete for jobs by offering to give more for the same price or by agreeing to reductions in dimensions of remuneration aside from the formal wage. As soon as we allow for human employers who are able to make sensible decisions, we arrive at a demand that is somewhat responsive to price.

On the other side of the market are the sellers, that is, those who are offering their labour services for sale. At an extremely low wage, only those with very unattractive alternative uses of their time will agree to supply their labour, and even those that do so will tend to supply restricted amounts. As the wage rate increases, these workers find it in their interests to offer to work longer hours. Something resembling 'penalty' rates would have to be paid in order to induce employees to work long and irregular hours, even if such rates were not centrally mandated. As well, some workers who would have been engaged in alternative pursuits at low wages find it worth their while to forgo these pursuits and offer their services for sale as the wage rate rises.

The Voluntary Nature of Employment Contracts

Our next topic is how the model is applied to understand observed wages and employment decisions. Before so doing, it is worth emphasising that all decisions made by both employers and employees are purely voluntary. That is, an employer purchases labour only to the extent she believes her own ends will be furthered by so doing. Similarly, a worker enters this market and offers his services only because the package of wages, fringe benefits, on-the-job amenities, safety, and the irksomeness or pleasure inherent in the work, is more attractive than his next-best alternative. Employers would always like to pay lower wages for a given amount of labour input, and employees would like to receive higher wages for a given amount of labour provided. These are not fully under their control, however. In the standard economic model the key decision for both parties is the extent to which they wish to participate in the particular labour market under analysis. The essence of a free market is that both parties have the right to enter into employment arrangements at terms that are mutually agreeable, with neither side having resort to fraud or force.

The determination of the actual prevailing wage rate in such a market is our next topic.

Chapter 3

Applying the Textbook Model

The supply and demand relationships laid out in the previous section are best thought of as the plans of labour market participants. This conceptual experiment represents a stage in the construction of a model. The mere existence of supply and demand curves tells us nothing about how the labour market does, or ideally ought to, operate. The model is given empirical content by interpreting real-world outcomes as representing what are termed equilibrium outcomes. Equilibrium is best thought of as the wage rate at which the plans of employers and employees coincide, or more precisely as the wage rate at which the amount of labour that employers wish to purchase equals the amount that employees wish to offer for sale.

The Assumption of Equilibrium

Equilibrium is one of the most controversial assumptions in all of social science. Some defence of its use is merited, partly because of the concept's central importance to economic analysis, and partly because many critics seem to feel that no analysis that invokes equilibrium is worth taking seriously. Equilibrium analysis attracts epithets like 'static' (as opposed to some ideal 'dynamic' analysis) and is purported to be inconsistent with the existence of any measured unemployment whatsoever. How could reasonable people maintain that the confusing and ever-changing real-world labour markets are in anything that remotely resembles an equilibrium?

There are two reasons why the equilibrium approach is used in essentially all economic analyses worthy of the name. The first is that without an assumption of equilibrium the model loses its predictive content. Any outcome is consistent with disequilibrium since, by definition, disequilibrium refers to all outcomes besides the equilibrium one including, for instance, situations in which no one agrees to work despite wage offers of a million dollars an hour, and those in which the entire populace works full-time for three cents per hour. The assumption of equilibrium obliges the analyst to make an explicit statement of all forces that are important to the behaviour of the labour market participants. To assert that markets are in 'disequilibrium' is to

give up any serious attempt to use economic tools. If we allow ourselves the luxury of invoking disequilibrium in the face of data or real-world experience that disconfirm the model, what was meant to be a predictive model becomes an ad hoc device where all the 'action' occurs in the mysterious region of 'disequilibrium'. If there are forces that keep the labour market from equilibrating, then they must be stated up-front and explicitly incorporated into the analysis. The result of so doing is a richer model that maintains its analytical and predictive cutting edge.

All of the modern research summarised in Part Two is based on explicitly introducing 'imperfections' into the market such as information problems, bargaining costs, training problems, and issues of employee motivation, and then showing how such imperfections influence equilibrium behaviour in the labour market. These analyses are fruitful precisely because they explicitly include a set of complications and then derive the implications of the model under the altered conditions, rather than saying that the simple model is 'invalid' because real-world complications are ignored.

Coase (1960) provides another compelling reason to use equilibrium methodology. His article emphasises that at any wage other than the equilibrium wage, both employers and employees can gain from further negotiation. If a wage is for some reason above the equilibrium level, then there are workers who stand to gain by offering to work for less. No trade unionist would deny the importance of this force, often tarring the behaviour with the epithet 'scabbing'. If, by contrast, the wage is set too low, then it pays at least some employers to offer a higher wage since they will be able to hire more labour at a price that is still profitable to them. No personnel or human resource manager who has ever experienced 'poaching' would deny the existence of this force either.[1] Only when the wage is at its equilibrium level is there no scope for either scabbing or poaching. This is the only meaning of the notion that the model invokes 'perfect competition'. We have simply assumed there are no important barriers to scabbing or poaching. If there are social or other barriers to either form of labour market competition, then they can and should be incorporated into the analysis, up-front, as costs that are borne by employee or employee in making offers to their trading partners. The analysis of minimum wages is the simplest version of such a model. Minimum wages, in an economic model, are precisely stated as a legal cost or penalty that is borne by an employee who offers to work for a wage below the minimum, or, equivalently, a cost imposed on an employer who makes an offer below the minimum wage.

The conclusion is that the labour market will arrive at the wage rate that equates labour supply and labour demand, accounting for cost barriers that are externally imposed and those that are 'organic'. Dynamics and changes in the labour market are then understood as changes in the underlying determinants of supply or demand, the much-reviled method of 'comparative statics'. This method disciplines one's theories of change in the same way that equilibrium analysis disciplines the way we model behaviour at a given point in time. That is, we do not attempt to understand why wages and/or employment levels change by asserting that the world had been in 'disequilibrium' for some time and employers and/or employees suddenly 'wake up' to the possibility of mutually gainful exchange.

The subtleties that are encountered in using the economic model to interpret real-world labour market outcomes is well illustrated by the case of equal pay for women, which was awarded in Australia by the Conciliation and Arbitration Commission in a series of decisions from 1970 to 1974. Given that the award was enforced, and that women were often paid less than men for similar jobs, the most obvious effect was to fully increase the 'price' of female labour in at least some sectors. Economic theory predicts that this change should result in a lower level of female employment than would otherwise have been observed. Gregory and Duncan (1981) found that, in fact, the total employment of women rose by 13 per cent between 1969 and 1972 and then by a further 9 per cent between 1972 and 1975. This evidence has been carelessly interpreted as a stunning refutation of economic theories of the labour market; higher wages are associated with more and not less employment. What their results really reflect is the unfortunate fact that in the real world we can rarely collect experimental data on topics like equal pay for workers. Economic theory says that female employment will rise less quickly (or fall more rapidly) than it would have if the wage increase had not been mandated. Subsequent work on female employment has more carefully identified the external factors that led to the growth in female employment, and concluded that the wage rise made the increase in female employment less spectacular than it otherwise would have been (see Eccles, 1983, for a review relatively sympathetic to the original Gregory and Duncan interpretation).

The pejorative terms 'scabbing' and 'poaching' have been used so far to describe what economists praise as 'competition'. How could economists support unfettered competition in the labour market, that is, a state of affairs where workers and employers are allowed to freely undermine their own respective 'class interests'? Imagine first the case where wages for a particular type of labour are below their equilibrium

levels, so that the problem of 'poaching' arises. Again, poaching consists of an employer offering higher wages or superior conditions to workers to attract them to her firm and to abandon their current pursuits, such as working for another employer in the same industry, working in another industry, or in self-employment, The term 'poaching' is applied by the current employer who must either match the new offer or lose the worker's services. There is no doubt that this employer loses. But society as a whole always wins because the gains to the winners outweigh the losses to the old employer. First of all, the employee's gain from being poached is always at least as large as the old employer's loss. Clearly if the old employer simply increased her offer to retain the worker then the employee's gains exactly equal the employer's losses. But, by definition, if the previous wage was below the equilibrium one then the other employer who made the more generous offer will attract some new workers, and the two of them will strike a mutually gainful bargain. At the previous too-low wage level there were opportunities for mutually profitable exchange that were unrealised, While the wage rise had some 'zero-sum' or 'redistributive' effect (From the employer who was, in an economic sense, underpaying workers), there is also an inevitable positive effect on third parties so that the net effect of poaching when wages are below their equilibrium level is always positive. Poaching can be successful only when wages are below their equilibrium levels, and gains from such behaviour disappear as wages approach the equilibrium.

Exactly the same analysis applies to the 'scabbing' issue. Scabbing arises in the situation, more common in Australia, where the wage is above the equilibrium level. In this case, some workers find it in their interest to offer to do the same job for less (in terms of wages or conditions) or to do more for the same wage. That there is a loss borne by the worker who previously enjoyed above-equilibrium conditions is clear from the very term 'scabbing'. Scabbing is nonetheless efficient, simply because the employer's gains equal what the old worker loses. If the demand for the firm's product has any downward slope, then new consumers will be attracted to the market for the employer's products, and their gain plus the employer's gain exceeds the worker's loss. And we still have to add in the gains enjoyed by the new worker who secures the job. Only when wages are in equilibrium is there no scope for scabbing.

This reasoning suggests that the arguments of Gregory (1992) that employment will not 'shoot up' if wages are reduced are, from a public policy perspective, somewhat beside the point. Allowing wages to

'equilibrate', that is, to be determined by market forces, increases gains to trade and improves the lot of all concerned. It is thus a desirable policy whatever the effect on aggregate employment, The concern that the wages of those currently in employment may well fall is true, but such a fall increases the profitability of their hard-pressed employers! Put another way, the focus on wages and employment implicitly assumes that employers are 'less deserving' and their gains should be ignored. The pensioner whose superannuation fund holds shares in such a company would not agree. 'Equality' cannot be achieved even by legislating that all workers receive the same wages, since every other income recipient would be affected.

Efficiency and Social Justice

It is important to distinguish between the notion that an equilibrium in the labour market is 'efficient' and the notion of efficiency used in the popular media. The market equilibrium is efficient because it maximises the joint welfare of employers and employees given limits of time, technology, ingenuity and other natural resources. This is not a Taylorite vision where workers are squeezed down to some bare minimum and/or work long and painful hours. It is inefficient to have an employee perform a task that is extremely irksome unless the benefits to the employer exceed the costs the employee bears. Costs are minimised, not by squeezing the last drop of sweat out of a harried labour force, but by striking a balance between revenue-generating activities ('work') and leisure, on-the-job perquisites and so forth. The employer's profits will be lowered if she ignores this balance and tries to extract maximal labour because the increment to revenues so earned is less than the additional costs he imposes on workers. Unless workers systematically overestimate the wages and perquisites that will prevail when they enter the job, the employer will have to offer greater compensation on other dimensions. IF the employer is pushing the labour force too hard in an economic sense, the employer's profits will be lowered because the additional wage costs will exceed any additional revenues. The same goes for an employer whose pay structure is 'unequal' in the eyes of workers who value equality. Average pay would have to be higher, and hence the employer's profit will be lower, than they would be if the employer were to indulge her employees' desire for wage 'justice'.

The economic model of the labour market also suggests that no particular importance should be attached to any particular wage or employment level. Given supply and demand conditions, the equilib-

rium wage and employment level is the right one. Not only does the outcome maximise the size of the social pie, but any attempt to fix a wage other than the equilibrium one will bring on attempts by employers and/or employees to subvert the system. If the equilibrium wage for a particular type of labour happens to be below what is considered acceptable for an Australian citizen, then this issue should be addressed directly. An honest assessment of alternative ways to ensure minimum living standards would almost surely indicate that safety net minimum awards are clumsy and counterproductive compared to more direct transfers outside of the labour market. Minimum wages both induce unemployment and set off counteractive forces as workers seek to secure artificially scarce and attractive jobs.

The approach here relies only on workers' ability to anticipate the conditions under which they work, or, more modestly still, to not systematically underestimate the time and effort required on the job. Equally important, it is irrelevant whether or not the employer is large and 'powerful' relative to the worker. A worker who is in small demand or whose skills are also owned by many others will receive lower wages (that is, lower pay, fewer perquisites, and so on). It still does not pay the employer to over-work even such a 'powerless' worker. Put another way, the poverty of such a worker is due to the fundamental facts of supply (many others can perform the same service) and demand (the services are not extremely valuable to many employers), and not to the capriciousness of an individual employer. The only policy that will help such a worker involves training to raise his productivity. The only alternative way to raise his wage is to discriminate against a subset of his fellows (competing workers) by not allowing them to compete for the job. This is the primary economic interpretation of union attempts to prevent scabbing or to prevent contract workers from doing similar tasks. The wages of low-skilled (relative to their pay, not necessarily in an absolute sense) workers are only kept up by discriminating against others with similar skills.

Chapter 4

How Do We Know If the Labour Market Is Functioning Well?

The question that properly arises at this juncture is how do we know whether or not actual labour markets approximate the economic ideal, and whether the economic ideal is in itself desirable.

What Macro-Statistics Can Tell Us

Particularly in the 1980s and 1990s, we have fallen into the habit of gauging the success of any economy by such outcomes as low unemployment, or more frequently, by balance of trade figures. Our review of the economic model suggests that these macro data, usually thought of as the stock-in-trade of economists, need to be interpreted with extreme caution. The goal of exchange and of a market economy is not to achieve high employment levels, nor is it to export more than we import. High employment could be achieved through slavery. The good is to maximise individuals' standard of living, which in turn is reliably increased by mutually voluntary exchange. The reason is simply that any action to which two parties mutually assent (trade) must make them both better off unless one party is actually defrauded. More work is not a desirable outcome if other aspects of life are compromised excessively. Japanese workers may work longer not because they share in the benefits or because their upbringing implements a taste for long hours, but because their cost of living is so high. Their long working hours are not necessarily something to envy, nor is the fact that they sell more products to foreigners than foreigners buy from them.

GDP, productivity measures, unemployment, and so forth, are at best positively related to the degree to which employers and employees are reaping the fruits of mutually voluntary exchange. Nor should we be led astray by the false dichotomy between short and long term. A great deal of voluntary exchange involves joint investment in human and physical capital. Part of any bargain struck between employer and employee involves training and investment (or, in the case of de-skilling popularised by Braverman [1974], negative investment). The way to maximise economic welfare is to reduce barriers to exchange in this dimension as well.

Standard statistical measures should always be interpreted as rather crude gauges of living standards. In his 1974 Nobel Laureate address 'The Pretence of Knowledge', Hayek (1978) argues that a fixation on aggregate government statistics can also have distinctly undesirable side-effects.

> While in the physical sciences the investigator will be able to measure what, on the basis of a prima facie theory, he thinks important, in the social sciences often that is treated as important which happens to be accessible to measurement. This is sometimes carried to the point where it is demanded that our theories must be formulated in such terms that they refer only to measurable magnitudes. (1978:24)

Hayek's position reminds us of the difficulty that outsiders face in reliably ascertaining the relevant facts that confront actual participants in economic situations. Although the economic model shows the properties of a market equilibrium and provides a useful lens through which data can be interpreted, we are rarely in a position to say, a priori, where that equilibrium will occur. In Hayek's words:

> We have indeed good reason to believe that unemployment indicates that the structure of relative prices and wages has been distorted (usually by monopolistic or governmental price fixing) and that to restore equality between the demand and the supply of labour in all sectors changes of relative prices and some transfers of labour will be necessary.
>
> But when we are asked for quantitative evidence for the particular structure of prices and wages that would be required in order to assure a smooth continuous sale of the products and services offered we must admit that we have no such information. We know, in other words, the general conditions in which what we call, somewhat misleadingly, an equilibrium will establish itself: but we never know what the particular prices or wages are which would exist if the market were to bring about such an equilibrium. We can merely say what the conditions are in which we can expect the market to establish prices and wages at which demand will equal supply. (1978:25-6)

This perspective, taken too far, presents many of the same dangers as disequilibrium arguments. Instead of rationalising all observations as reflecting mysterious forces of disequilibrium, we instead claim that supply and demand must have intersected at the point that we actually observe.

While Hayek's perspective can be taken too far, it reminds us that part of the miracle of markets is to confer benefits on the individuals who participate in them even when researchers and government representatives are ignorant of key details of their individual situations. So although an Industrial Relations Commission whose members knew each labour market's demand and supply could mandate equilibrium wages and employment levels in order to maximise the welfare of the participants, the decentralised economic system produces this outcome even in the presence of rampant ignorance at the top. To again use Hayek's words:

> Into the determination of these prices and wages there will enter the effects of particular information possessed by every one of the participants in the market process — a sum of facts which in their totality cannot be known to the scientific observer, or to any other single brain. It is indeed the source of the superiority of the market order, and the reason why, when it is not suppressed by the powers of government, it regularly displaces other types of order, that in the resulting allocation of resources more of the knowledge of particular facts will be utilised which exists only dispersed among uncounted persons, than any one person can possess. (1978:27)

This approach highlights another key feature of the economic approach: individual transactors know more about their own circumstances than outside observers do. The decisions made by individual employers and employees reflect a greater sensitivity to their true circumstances than any regulatory decision an outsider could make on their behalf. Hence, the 'objective' outcome of employment contracts in terms of wages, employment, and so on is not so important as the fact that they reflect bargains entered into freely by persons who, again, both know their personal circumstances better than we do and also foot the bill for any mistakes they might make.

The economic model of the labour market suggests that macroeconomic statistics can be misleading. It also suggests a supplementary set of facts we can use to assess real-world labour markets: impediments to mutually beneficial exchange between employers and employees. The next section suggests some key characteristics of labour markets that tend to make individual decisions and market outcomes more, or less, desirable from the social viewpoint.

What We Can Infer from the Structure of the Labour Market

The centralised and coercive nature of the Australian wage-setting and industrial relations system is clearly at odds with the economic model. But if this system were substantially disbanded, would the Australian labour market possess many of the attractive features of the neoclassical economic model of the labour market?

There are two generic ways in which a deregulated labour market could produce undesirable outcomes: monopoly and externalities. Issues raised by the presence of long-term employer-employee relationships are analysed in Part Two.

Monopoly. In the absence of closed shop monopoly unionism, monopoly in the labour market could arise where a substantial fraction of workers are hired only by one employer, or by a few large employers who collude with one another. Such monopoly power would result in wages artificially below the market-clearing level. The result is too little employment and an inefficient labour market outcome, as well as a redistribution of wealth to employers from employees. The supposed existence of such a 'bidder's cartel' is a critical underpinning of those accounts of the labour market that stress unequal power in favour of employers.[2] If, by contrast, employers compete with one another to secure employment services through wage and perquisite offers, then labour market outcomes are more likely to be efficient, and observed low wages are likely to reflect more fundamental problems of low skills or productivity.

There is little evidence to suggest that employers' cartels are a pervasive feature of the labour markets of most western countries, including Australia.[3] First of all, the fundamental aim of an employers' cartel is to ensure that workers receive a wage that is below the market-clearing rate. In the absence of the cartel, employers would poach until the market equilibrium was achieved. An employers' cartel is inefficient because some individuals will not choose to work at the prevailing wage, even though they would be willing to work for a (higher) wage that more closely reflects their value to an employer. But if this were the case, observed unemployment would be associated with a surplus of job vacancies rather than with the queues of workers that we tend to observe. Moreover, if employer cartels were a problem then the efficient way to handle them would be through the Trade Practices Commission or the Prices Surveillance Authority. Adding employee collusion through mandated centralised wage-fixing exacerbates rather than redresses the problem. Further decentralisation, not 'countervailing power', is the solution to an employer cartel.

The only evidence that suggests the presence of bidders' cartels in the larger economy is the existence of employer groups and organisations. Although Bernheim and Whinston (1985) show theoretically that such bodies could facilitate collusion between employers, the New Zealand experience suggests that this is not, in fact, the outcome. Employer groups primarily serve as lobbyists and counterweights to union power in the political arena, rather than as a device to facilitate collusion between employers. Boxall and Haynes (1992:228) survey developments in New Zealand after the passage of the Employment Contracts Act (ECA) in 1991, and conclude:

> ... it is clear that the change in bargaining structure brought about by the ECA and the ongoing impact of economic liberalisation since 1984 has passed the strategic initiative in labour relations from the historical trade unions to employers and, in some cases (but probably increasingly), to the workforce itself. We must emphasize that the words chosen here are important – the initiative has passed **not** to the employer organisations but to the employers. Employer organisations and lobbyists have played a critical role in the reform of labour market regulation since 1984 but the effect of the reforms has been to place the initiative in the hands of **individual** employers. (emphasis added)

Some more systematic evidence appears in Harbridge (1993), who documents little overall wage movement since the passage of the Act. No latent employer monopoly power was unleashed by allowing for individual bargains even in an economy with far fewer employers than Australia.

Externalities. Even if there are no monopoly employers or labour associations to keep wages from reaching their equilibrium levels, the equilibrium outcome could be undesirable in its own right if employers and employees impose substantial externalities on third parties. Simply put, if the private actors ignore an important set of costs or benefits their actions impose on others, then their own decisions will not be optimal and there is scope for intervention, not only on grounds of fairness or equity, but also on grounds of efficiency.

For example, there would surely be externalities involved if by purchasing an apple I did in fact receive the right to propel it through my neighbour's window. Similarly, if I were able to build my home as high as I wish without conferring with anyone else, I would place too little weight on the fact that my new additions block my neighbours' views and deny sunlight to their gardens. Some forms of zoning can

be understood as a sensible response to the problem. To be sure, there are many ways to ensure that I take proper account of the costs my actions impose, including individual negotiation with neighbours. The best response depends on the particular circumstances.

We now turn to the cause and solutions to some alleged externality problems in the Australian labour market. A common concern is that deregulation will led to wages blowing out to an unsustainable level. A succinct version of this view is provided by Roberts' (1992) commentary on the federal Coalition's Jobsback proposals prior to the 1993 elections.

> On a broader level, one has to question the wisdom of any national government abrogating its power to affect aggregate wage outcomes as the Opposition proposes.
>
> The Labor Government has used these powers and links with the unions to force down real wages and it is essential that government retain the ability to act on wages in future for the collective good.

The problem can be cast in externality terms in the following way: an employer who agrees to higher wages also requires participants in unrelated labour markets to pay similarly high wages. This is the meaning of a 'flow-on' that leads to inflationary pressures. This is indeed a problem in the current system. But unless centralised wage-fixing and union coverage automatically link wages across organisations and occupations, there is no way for the process to begin! An employer who agrees to high wages may have happier employees and probably will even experience a queue for jobs at her establishment. But unless workers have higher productivity at her enterprise than elsewhere, her high-wage strategy is not sustainable. If there are no productivity increases, the employer will lose profits and market share to competitors who did not raise wages. Market forces lead to aggregate wage blow-outs only because wage increases are imposed on other employers. Without such a linkage, individual employers and employees bear all the costs and benefits of the wage deals they strike. If the wage is too low, workers lose and many will eventually quit or at least lower their commitment to the employer. If the wage is too high, the employer is transferring wealth to workers from investors, which invites insolvency, proxy fights, and/or takeover threats.

The conclusion can be made most starkly by considering the Hawke-Keating government's frequent claim that it has succeeded in keeping overall wages down, with increases justified by productivity.

The first response, suggested by Hayek's (1978) approach, is that productivity is extremely difficult for anyone to measure, and this difficulty increases the further from the shop floor one goes. Individual employers and employees are the best judges of productivity. Not only are they at the coal face, but they also pay the bills. Any admiration one might feel towards governments' or unions' ability to restrict wage rises to those justified by productivity is akin to the admiration one might feel for a man who is able to move forward with both his legs tied together. He is progressing admirably given his self-imposed handicap, but could move more swiftly and surely if he would untie his legs.

Australian government policies have given some recognition to the difficulties of assessing productivity at the federal level. In a Department of Industrial Relations (1992:8) pamphlet describing the first 100 workplace bargaining arrangements, it is recognised that:

> The October 1991 National Wage Case (*NWC*) Decision extended the movement towards a greater workplace and productivity focus in Australia's industrial relations system which can be traced back to 1987.
>
> Underpinning this process has been a general consensus that the wage system needed to give greater emphasis to productivity and to act as a catalyst for structural efficiency. This, in turn, required a greater decentralisation of wage fixing to the industry and enterprise levels, combined with scope and incentive for workplace negotiations.
>
> Major parties to the October 1991 *NWC* argued that bargaining at the workplace level could lead to more flexible arrangements and greater responsibility by the parties for developing arrangements suited to their particular needs and circumstances.

Such movements certainly involve some loosening of the bonds that tie the economy's 'legs' together. At least decisions about worker productivity and appropriate wage levels need not be made at the very peak of the governmental hierarchy, where individual productivity is most blurred by external factors. Still, there remains a reluctance to actually untie the strings:

> The Commission also noted two risks in a further devolution of the wages system. First, if bargaining mechanisms were inadequate, expected efficiency gains might not be made; and, second, any flow-on of wage increases could generate excessive wage outcomes.

> The Commission stressed that 'wage increases achieved through enterprise bargaining ought, in our view, to be justified by and commensurate with employees' contributions to enterprise efficiency and productivity'. (1992:11)

The first concern, that efficiency gains might not be realised, is utterly misplaced. Although, in an uncertain world, it is certainly true that efficiency gains might not eventuate, the real issue is whether or not such gains are more likely to eventuate under decentralised than under centralised bargaining. Moreover, how would the Department of Industrial Relations know whether or not such gains had been achieved? If they were in fact able to make such judgments with much reliability, there would have been no need to decentralise in the first place. Similarly, the concluding paragraph is either a platitude or a serious misunderstanding. If wage increases are not commensurate with productivity, then the individual employer bears the costs! Why should we, whose profits and survival are not at stake, second-guess her judgment on the matter? The absurdity of legislating a concern for productivity to profit-seeking businesses was, fortunately, quickly, if only implicitly, recognised by the new amended Act in force on 23 July 1993 (see for example McCallum, 1993, for a survey). No mention is made of mandated productivity measurement or linkages, and the clause that reserves the Commission's right to invalidate agreements 'in the public interest' was to be phased out by 23 January 1994, at least for single workplace agreements. Although much of the minimum-wage apparatus will remain, there is some hope that employers will be allowed to judge productivity gains for themselves, and to bear the costs and benefits associated with such judgments.

Another alleged externality associated with deregulated labour markets appears in Gittins (1992). He points out that regular working hours support many workers' family structures and that 'penalty rates' could be seen as a way to ensure that employers compensate employees for the extra burdens imposed by long hours. The economic logic is superficially plausible; if employers were able to call on employees for extra work too cheaply, then there would in fact be too much overtime and our nation would suffer.[4] Gittins then claims, however, that the centralised system in effect at the time was far superior to the deregulated approach proposed in *Jobsback*:

> But we don't need radical reform to allow changes in working-time arrangements and penalty rates to occur. It's already happening within the award system under the Accord partners' version of enterprise bargaining.

> If the process of rationalising working-time arrangements and payments to fit the economy's changing demands is already under way, what reason is there to believe it would proceed much more quickly under *Jobsback*?

Not only is the present system successfully handling this problem, but under a more decentralised system, we would have too much work:

> It can only be that *Jobsback* would change the balance of power in favour of employers, so that they could more easily achieve the working-time arrangements they wanted at a cost they found more acceptable.
>
> That might be economic progress, narrowly defined. But I doubt it would be a boon to workers with families. If I was worried about 'blending family and workplace responsibilities' I wouldn't regard *Jobsback* as the breakthrough I was searching for.

This conclusion is nonsense unless we are in the monopolist employer world. Otherwise, the conclusion is reversed: the award system is unable to take account of the great variation in workers' personal circumstances. Some workers are willing to do much overtime or work odd hours for relatively little, and are being denied the chance to do so by a centrally-imposed penalty structure. The outcome of the centralised system is to restrict workers from competing with one another or, put another way, to deny workers who wish to trade off money for overtime the right to do so. Persons who wish to work long hours, or whose biology or other inclinations lead them to prefer a night-life, are denied the right to make the most of their specialities. Penalty rates would then have to be justified by some form of 'social policy' involving discrimination against those who are not hard-wired to work 9am to 5pm, five days per week.

Another concern about a deregulated labour market is that it would lead to lower wages for at least some workers. But unless this outcome reflects the presence of an employer cartel, low wages reflect low worker productivity. Simply legislating higher wages will reduce other facets of remuneration as well as employment, with still greater inequality between those workers fortunate enough to find employment and those who would have been employable at the lower wage rate. As we will see in Part Two, it is also easy to argue that freedom of contract (that is, a system that allows supply and demand forces to work in the market for employer-employee relationships) provides an ideal milieu in which worker productivity can be enhanced so as to

raise the future market wages of currently low-productivity workers.

One recent line of attack on any proposed deregulation of the labour market denies this approach. Essentially, it is argued that a country's competitiveness in a few 'attractive' sectors is the best gauge of the success of its labour market. The argument begins by asserting that there are two types of Australian employers: progressive or 'best-practice' firms, and the backward remainder. The former employers have two features: they are able to work within the existing industrial relations system, and they are said to be those who possess the attributes that are seen as critical to success in Michael Porter's tome ***The Competitive Advantage of Nations*** (1990). Mathews (1992) asserts:

> We have had nearly a decade of adjustment, with companies pursuing value-adding strategies based on the export of elaborately transformed manufactures. The balance of payments picture is starting to reflect the success of this national competitive strategy.
>
> Under great pressure, the industrial relations system has evolved to match these changes. Gone are the rigid awards laying down the same conditions across whole industrial sectors, and wage movements affecting whole sectors through 'comparative wage justice'.
>
> Award restructuring and the shift towards enterprise bargaining have changed all that.
>
> Under the regulation of the Australian Industrial Relations Commission through the Structural Efficiency Principle (August 1988) and more recently the Enterprise Bargaining Principle (October 1991), wages and conditions now reflect the productivity and performance of the enterprise and the skills of the workforce.
>
> Behind the brouhaha over tariffs lies a revolution in industrial relations that puts workers' skill, quality assurance and performance at the centre of industrial negotiation, with the unions driving the process of change to the industrial relations system.

Thus, the current system seems to give substantial and positive flexibility and is expected to gradually deliver more. But if flexibility is desirable, why not go further? Why not move faster?

Mathews' (1992) answer seems to be that there is good flexibility and bad flexibility. Good flexibility allows companies and workers to unlock productivity potential that was previously lost, or, in truly economic terms, allows for more mutually gainful exchange between

firm members. But flexibility allows employers to succeed by cutting costs, including labour costs. Some employers will respond to a freed-up labour market by enhancing productivity and others will respond by squeezing down costs. Mathews describes the difference as:

> The key to industrial success is the competitive strategy pursued by companies. Either they seek to compete along a spectrum of issues, including quality and its assurance, customer service, responsiveness and innovation, as well as cost, or they seek to compete in terms of quantity and cost alone.

This sounds to an economist like a desirable mix of different approaches, each appropriate to a different set of consumers and/or production processes. Not so, argues Mathews. The low-cost bad types will drive out the good types:

> ... by removing the brakes of award conditions on employers, the Coalition's policy certainly enables good companies to reward productivity as they see fit. But the system has been evolving to allow this anyway. The problem is that the Coalition's policy also takes the constraints off the bad employers who lack the wit or imagination to compete on anything other than low-cost grounds.
>
> My concern is not so much that such employers would offer poor conditions to their employees, but that such employers will undermine the competitive strategy of their more far-sighted and sophisticated colleagues. A spiral of cost-cutting drags the whole country down, making it harder than ever for Australia to compete in sophisticated markets where cost is not the whole or even a significant consideration.
>
> Hence the productivity paradox at the heart of the Coalition's industrial relations policy. By maximising the freedom of choice of individual employers, they in effect minimise the freedom of choice of the country as a whole to shift itself onto a high-wage, high-skill, high-productivity trajectory.

The argument Mathews is trying to make is that low-cost firms impose a large externality, not only on the good employers (this simply reflects ordinary competition), but on Australia as a whole by denying 'us' access to a desirable future. The argument that low-cost firms drive out good ones is impossible to accept on its own terms. In essence, it asserts that, despite the great benefits consumers reap from quality and service, they will defect en masse to a cheaper product if given the choice of so doing. This amounts to saying that consumers do not

know what is good for them. If accepted, the argument would be that we need either to tax 'low-wage' companies and to subsidise 'high-wage' ones. Even if this were a sensible strategy it should be dealt with as an industry policy, perhaps using 'strategic' trade subsidies. Mathews effectively argues that we should abdicate industry policy, not to market forces or consumer desires, but to the dictates of trade unions.

The conclusion from this treatment of externalities is that our attention in the labour market should be focused on whether or not employers and employees are able to achieve their goals and exploit the huge potential gains to exchange that exist. Even if their agreements do impose costs and benefits on third parties, there is little to suggest that these spill-overs are of great magnitude. The real problem is to support the mutual exchange and enforcement of the complex, long-term associations and contracts that are the real item of trade between employers and employees, Part Two turns to more detailed studies of the exchange process that occurs after employers and employees have negotiated initial terms and understandings.

PART TWO

Insights From Modern Labour Economics

Chapter 5

Training and Human Capital

The most fruitful work in modern labour economics expounds and extends upon the textbook model by explicitly analysing the complex bundle of rights that are explicitly and implicitly exchanged between employer and employee. The common thread between all the theories is that they accept the basic neoclassical approach, but allow for greater richness in the 'items' subject to exchange between employer and employee. The gain is a greater understanding of existing practices as well as a powerful perspective on labour market policies that is summarised in Part Three.

The first work to address explicitly the multi-dimensional nature of exchange between employer and employee is Becker (1962). Becker emphasises that an employee's productivity is not simply endowed by nature but requires a substantial investment in training. If the training has applicability to a wide class of firms (what economists term general on-the-job training), these skills become, de facto, the property of the worker. This investment, Becker observed, would generally be funded by the worker by accepting a wage that is below his next-best option and then recouping the return to investment in the form of higher pay later in the career.

The existence of general training helps explain why workers' pay increases with job experience as well as with seniority at a particular firm (see for example Hutchens, 1989, on the US, and Chapman & Miller, 1983, or Borland, Chapman, & Rimmer, 1991, on Australia). This is because productivity increases, and the firm's need to pay for training, both fall over time. Becker also recognised that a great deal of training was specific to the firm. Such training raises the worker's productivity with his current employer but has little value outside. In this case, the worker may not pay for training by accepting a low wage because he cannot be certain of recovering the returns. Therefore the worker and the firm will, effectively, share the costs of training.

The addition of training to the simple labour market model yields two fundamental insights into the working of actual employer-employee exchanges. The first is that a worker's wages at any point in time may be only loosely associated with his concurrent productivity (that is, demand) and the worker's outside market opportunities (that is, supply). Workers who receive substantial training will be underpaid

at the beginning of their tenure with an employer, and overpaid subsequently. The worker's expected lifetime earnings must now replace the simple spot-market wage portrayed in the neoclassical model. Actual wages at any point in time reflect not only the worker's current productivity but also past investments and anticipated future rewards.

The second key observation is that contract formation and enforcement, and the reputation or even the 'culture' of the employing organisation, suddenly become important to achieving an efficient market exchange. In the case of general human capital, the problem is that, should the employer bear any of the costs of training, he must receive future services from the employee as 'consideration' for the 'reliance' investment. Since the skills are portable and 'vest' in the employee's brain and hands, he is able to take the skills elsewhere. Consequently, the employee can force the employer to pay a wage that reflects post-training productivity, without regard to the employer's up-front investment. Both legal and compensation devices aimed at bonding the worker to his employer suddenly play a critical role in achieving economic efficiency. Seniority rules (Hutchens, 1989) and payment systems that emphasise fringe benefits over wages (Brandon & Garvey, 1994) are examples of devices used to support exchange when general training is important.

The development of specific human capital poses a symmetric problem. In this case the worker is unable to go to outside employers to secure a return to training. Hence the problem is that the employer can appropriate an asset (specific human capital) the development of which was partially financed by the employee. This results in lost gains to trade since the employee who anticipates such behaviour will shift towards the development of general capital (like building up one's résumé) rather than specific capital (institution-building and service). Labour market practices that help overcome this problem and support the development of specific human capital include job ladders (Carmichael, 1983), the development of firm reputations (Macleod & Malcolmson, 1989), and the up-or-out system of promotion (Kahn & Huberman, 1988). These arrangements indirectly support the development of specific human capital by reducing the gains the employer can realise from cheating. In essence, the employer denies herself the option of under-rewarding trained workers by pre-committing to promote some fraction of employees to fill in tasks higher up in the job ladder.

Chapter 6

Incentives and Internal Labour Markets

When there is firm-specific human capital, the very notion of a labour market becomes quite subtle. Once an employee is trained, he is worth more to the current employer than to any prospective ones. Hence the contemporaneous labour market does not fully determine his remuneration and employment status. Competition and market forces are more keenly felt at the time the employee joins the firm, because there is no specific capital at that point. Hence, although the theory predicts that employees will receive competitive remuneration levels over their career with the firm, the payment that an employee receives at any point in time will not be fully determined by market forces.

Efficiency Wage Models

A class of theories called 'efficiency wage' models make a closely related argument in an attempt to understand why some employers provide workers with pay and perquisite packages that are substantially more attractive than those they could obtain elsewhere. In general, it pays to offer wages above the market rate if the induced change in employee behaviour increases profits more than dollar-for-dollar. Models in which employers are in fact able to increase their profits by paying above market wages in this way are termed 'efficiency wage models of the labour market' and are surveyed by Akerlof (1982; 1984), Shapiro and Stiglitz (1984), Carrnichael (1989) and Lang and Kahn (1989).

All efficiency wage models begin by recognising that the employee has control over a host of decisions that affect the employer's profits, such as: refraining from theft and excessive consumption of those on-the-job perquisites that are not allocated by user-pays (Burroway, 1979, and Mars, 1982, provide evidence of the importance of this phenomenon); exerting greater effort, diligence and responsiveness to the employer's interests (Levine, 1987); staying with the firm that has invested in his training (Salop & Salop, 1976); refraining from collective action with his fellow workers that would harm the employer (Dickens, 1985); or simply exuding higher morale, which motivates his fellow workers (Ackerlof, 1984). The problem is that the worker must

be provided with an incentive to take any of these actions. Although some degree of effort is exerted because of inherent interest or to avert boredom (and is thus a free good as it increases both employer and employee welfare directly), eventually the worker will have to make trade-offs between the interests of his employer and his other interests (including family, leisure, and so on). The key insight of the efficiency wage approach is that if the employer were to pay a market-clearing remuneration package, even the employer's most powerful sanction, dismissal, may not represent much of a threat. When there is firm-specific human capital and other 'natural' costs of relocation, the employee will bear some costs upon dismissal. But when these costs are not sufficient to guarantee employee diligence, it pays the employer to make the current job more attractive than the employees' alternative. Since the alternative is out of the employer's control, her only strategy is to increase the wage and other perquisites at the current job.

These arguments are unremarkable and even seem common sense to many employers. The reason that the efficiency wage approach has generated such interest in the economics literature is the effect that a 'high wage' strategy chosen by individual employers has on the market level outcome. The problem is that, if all employers pay above the market wage, then the market wage itself rises. An employee's cost of job loss reflects only specific capital and relocation costs, because there are many more 'overpaying' employers in the market. What happens, however, is that the increased cost of labour eventually restricts the profitability of hiring workers at all. The market equilibrium in an efficiency wage world involves relatively high wages for those employed but, as a consequence of this high wage, there is less than full employment. Now the sanction of dismissal has a significant bite since the employee would be displaced from a high-paying job to the 'reserve army of the unemployed', to use a Marxist term,

This market equilibrium is arrived at in a distinctly neoclassical fashion. Employers are simply trying to maximise their profits and employees to maximise their welfare. There are no monopoly unions or government-mandated minimum wages. Once we include the complication of asking how employees behave in the workplace, after having made the 'market-driven' decision of taking a job, the play of free market forces apparently yields substantial unemployment. Moreover, the outcomes appear to be arbitrary in the sense that some workers are fortunate enough to obtain 'good jobs', while others who

are essentially identical in terms of intelligence, character, skills, and so on receive substantially less attractive positions (Bulow & Summers, 1986). As in markets with rent controls (Cheung, 1974) or socialist markets with their chronic shortages (Shleifer & Vishny, 1992), the party on the 'short side' of the market (for example, the landlord or the employer) has a substantial amount of discretionary power over the welfare of individuals on the 'long' side. This is not the case in a textbook labour market since the employee can quickly get another equivalent job.

The efficiency wage model provides an apparent explanation for two features often observed in labour markets. It is consistent with both involuntary unemployment and the observation that employers often do exercise substantial 'power' over their employees. An often neglected feature is that the models provide very few direct policy implications. Although they provide an explanation for why we might observe labour market outcomes that are not as desirable as the neoclassical one in terms of efficiency (there is involuntary unemployment) or equity (those unemployed fare worse than the employed although they are equally productive, and the choice of whom to hire is subject to the employer's discretion), no insight is provided into how public policy might improve matters. Certainly it is the case that everyone would be better off if workers could commit up-front to fulfil their end of the vague employment contract, but there is no obvious way in which governments can achieve this end in ways employers cannot. As we shall see later, there may be a role for unions or some other collective body to enhance labour market performance, but such institutions would arise naturally since they also enhance the welfare of the employer. Indeed, one version of the efficiency wage model envisions high wages as an inducement to prevent workers from unionising (Dickens, 1985). In this case the way to improve the efficiency of the market would be to remove the threat of unionism, that is, either to ban unions as a matter of public policy or at least allow employers and employees voluntarily to contract out of the unionised sectors.

Specific versions of the efficiency wage model, particularly those that involve 'morale' arguments or the implicit threat of unionism, are hard to test as their underlying constructs are so vague and subjective. The version of the model that stresses turnover problems does receive support in that firms that provide greater remuneration do experience lower turnover, holding constant other features of the worker and work environment (Oi, 1988; Brandon & Garvey, 1994). Similarly,

employers that pay relatively high wages experience longer queues and have a larger applicant pool (Holzer, Katz & Krueger 1991).

The Work Discipline Model

The specific efficiency wage model that has received the most attention is the work discipline model exemplified by Shapiro and Stiglitz (1984). This model has a distinctly Marxist flavour in that the employer uses the threat of dismissal to extract more work from the employee than he would otherwise provide although, as stressed by Alchian and Demsetz (1972), the high wages the employee receives as a consequence of increased productivity more than compensates. It is best to think of the discipline model as one in which the employee would like to be able to commit up-front to be diligent on the job. But once at the coal face, the employee no longer directly bears the costs of his actions unless the employer takes positive steps. In the work discipline version, the employer supervises the employee and dismisses him if he is detected 'shirking'. A straightforward implication of this model is that the wage premium will be lower when the employer can cheaply determine the worker's productivity. Essentially, the minimum efficiency wage premium equals the employee's cost of working harder divided by the difference between the probability of being dismissed for working as opposed to shirking. Better supervision increases the denominator of this expression and reduces the required efficiency wage. The evidence for this proposition is mixed at best. Leonard (1987) and Gordon (1990) both find that the intensity of supervision in large samples of US firms is effectively unrelated to the wage level. Krueger (1991) finds, however, that in the fast food industry, franchised outlets tend to pay lower wages than do employer-owned outlets. This study made great efforts to control for regional, educational, and other determinants of wages, and is consistent with the efficiency wage model if franchisees are more diligent supervisors than are employee-managers. He also finds that turnover is lower in employee-owned outlets.

Efficiency wage models have also been offered as an explanation for the fact that large firms and firms in concentrated industries pay higher wages, all else being equal (Krueger & Summers, 1988). As Carmichael (1989) points out, however, efficiency wage models imply only that wages may be above market-clearing levels. To rationalise the inter-industry wage structure, it must also be the case that the contractual problems that motivate the payment of efficiency wages are more severe in large firms or in concentrated industries. While Oi

(1988) and Garvey (1993) offer some reasons why this might be the case, the facts are also consistent with a simple 'rent-sharing' model in which workers split the high profits due to size, superior efficiency, or entry barriers with shareholders and other investors (Rose, 1987). Certainly the development of high tariff barriers as a way to support high wages in the McEwen era are more consistent with the rent-sharing model.

The Deferred Compensation Model

The evidence is thus somewhat supportive of the efficiency wage view, although important anomalies and unexplored areas remain. A more fundamental problem is pointed out by Lazear (1979) and Carmichael (1985). It is clear that worker productivity is enhanced if they face a substantial cost of job loss. What Lazear and Carmichael show is that this only suggests the importance of long-term employer-employee 'bonding' arrangements. Such arrangements need not imply above-market remuneration levels and consequent involuntary unemployment. All that is required is for employees to face a prospective surplus to remaining on the job at the time they choose effort, theft, quitting, union status, and so forth. But workers will compete for this surplus, just as firms expend resources to enter attractive industries (Barney, 1986). The most direct way to secure a 'good' job is to pay for it. There is an incentive to compete in this fashion until the sum of the money payment up-front, plus the post-employment wage premium, just equal the present value of the competitive expected stream of payments over the worker's career. Although explicit payments for jobs are mainly restricted to cases where employees also receive ownership rights (such as franchise fees or the payments made by worker-owners to join a cooperative; see Levering, Moskowitz and Katz, 1985, for examples), Lazear (1979) shows that the same outcome can be achieved by an 'experience-earnings profile' that underpays the worker when he joins the firm and overpays him subsequently, Such overpayment takes the form of high wages late in the career (see Medoff and Abraham, 1980) and post-retirement pay that is lost if the worker leaves or is dismissed (Ippolito, 1985). The worker expects to earn a competitive present value of salary at the time he joins the firm. This amendment to the efficiency wage model is termed the 'deferred compensation' or 'wage profiles' approach.

The deferred compensation model neatly integrates the efficiency wage and the textbook approaches to labour markets. The market for jobs or careers behaves in a textbook fashion. Workers do not

compete by accepting lower wages overall (since this would destroy motivation and/or selection) but by agreeing to be underpaid at the start, that is, by agreeing to defer substantial amounts of compensation. The market for careers should approximate the textbook labour market. Those workers who are already on a career path will appear to earn more than the going rate, and to be on the 'good jobs' or the 'primary' side of a dual labour market. The Lazear approach suggests that the appearance is systematically misleading: workers who appear to be placed in good jobs are actually earning a market rate of return on their past service and investments in their employer.

A substantial body of evidence supports this approach. Most studies focus on the prediction that the experience-earnings profile should be steeper (i.e. workers defer more compensation) when contractual and effort problems are more severe. Hutchens (1987) finds that the key elements of Lazear's deferred model (pensions, long job tenure, and high wages for older workers) are all more prevalent in jobs where it is more difficult to monitor worker performance. Lazear and Moore (1984) find that the experience-earnings profile is flatter for self-employed persons than for those employed at a large firm: which is consistent with the theory since there is no motivational problem for the self-employed. Ippolito (1985) shows how the use of non-vested pension plans in the US also make sense as an arrangement whereby workers and employers voluntarily agree to defer compensation in a way that bonds the workers to the firm.

Although the deferred compensation theory was developed in the context of specific incentive problems in the labour market, it is based on the much more fundamental insight that competition is multidimensional. Although contractual problems require workers to earn a premium over the textbook market rate once on the job, there is nothing to rule out competition between workers for future wage premiums. Indeed, the prospect of such a premium (that is, a good job or a good career) is precisely what entices workers to compete, both by obtaining outside qualifications and by making up-front payments in the form of low wages at the beginning of the career.

These insights continue to hold in the presence of monopoly unions and binding minimisation of rates that ration access to jobs. The presence of such unions simply alters the form of competition once again. In addition to productivity and patience, what matters is one's union connections or, in a more abstract sense, one's ability to jointly satisfy the requirements of the union and the employer more fully than other workers. Bronars and Lott (1989) use this approach to highlight

some neglected social costs of monopoly unions and minimum wages. They also show that even those workers who do end up with good jobs need not gain once account is made for the cost of entry.

Chapter 7

Some Further Complexities in Internal Labour Markets

Although the theories and research surveyed in the previous chapter represent a substantial advance in economists' understanding, they are far from complete. We now turn to newer research that explicitly introduces some additional complexities encountered in internal labour markets.

The research begins with a fuller recognition of the two-sided nature of the employment contract. The efficiency wage and the deferred compensation theories focus on motivating the employee to exert effort and initiative and to refrain from prematurely leaving the firm. It is implicitly assumed that the employer always invests the promised amount of resources in training and dismisses only those workers who are known to have dishonoured the terms of their employment. But, particularly in the deferred compensation model, the employer has a clear incentive not to hold up her end of the bargain. In that model, once a worker has been with his employer for some time, the worker will be overpaid for the rest of his tenure with the firm. That is, the firm could gain by dismissing the experienced worker or, more tempting still, could renegotiate his wage down to the workers' next-best option. Essentially, the employer claims, falsely, that the employee had dishonoured the contract in order to reduce the prospective wage bill. Of course, if such behaviour is anticipated by the employee then he will demand more compensation up-front and the efficient, market-clearing contract will be undermined.

This opportunism story has been used in many ways, first and most obviously as an explanation for why some workers do not, in fact, pay for their jobs in great degree (Dickens, Katz, Lang & Summers, 1989). More fruitful research has analysed various ways in which the problem is overcome. The most obvious solution is by recourse to reputation arguments: it does not pay to cheat a single employee if all future employees will reduce their commitment and performance in response (Bull, 1987). Such solutions are problematic, both in theory (Macleod & Malcolmson, 1989) and also in practice when information flows are less than perfect. Outsiders need to be able to discern whether an employee was denied the premium in the future justly (because he under performed) or unjustly to avoid paying the promised amount (Bhide & Stevenson, 1989).

The Tournament Theory

An alternative solution to the problem of ensuring that both employer and employee honour the contract is to pay deferred compensation in the form of promotions. In such a system, a fixed number or percentage of each class of workers are promoted, regardless of individual performance. Malcolmson (1984) and Carmichael (1983) show theoretically how such a 'forced-ranking' system ensures that the employer will honour a contract that now promises to pay a premium to the top performers in a class rather than a premium to all whose performance meets or exceeds an exogenous standard. Galanter and Palay (1991) apply this theory to explain promotion systems in law firms, and Gibbons and Murphy (1990) find that relative performance is an important determinant of the compensation of chief executive officers.

The 'tournament' theory goes some way towards explaining the prevalent use of job ladders and promotion as a motivator (see Gibbs, 1992, for a detailed study of the internal labour market of one large firm). It also explains why there are limited 'ports of entry' to most internal labour markets, meaning that only limited hiring is done from the outside. Hashimoto and Raisian (1985), Hashimoto (1989), and Kato and Rockel (1992) present compelling evidence that these elements of steep experience-earnings profiles, long-term employer/ employee attachments, and the importance of promotion as a motivator are even more descriptive of large Japanese companies' employment practices than they are of the US.

There are, however, important limitations to the tournament approach. As any instructor who marks strictly 'to a curve' has experienced, such a system positively discourages cooperation and mutual help between students who are turned into contestants. Lazear (1989a) shows how this problem can, in theory, lead to outright sabotage as well as insufficient cooperation and stresses that often the only solution is to reduce the stakes. Such an approach has the disadvantage of simultaneously reducing the reward to individual initiative (see Murphy, 1990, for a case study that illustrates these problems).

The problem of employer opportunism stressed in the original tournament literature sits poorly with the more common rationale for forced ranking systems as a way to counter problems of 'grade inflation'. Such inflation represents excessively lenient performance appraisal and overly generous rewards (see Baker, Jensen and Murphy, 1988, and Medoff and Abraham, 1980, for evidence of this phenom-

enon). The reason for the different emphasis is that the standard economic analyses assume that pay and promotion decisions are made to maximise profits or shareholder wealth. In fact, many such decisions are made instead by managers who are not themselves rewarded according to profits in any great degree (Jensen & Murphy, 1990). Garvey and Gaston (1991) find that these issues of shareholder-controlled versus manager-controlled decisions over labour are important to the pay structure of long-term, white-collar employees in a sample of large Australian firms. Specifically, they find that the experience-earnings profile is significantly less tilted, reflecting less deferred compensation and implying less trust of the employer's promises, when the ownership of its shares is more concentrated. Similarly, Pontiff, Shleifer and Weisbach (1990) and Ippolito and James (1992) find that hostile takeovers are often associated with a wholesale reduction in deferred compensation plans. Garvey and Swan (1992a) combine these features with the finding that top managers bear far greater costs if they reduce the wealth of their creditors than if they do so for their shareholders (Gilson, 1989) to show how employee tournaments are optimally overseen by a manager who is insulated from takeovers, who faces a mild threat of financial distress, and who also has some tendency to favour the interests of workers over those of shareholders, These insights are shown to be even more descriptive of the employment and corporate governance systems in Japan by Garvey and Swan (1992b).

The Importance of Institutions

The overall lesson that emerges from these more detailed analyses of the labour-contracting process is that institutional arrangements and implicit-contracting practices are important, not only to a realistic description of labour markets, but also to their efficient operation. The actual labour market is surely more efficient than a spot market would be in the actual circumstances that surround the exchange of labour services. That is to say, institutional features like seniority, promotion, and so forth, help overcome practical impediments to trade between employers and employees. Note also that all the institutional and contractual features surveyed here are seen as emerging naturally to serve the mutual interests of employers and employees. While a snapshot of any firm's internal labour market will reveal myriad restrictions and departures from the neoclassical model, many such departures are in fact adaptations that allow real-world markets to more closely replicate the neoclassical outcome, where wealth is

created by gains to trade, than would be the case if these features were absent.

Modern contract theories present a more realistic and satisfying vision of the labour market. Long-term attachments between workers and firms are seen as important to the efficient functioning of the labour market. Internal labour markets might appear, on the surface, to artificially restrict competition between workers and distort the market. For example, in the training model of Becker (1962) or the deferred compensation approach of Lazear (1979), workers are not paid the market-determined rate except on average over their entire working career. In tournament models of the internal labour market (Malcolmson, 1984), competition for a job is 'artificially' restricted to include only those who already work for the firm. Garvey and Swan's (1992a) approach even provides a rationale for the substantial barriers that impede the operation of the free market for corporate control (Manne, 1965). The key insight is simply that when contracts are costly and incomplete, what appear to be restrictions on a free market often serve to support exchange between employers and employees in such subtle but crucial dimensions as skill development, diligence, cooperation with fellow employees and so forth.

The recognition that contracts are incomplete and that workers are imperfectly mobile also integrates the radical or Marxist view in which the workplace is characterised by conflict and wealth redistribution rather than by wealth creation. For example, the effort problem that motivated both efficiency wages and deferred compensation arrangements is also fundamental to radical accounts of the labour market. Edwards (1979:12) argues:

> Workers must provide labour power in order to receive their wages, that is, they must show up for work; but they need not necessarily provide labour, much less the amount of labour the capitalist desires to extract from the labour power they have sold . . . there is a discrepancy between what the capitalist can buy in the market and what he needs for production. (Quoted in Goldberg, 1980:258)

This approach to the effort and diligence problem is virtually identical to the one that motivated the use of efficiency wages and deferred compensation. All the 'capitalist' can buy, and all the 'worker' can sell on the external labour market, is mutual assent to a vaguely specified job or a career. More detailed obligations may not even be explicitly discussed. Rather, the employer and employee agree on an incomplete and implicit contract, in which issues of how much 'effort'

the employee will exert, the degree to which he will aid his fellows, and the amount of training, compensation, and promotion the employee will receive are all decided upon after the decision of whether or not to hire the worker is made.

The key difference between the radical account and the standard economic model is that the radical one focuses on rent-seeking elements of the relationship. That is, the 'boss' would always like to extract more labour from the workers and similarly the workers would always like to provide less labour. Hence the imagery of 'struggle' and 'control'. The modern economic account does not deny these forces but, by respecting the presence of the broader market and the requirements of efficiency, drastically changes the interpretation. If there are no incentive mechanisms available for the capitalist to extract labour power from the worker, then the worker's productivity and wages must be lowered or the capitalist will go out of business (either by bankruptcy, takeover threat, or the inability to raise capital in the first place). It makes more sense to see deferred compensation as a bond posted voluntarily by the worker to guarantee his own future performance than as a club or carrot used by the boss to 'exploit' the worker.

Moreover, the problem is symmetric. If the capitalist over-uses the carrot, that is, extracts labour power to a point where the incremental net cost to the employee exceeds the incremental net benefit to the capitalist, then her overall profits will be reduced. So long as employees do not systematically underestimate the demands of the job, they will demand higher wages to compensate for the costs they bear in exerting extra effort and, if the capitalist is truly over-using the workers, the increment to her profits from excessive labour is less than the extra wage costs she must pay. Hence it pays the employer also to make credible promises not to deny deferred compensation to those workers who do perform as promised, and to refrain from using the threat of dismissal or wage reductions to extract excessive efforts from workers. The purpose of internal labour market organisation and labour-contracting practices is to allow employer and employee to exchange mutually credible promises to behave in an efficient manner at the workplace.

One key point that is frequently missed in this discussion is the irrelevance of market power or size to the above insights. For example, if a worker's skills are in such low demand that his next-best option earns only, say, seven dollars an hour, it still does not pay the employer to overwork him, If the employee expects to be assigned to extraordinarily irksome tasks or to be 'forced' by the use of carrots and sticks

to work very long hours, then he will not work except for a wage substantially greater than seven dollars per hour. Bargaining power as such does not change the fundamental insight that it pays the employer and employee to credibly commit to demand, and to provide, only the optimal amount of effort, diligence, training and so forth. 'Optimal' here is understood in the economic sense of exchange, that is, the optimal amount of effort involves the employee only working up to the point where the cost to him of putting in an additional hour equals the benefits that would be conferred on the employer by so doing.

Chapter 8

Authority Structures and Managerial Prerogative

The previous chapter showed how key elements of Marxist and 'institutionalist' approaches to the labour market can be easily accommodated into an enriched, 'market-friendly' economic model. This chapter addresses one final justification for the assertion that labour markets are different. By agreeing to an employment contract, the employee often also agrees to follow the 'reasonable' dictates of the employer. This provision, commonly termed 'managerial prerogative' or even 'authority' (see, for example, Storey, 1983) leads many commentators to deny that the employment relation is in any important sense contractual (e.g. Stone, 1981). The essence of a contractual relationship is that all elements are mutually voluntary. When employers have a right to order employees to take certain actions, are we not dealing with a relationship between master and servant rather than between two entities whose wealth is mutually increased?

The Employment Relationship as a Contract

The first point, due to Alchian and Demsetz (1972), is that the distinction between the exchange of labour services and the exchange of apples is not as simple as is often claimed. In both cases the seller could be seen as 'ordering' the buyer to pay him a certain amount in order to receive the good, or alternatively one could view the buyer as ordering the seller to provide the good the buyer wants or else to withdraw her payment. According to this view, any assertion that employers exercise authority over employees simply overlooks the quid pro quo. Thus, for example, the statement that labour hires capital, or that workers hire their manager, makes as much sense as the more traditional description of 'capitalist' work practices.

We can go further than simply denying that 'authority' exists by recognising the fact that employment and other exchanges often unfold over a substantial length of time, and that accounts are not always settled up completely at the end of every working day or hour. Coase (1937) stresses that the crucial difference between organisation inside a firm and organisation across a market interface is that in the former case the employee agrees not to provide a pre-specified good

or service but rather to follow the dictates of his employer over a substantial range of alternative tasks. For example, one can pay an independent contractor to dig a ditch and the payment will be based only on the outcome. Alternatively, one can hire an employee and direct him as to how the specific task is to be done. Simon (1957) provides an early mathematical formulation of the extra 'flexibility' that is gained by the use of the employer/employee relationship.

The Delegation of Rights

The broadest model of the employer/employee relationship is thus that of an exchange that involves the delegation of rights to decide on how the employee uses his time. Stone (1981:1533) reports an explicit attempt to detail those rights that are retained by the employer:

> The Company retains the sole right to manage its business, and direct the working force, including by way of illustration, but not limited to the rights to decide the machine and tool equipment, the materials to be processed, the methods of processing, the schedule of production, together with all designing, engineering, and the control of raw materials, semi-manufactured and finished parts which may be incorporated into the products manufactured; to maintain order and efficiency in its plants and operations; to hire, layoff, assign, transfer, and promote employees, and to determine the starting and quitting time and the number of hours to be worked, subject only to such regulations governing the exercise of these rights as are expressly provided in this Agreement.

More often, the items that fall under managerial prerogative are defined by the common law. Stewart (1992:114) points out that in the Australian context:

> In the eyes of some, particularly the so-called New Right, the ultimate in procedural flexibility would presumably be an unfettered managerial prerogative to set and change employment conditions.
>
> . . . to the extent that the obligations governing an employment relationship are not exhaustively set out in the terms expressly agreed between the parties, the common law has been more than willing to step in and provide 'default' rules.
>
> While restrictions have undoubtedly been imposed on the employer's legal capacity to vary working arrangements – in the absence of express authority, unilateral pay cuts are forbidden, as

are demands that an employee switch to an entirely different job – there is much that can still be done. Employers have been permitted, for instance, to introduce new technology which, while it does not change the name and purpose of a job, nevertheless requires it to be performed in a different manner. Similarly the location of a workplace can be changed, provided excessive travelling burdens are not imposed on existing employees.

The economic rationale for the above delineation of rights is as follows, Given the high costs of explicitly providing for all contingencies in up-front contracts, there will always be areas of any long-term exchange relationship that are left uncovered. If the parties to the exchange are independent contractors, then both retain the rights to 'walk away' if they are not compensated adequately for new items that arise in the relationship. In the case of an employer/employee relationship, the employer has some right to unilaterally vary terms of the agreement in response to contingencies that arise over time. The distinctions are subtle since an employee can always quit, but Masten (1988) makes a compelling case that the employee's threat to quit is substantially curtailed by the duties he is deemed to have taken on. The most extreme manifestation is highlighted by Storey (1983:25), who says 'Every act which a manager or his subordinates can lawfully do, and without the consent of the worker, is done by virtue of this prerogative'.

This statement highlights the possibility that the employee will be called on to take actions that actually make him worse off. Stewart (1992) points out the clear dangers if this is taken too far: presumably the best alternative for the employer would be to retain the right to reduce wages after the employment contract is entered into to any level she deems fit, or to similarly increase hours. Is the only protection for the employee then to be found in the tender mercies of the courts and/or the unions? Such a view neglects the fact that if employers reserved the right to alter any terms they chose, no promise of wages or conditions would be credible, or would be credible only insofar as the employer's reputation were at stake. Employers would have to pay wages up-front, since promises to pay wages later would not be believable. The economic rationale for the delineation of rights expressed in the common law is to retain for the employer the right to decide on issues that are important to the firm's success and that are not of overwhelming importance to the employee. On the other hand, the employer is not empowered to renege on such basic and crucial elements as wage payments. This system serves the interests of

employers as well as employees by allowing the exchange of that complex and ill-defined bundle of inputs which are summarised by the term 'labour services'.

The argument is simply that there are wealth gains to be made by allowing the employer to wield unilateral authority over certain dimensions of the relationship with the employee. Part of the worker's wage must then be seen as compensation for the costs he expects to bear by virtue of the employer's exercise of authority (as well as any direct 'disutility' due to a loss of autonomy). It is thus in the employer's and employee's interest to commit, up-front, to give and receive only those orders that represent wealth creation rather than wealth redistribution. This neat economic logic applies only in an average sense. There will be instances of unilateral exercises of power by the employer that will make the employee worse off, Indeed, some employers in New Zealand seem to have taken the logic of employer prerogative too far. Kiely and Caisley (1992:238) report:

> The right to unilaterally vary is most commonly alleged to arise as part and parcel of 'an employer's right to manage their business'. Precisely why this 'right' should give rise to a power to unilaterally vary contracts is not clear. It is unlikely that there is a business person in the country who would assert that his or her 'right to manage their business' gives them the power to unilaterally reduce the rent payable to their landlord, or unilaterally reduce the price of supply contracts, and yet for some reason they persist in asserting that they do have the 'right' to unilaterally vary their employment contracts. The fact that there is this different attitude in the area of employment suggests that the concept of an employment 'contract' is still not well understood.

Again, if employers did retain the rights to unilaterally vary all terms of an employment contract then the very notion of employment agreements would be voided. Since no promises by the employer would be credible, we would be restricted to a 'spot-market' for labour. Of course, the common law provisions just detailed as well as management's concern for reputation help to ensure against such a dire outcome.

The Potential for Abuse

Still, the existence of managerial prerogative does leave open the potential for some misuse of authority which both vindicates the traditional Marxist concerns with hierarchy and also reduces the joint

wealth of employer and employee whenever the employer assigns the employee to a task in which the costs borne by the employee exceed the gains to the employer or, more generally, make a resource allocation decision that reduces net wealth. Dow (1987:26) cogently summarises the key problems:

> ...the central authority may intervene for self-interested reasons, ignoring the losses inflicted on other agents, and there may be no cheap mechanism by which the losing agents can detect or abort such interventions. That is, because authority can be wielded opportunistically, the injunction to intervene only upon a showing of expected net gains to the collectivity is not incentive-compatible. The resulting direct losses, along with the resources expended by subordinates to guard against these self-interested interventions, could well outweigh any gains from greater coordination or adaptability.
>
> Any organisation which relies on internal authority as a means of resource allocation must face the question of who guards the guardians. The question can be framed more precisely as, who monitors those in positions of authority, in order to ensure that their self-interest does not threaten collective interests?

These problems are of concern both to traditional industrial relations (IR) scholars who fear that unfettered use of employers' power will reduce workers' overall welfare, and also to the labour economist who stresses that such behaviour will tend to be reflected in lower profits as well as a fall in employee welfare since wages or other aspects of the agreement must compensate employees on average for the costs they bear as a result of employer opportunism. The economic literature on this topic focuses on the extreme case where the employer is indeed expected to exercise prerogative without much effective oversight by third parties. The question then becomes, under what circumstances will this situation of relatively unchecked employer power be voluntarily chosen in a world where employers must compensate employees for the costs they expect to bear, that is, in a world where managerial prerogative does not give a free lunch to the employer?

One answer is provided by Grossman and Hart (1986) and extended by Hart and Moore (1990). These authors stress that employers and employees often bargain even in cases where the employer possesses effective rights to make unilateral decisions. Employer power still matters, however, because the employer can

unilaterally reassign the employee if negotiations break down. As a result, the employee is in a weaker bargaining position than he would be if the relationship involved independent contractors. The forces at work are echoed in Storey's (1983:171) account of disputes over management rights in the engineering industry:

> Both sides sought to control the 'status quo' in their own favour – the employers claiming the right to make changes first and argue through procedure afterwards (with the changes meanwhile intact) and the unions claiming a different status quo – that proposed changes would not be operative whilst a dispute concerning them moved through procedure.

Just as in the Marxist account, the employer's ability to control elements of the relationship allows him/her to reap more of the surplus.

The difference between economic and the Marxist approach is that the employer pays up-front for this right. Therefore hierarchy is not automatically preferred as a way to extract wealth from one's trading partner. The choice between organising via the employer-employee route and the alternative of remaining independent is based on the total wealth created under the two approaches. The size of the pie is affected by the choice because an employer who extracts most of the surplus also has a greater incentive to invest in fixed capital. This incentive gain is however, purchased at the cost of a reduced willingness of the employee to invest in firm-specific capital. The Grossman-Hart-Moore theory implies that the traditional capitalist firm is optimal when the formation of physical capital is of greater importance than is the development of employees' human capital. As the importance of human capital increases, more participatory modes of organising are preferred, and at the other end of the spectrum where human capital is of paramount importance an employee cooperative or partnership form is superior. None of these forms of organising is globally superior, and it does not pay a 'capitalist' to insist on control. The cost of such control is a reduction in human-capital investment and is borne by the capitalist. This theory is broadly consistent with the observation that professionals tend to organise in partnerships (and indeed experience substantial problems when they try to convert to a capitalist type firm by going public).

A problem with the Grossman-Hart-Moore approach is that their model implies that the employer never actually uses her authority. All that matters is the fact that she could exercise such authority. Williamson (1985) has stressed that authority or managerial prerogative

often circumvents the need to bargain altogether. Williamson argues that this is beneficial since the delays that often accompany bargaining over many issues are avoided. Dow (1987) makes an important criticism of this approach, stressing that unilateral acts by the employer could well discount the cost imposed on the employee. The employer no longer has much incentive to take account of the costs that the employee bears in complying with directives, because the employee has suspended his right to say no.

Garvey (1993) evaluates these issues in a model that stresses the problem of bargaining when neither party knows exactly the size of the pie. This problem, known as 'asymmetric information', implies that there are costs associated with organising either as independent contractors (which necessitates bargaining) or as a traditional hierarchy (with one party unilaterally deciding on the tasks to be performed). The costs due to bargaining problems become large relative to the costs associated with imperfectly informed hierarchical decision-making only when the stakes are large: that is, when there are large amounts of specific capital on both sides at stake. The reason is that bargaining does reveal information about the costs one's partner would bear in performing the task in question. It does so, however, at the cost of delays and outright failures to agree. The latter costs become large as the stakes increase because it pays each party to bargain harder and thereby dissipate more of the gains from trade. This version of the theory receives support from studies of the organisation of production in aerospace and automobile manufacturing in that inputs which are highly specific to the user and which are surrounded by substantial uncertainty are more likely to be made in-house, using employees, than 'outsourced' from independent contractors (see Joskow, 1988, for a survey).

Despite these advances, the economic theory of managerial prerogative is still quite primitive. There is little doubt that the efficiency enhancement element is significant, but so is the potential for abuse by employers. The economic approach also stresses that there is nothing inherently natural or sacred about the employer's right to control the manner in which work is done (see Storey, 1983:168-90, for examples of employers who take this view). Rather, there are practical and situation-specific reasons why the employer should, in some cases, be able to exercise effective authority. This of course gives the impression of 'unequal' exchange, but recall that the employee was originally independent and was paid to forgo control over some aspects of his time.

PART THREE

Centralised Intervention In The Labour Market

Chapter 9

Specific Legislation

The preceding lengthy review of the economics of incomplete labour contracts makes possible a succinct statement of the positive role that might be played by government policy or unions: to support exchange, and in particular to lend credibility to promises (explicit and implicit) made by employer and employee at the time initial agreements are entered into.

This role has two dimensions. The first is at the contract formation stage, when both employer and employee are free to walk away. The second is during the 'execution' of the employment contract, that is, over the span of a worker's career with a firm. The possibility that a collective voice of workers could enhance efficiency should be apparent from the previous chapter. If the three private mechanisms — explicit contracts, reputations, and delegation of authority — that help employers to commit themselves to uphold their end of an employment relationship are imperfect, there is scope for wealth to be increased by allowing the exercise of voice by workers in decision making after they have been employed (Hirschman, 1970; Freeman & Medoff, 1984). For example, if the employer faces a temptation to overwork some employees, to unjustly deny their deferred compensation, or to neglect obligations to train the labour force, formal grievance mechanisms and union voice can help blunt this temptation and increase the overall wealth of employer and employee (Williamson, Wachter & Harris, 1975). Even the much-abused practice of job demarcation could be rationalised as a (costly) mechanism whereby employers pre-commit not to overwork or misallocate employees. This is particularly the case if one takes the view that 'de-skilling' is a temptation facing employers (Braverman, 1974). In economic terms, de-skilling involves wasteful changes in the production process aimed at reducing the market wage (outside opportunity) of key employees. If de-skilling is truly wasteful and is anticipated by workers (at least on average, or, put another way, if employees do not systematically 'rose-tint' their view of their future career with a particular employer), then it pays the employer to introduce or to accept mechanisms that serve to forestall such behaviour. Traditional craft unionism is one, albeit extreme, response.

Similarly, legislation requiring employers to give advance notice of closings could enhance the well-being of employers as well as employees. While an employer can hire workers for less if they believe she will allow them time to relocate, search for jobs, and so on, should she have to shut down, in the event of a shutdown the employer may be tempted to keep workers in the dark since by so doing the employer receives greater (indeed, misplaced) effort and commitment (see for example Furubotyn & Wiggins, 1984). If alternative mechanisms are insufficient to ensure employers overlook the latter temptation, then mandatory minimum notice periods might create wealth and indeed be supported by employers.

Trade Unions in a Deregulated Labour Market

Before turning to the role of special labour legislation and unions, we should more fully specify the alternative 'deregulated' structure. The alternative is not a pure spot market for labour; no such framework exists anywhere in the world. Rather, the alternative is the common law that governs other commercial relations in countries that have inherited British notions of law. A deregulated system would not ban all departures from the neoclassical spot market. Rather, employers and employees would be able to enter into any structure they found mutually agreeable. If the arguments about the efficiency properties of long-term relationships and internal labour markets in Part Two are correct, many such features will persist and some will surely expand their coverage in a deregulated labour market. Both employers and employees agree, before the employment contract begins, to structures that restrain their freedom, after the contract is made, if such freedoms would be exercised in a way that reduces the joint wealth of employer and employee. This suggests that all features of the employment relationship should at least in principle be negotiable, a stance that follows almost irresistibly from the economic focus on mutually gainful exchange. Not only would employers and employees be permitted to fix any level and composition of pay and performance, but they can also involve third parties to the contract such as arbitrators or even unions. Employees would be able to form an enterprise union to oversee their agreement, but could also choose to join a traditional craft union, industry union, or no union at all. If such a union is expected to interfere with the employers' plans, then workers' wages will be lower and many employers may indeed 'demand' a non-union workplace. But if workers value the presence of a union, then such employers will have to pay higher wages to attract workers and

perhaps also suffer lower productivity. If unions do create wealth, either by enforcing agreements or providing services to employees, then the anti-union employer will actually be throwing away money, and moreover will not be able to compete with a unionised employer. To say that the union creates wealth is to say that the costs associated with union interference are lower than the benefits they confer on workers and perhaps on employers.

The deregulated system would thus take a neutral stance towards unions, that is, would treat them like any other business concern. Trade practices and prices surveillance issues might be relevant for a union that appeared to exercise monopoly power over a particular class of labour, but otherwise there would be no particular attachment to one industrial structure over another. Advocates of 'enterprise unionism' (e.g. Business Council of Australia, 1989) would be seen as making a statement about what is generally the best structure, a statement with which individual employers and employees are free to disagree by choosing representation at the craft or industry level, or alternatively by having no unions at all. The objections voiced by critics such as Bennett (1992:138), that 'Those who advocate enterprise unions do not advocate the break-up of multinationals, conglomerates, or mega-corporations', have no force because all structures are chosen voluntarily.

The *Case* of the Training Guarantee

The discussion of public and union policy here is guided by this definition of the deregulated alternative. In this section, I use the phrase 'public policy' or 'intervention' to refer to features of the employer-employee relationship that are imposed from above and that are not subject to negotiation between employers and employees. Unionism will here generally refer to a system where a particular means of worker representation is either made compulsory or is at least favoured by government policy. We begin with the topic of special public policies toward the labour market, focusing on concerns about training expressed most fully in the Carmichael Report (ESFC, 1992).

The key concerns are succinctly stated in a letter from Mr John Dawkins, the then Australian Treasurer, to the *Financial Review,* 17 May 1991:

> By 1987 it was clear to the Federal Government that Australia was suffering from a serious under-investment in human resource training.

> Australian expenditure on training lagged – and lagged woefully – behind the spending of our most successful OECD trading partners and behind the most dynamic economies in Asia.
>
> No-one can credibly say the market alone can right Australia's training deficiencies. Not until the allocation of training resources and the recognition of skills and competency become an unavoidable and necessary part of planning in the boardroom and on the shop floor can we begin to breathe a little easier.
>
> In the past, it is more than clear that the market could not achieve this. Despite what the critics say – and what the critics say is predictably garnished with straitjacket laissez faire ideology – the Government's training policies will result in more investment in training and facilitate the creation of an open, competitive training market.
>
> The Training Guarantee has attracted most attention during discussions on training policy, It peeves some free marketeers because it attempts to correct a clear case of market failure.

Note first of all that no direct evidence of 'market failure' is given. Rather, we are simply told that Australians invest less than some referent group of nations. But a market failure exists when employers and employees are unable to reap the gains to investment in training, that is, when training imposes a positive externality on the rest of the community. In this case we might be able to conclude that 'the market' or, more accurately, the exchange relationships between employers and employees, will be characterised by too little investment in training. The amount of explicit dollar expenditures made by some referent group of nations is, on its own, almost completely uninformative. (Swedish citizens drink more distilled spirits than do Australians, but no one has suggested reducing the tax on this product to encourage consumption!) H. M, Boot (1992:14) is even more critical of the notion that there is under-investment in training:

> Neither the Prime Minister's One *Nation* statement ... nor the much longer Carmichael Report ... offers any proof of, or explanation for, the alleged inadequacy of training beyond repeating that there is general concern in the community that somehow Australia is falling down on the training of its workforce. As Stromback and Moy ... have shown, this concern has been largely created by the government or its agencies, and is based upon remarkably little hard evidence. Usually only money spent on

> formal off-job training programs (a small part of total investment in training) is recorded and can be observed directly. Expenditure on other forms of training, such as on-the-job training, is difficult to observe but accounts for the greater part of the expenditure on training modern workforces.

These arguments point up the difficulty of identifying circumstances where intervention is actually warranted. The goal of an economic market, we should recall, is to maximise the well-being of its participants. Mr Dawkins' and the Labor government's views seem to imply that the goal is to spend as much as other developed nations. Boot (1992:16) also describes the problems encountered in implementing a policy that would actually produce anything beyond an increase in the dollars spent on training:

> ... if the program is to be fully successful, the government must have knowledge of the skills required by each firm. It is important also to recognise that too much training is as much of a mistake as too little. Excessive expenditure on training wastes resources. Excessive expenditure is much more likely than people suspect, since the large subsidies being proposed will create incentives among trainers to offer, and trainees to seek, far more training than is optimal for Australian needs. Only if incentives are pitched exactly right will the correct amount be invested in training. The government will find it difficult to determine the best distribution of training requirements across firms and industries. . . Despite the large resources devoted to training, one may confidently predict that the skills supplied will rarely meet the needs of industry, while large numbers of young people will be trained in skills that are of little value in gaining a job. There is no doubt, however, that governments will take much satisfaction in claiming that they have trained more people than ever before, and that they have spent a great deal of the nation's resources to do it.

This criticism relies only on the sensible idea that individual transactors know the opportunities and problems they face far better than do would-be central planners. The arguments presented thus far highlight the difficulties encountered in reliably identifying circumstances where exchange processes break down, and in designing remedies that actually address the problems. Part One suggested an alternative approach to identifying and correcting problems in the labour market: look for structural elements that are likely to impede the achievement of economic efficiency. In the case of training, we would

look for factors that undermine employers and employees ability to profitably invest resources in on-the-job training programs,

A well-known contractual problem that can undermine the development of human capital is the fundamental freedom of persons to move to another job when they see fit, that is, the impossibility of entering into what amounts to an indentured servitude agreement (Becker, 1962). Clearly there are powerful countervailing ethical and efficiency considerations that militate against such contracts. But even in the absence of contracts that involve 'slavery', there is a way for the employer and employee to exchange training services that is similar to the Lazear (1979) approach already discussed. The employee pays the employer for the resources invested in training by agreeing to take relatively low wages early on in the career (when the employee is being trained) and receiving a premium later on in the career. Such a wage profile reduces employee turnover and provides both parties with a direct return to the training investment (Salop & Salop, 1976).

Even this brief analysis immediately points up an obvious and remediable impediment to the development of human capital. Awards in the form of binding minimum wage requirements, and other safety-net provisions, directly undermine the viability of deferred compensation arrangements. Borland, Chapman and Rimmer (1991) find that experience-earnings profiles for Australian workers are, in fact, significantly flatter on average than those in other developed countries. This evidence, rather than crude comparison of dollar expenditures across countries, does suggest that Australian workers are receiving less on-the-job training than their overseas counterparts.

Moreover, Hashimoto and Raisian (1985) find that experience-earnings profiles are steeper in Japan than in the US. It also suggests a far simpler solution than the introduction of the elaborate schemes envisioned in the Carmichael Report: allow employers and employees greater freedom in negotiating wage packages. Boot (1992) provides a rather compelling piece of evidence that 'free market' agreements do in fact lead to more training. He finds that the growth of earnings with experience for a worker in the British cotton industry in the 1830s (usually portrayed as the depths of unskilled labour consigned to 'dark Satanic mills') was in fact no less than that experienced by US wage earners in the late 1950s.

In the case of training at least, the use of blanket legislation is a blunt solution which is only 'required' (if at all) because of other distortions that themselves are due to public policy. Although this single case does not rule out the possibility that blanket public policies

might improve on market outcomes in other areas, it suggests the following severe caveats:

- the difficulty of identifying cases where true inefficiencies or social losses exist;
- the difficulty of formulating a policy at the national level that provides anything beyond cosmetic or accounting improvements; and
- the fact that many inefficiencies or failures are cheaply avoidable by removing other public policy-induced distortions.

The discussion so far has focused on policies aimed at specific aspects of the employer-employee relationship. In the Australian case, the most important policy is more general in its effects. In addition to specific legislation, in Australia a particular set of employee representatives is systematically favoured by governmental fiat.

Chapter 10

The Role of Unions

This chapter analyses public policies towards collective worker organisations ('unions'). The question is: should government mandate or favour any form of unionisation of workers and/or workplaces?

This question must be distinguished from the question of whether or not various forms of unions do in fact enhance worker welfare and/or productivity. These issues are more pertinent to the question: will unions continue to represent most workers in an environment where they are not favoured by government policy, and how will they be altered in form or practice? I will treat this second question in only a superficial way, mainly because economic research in the area of how unions actually do contribute to workers' and employers' welfare is still in its infancy. The 1989 Business Council of Australia Study Commission on Employee Relations, and, more recently, Drago, Wooden and Sloan (1992), argue that in many cases it would be desirable to have workers represented by an enterprise union. The interpretation of their results is still controversial (see, for example, Frenkel & Peetz, 1990), and most of the benefits seem to have little to do with the advantage of enterprise unions as such, but rather from the simple fact that the presence of an enterprise union at least avoids the duplication and conflict created by the presence of many active unions at one workplace. These multiple union structures appear uniquely inefficient, Precisely what the key distinguishing features of an enterprise union are, and whether this form of organisation would improve the outcomes in the great majority of employer-employee relationships in Australia, remains an open question. As we shall see, however, it is not necessary to establish the global superiority of one form of organisation (such as enterprise unions, industry unions, or no unions at all) to support free choice of union status.

Compulsory Unionism in Australia

Despite substantial changes in recent years, Australia still can be fairly characterised as having near-compulsory unionism in many important areas of employment. Perhaps the most obvious evidence of this is the storm of protest which greeted the release of Jobsback, the federal

Coalition's industrial relations platform, in October 1992. The key element of the platform was 'A stripping of union monopoly in wage bargaining through the abolition of closed shop arrangements and other practices which support compulsory unionism' (*The* Sydney Morning Herald, 21 October 1992).

Although the phrase 'compulsory unionism' may be an overstatement, it is certainly the case that members of the ACTU receive substantial favouritism from the federal government. First of all, there is no effective provision for individual contracts as in New Zealand. Even collective agreements at the enterprise level are subject to certification by the Department of Industrial Relations. It appears that some forms of agreements can be denied certification for no specific reason: 'the Commission may still decline to certify an agreement if it believes it to be contrary to the public interest' (McCallum, 1993:66; emphasis added).

Although the capacity to refuse certification on subjective notions of 'public interest' lapsed on 23 January 1994, individual workplace agreements are still highly restricted. They may not provide for any wage increase except when consistent with a National Wage Case decisions; they may not provide for any reduction in wages or time below Commission standards; and they must be approved by the relevant state tribunal. These requirements are all in addition to the requirement that the individual employer and employee find it acceptable. This clearly represents a system where traditional unionism is favoured over more decentralised enterprise unions, and individual contracts remain beyond the pale.

To support freedom of choice in union status is not to advocate doing away with unions altogether. Harbridge (1993) and Kiely and Caisley (1992) both document the fact that some unions in New Zealand have actually increased their membership since the Employment Contracts Act 1991 effectively removed union monopoly. This suggests that there are cases in which such representation is efficient, in the sense that the costs imposed on the employer are less than the benefits enjoyed by employees. This is particularly likely to be the case when there are long-term relationships between employers and employees that present both parties with temptations towards short-run opportunism, If, for example, the employer is tempted to deny deferred compensation unjustly or to demand excessive hours from an employee whose mobility is restricted by the fact that many of his skills are firm-specific, then union representatives may play an *important* role. Unions in this case supplement the effects of reputation on the

employer and ensure that promises to the workers are carried out. This is the essence of the argument that unions may be 'efficient' or enhance productivity by giving workers more voice (Freeman & Medoff, 1984), a role that could in principle involve unions that cover only a single workplace, or a subset of workplaces, or an entire corporation, or an entire industry or craft. The advocacy and success of some unions at the enterprise level may simply reflect the fact that the workers concerned had skills and knowledge that were specific to the enterprise and that the appropriate area of union coverage was at that level. A corporate rather than a workplace union might be preferred if workers' skills were specific to the organisation rather than to a workplace.

The conclusion, then, is that modern economic theories of implicit contracts and internal labour markets certainly open up the possibility that union organisations of various dimensions might be desirable and might be chosen voluntarily as part of contractual/organisational structure. Our knowledge is not, however, nearly well enough developed to be able to identify the circumstances that will favour the formation of craft unions, industry unions, company unions, enterprise unions, or no unions at all. Some suggestive evidence that multiple unions at the workplace are unlikely to survive such a system is provided by Drago, Wooden and Sloan (1992). In addition to negative investment effects, multiple unions seem to rely more heavily than single unions on outside compulsion, that is, on closed shop agreements. Beyond this, we have little to say at present about the optimal scope of union coverage for the Australian economy,

Although this shortcoming greatly reduces the role that economic analysis can play in advising particular employers or employees on the sorts of collective representation they should implement, it increases the importance of allowing individuals' free choice of union status. The argument, again, is that employers and employees know their own circumstances in greater detail than outsiders do, and bear the costs of any mistakes. An employer who agrees to have multiple unions at a single workplace bears the cost of this arrangement, particularly if legislation does not impose this structure on her competitors. Similarly, an employee who agrees to work without the protection of a union representative will bear all the costs of any 'oppression' (such as refusal by employer to raise future wages to compensate for the employees' past contributions) that may be brought on by this omission. Attempts to legislate a particular outcome in terms of collective organisation will, at best, do no good if the exact forms would have been adopted

anyway. More likely, such a policy will do positive harm by imposing a particular union structure in areas where such structures are inappropriate.

The general argument is that specific organisations and employment practices should be neither supported nor suppressed. To say that this advocates 'letting the market decide' is not incorrect, but such a statement unnecessarily depersonalises the underlying justification. The notion of a market enters only because many of the interactions that take place through the organisation involve cash transfers (consumers pay prices, employees receive wages, and so on). We should not forget that underlying the mechanical and seemingly depersonalised depiction of a market are a host of voluntary decisions of individuals. A succinct statement of the economic basis of policy would rather be: 'We as policy-makers do not know what is best for individual employers and employees. We should let them decide what is best for their particular circumstances. Employees will not agree to any arrangement that makes no positive contribution to their welfare. If their current circumstances leave them at a standard of living that is deemed unacceptable for an Australian citizen, then we should attack that problem separately and not implicitly assume that minimum pay standards provide the most effective form of safety net. Indeed, by directly intervening in the employer-employee relationship we are likely to reduce the chance of any agreement and thus increase the transfer payments we have to make now (since they will not receive wages) and in the future (since as argued in the previous section their training for the future will also be undermined).'

By portraying union status as an economic choice subject to mutual negotiation, we are also able to identify cases where there might be 'market failure', in which case the choices we observe are not necessarily those that maximise the well-being of employers and employees. In order to even begin to justify compulsory unionism, the argument would have to be that the outcomes bargained by employers and employees would be unduly biased against union presence.[5] This requires much more than the statement that many employers will be reluctant to have unions on site, all else being equal (of course, if unions are associated with higher productivity then, all else being equal, they would be welcomed by a profit-seeking employer). If workers gain more than the employer loses, then we can still expect unions to be part of a voluntary agreement (after all, this exact same type of trade-off is made all the time in areas of fringe benefits, work amenities, and so on). Unions will be systematically underprovided in

a free labour market only if workers are unable to fully represent the importance of union presence in agreements reached with employers.

Free Rider Problems

There is, in fact, a prominent argument that suggests just this outcome: employees will be tempted to free ride on one another in the payment of dues and generally in supporting the union (Masters & Akin, 1984; Jermier et al., 1988). Free rider problems exist when persons who have not paid for the benefits conferred by a public good cannot be excluded from receiving the benefits. In the union context, this condition clearly arises when non-members receive award or other union-conferred benefits. But stating the problem in this fashion also suggests that in many cases it is far cheaper and more effective to deny award payments and other benefits to non-union members. The direct costs of such exclusion are not high since union status can be easily verified. Thus it would be a relatively simple matter to solve many aspects of the free rider problem directly, in which case we could be more certain that the workers' expressed demands for a union actually reflect the value they place on union status.

Although it is technically a simple matter to ensure that the free rider problem does not unduly hamper the formation of unions, there is an equally compelling reason why unions prefer the compulsory unionism alternative. If workers could be excluded from the wage and other benefits conferred by union membership, they would also be able to compete with union members for jobs! Excluding free riders thus robs a union of its ability to act as a traditional monopolist, which in the case of labour involves excluding a large number of workers who would be willing to work for the award wage or for less than that wage. The problem of non-members free riding on the benefits paid for by members exists in the first place mainly in order to maintain a cartel over the supply of labour services. If union benefits could be and were restricted to union members, then unions would have to compete by providing better services to members or by actually serving the governance role that is ascribed to them in the theories of Hirschman (1970) or Freeman and Medoff (1984). Compulsory unionism overcomes a free rider problem that at least in part reflects the desire to monopolise the labour market. This concern remains even in the case of goods such as safety, for which it may be more difficult to implement user charges. As Brook (1991) argues in the case of New Zealand, extending antitrust law to cover the labour area is not only fair: it is essential.

For Free Choice of Union Status

The first and primary reason to allow free choice of union status is to ensure that union coverage is adopted only when it confers net benefits on employer and employee. Freedom of choice also has a predictably salutary effect on the behaviour of unions. Any free rider problem that exists when workers decide on whether or not to become members can be amplified only when decisions pertain to monitoring the behaviour of their union representatives. Berle and Means (1933) stressed the problems that individual shareholders face in collectively acting to exercise their rights in the firm. These problems are trivial compared to those faced when no member even has the right to choose whether or not to participate; Karpoff and Rice (1989) document the severe conflicts of interest and 'agency problems' that assailed shareholders who were denied the right to choose whether or not to become or to remain shareholders. The problem is recognised even by supporters of compulsory unionism such as Bennett (1992:154):

> The system of union recognition adopted in Australia does have negative consequences for trade unions and their members. The system can devalue the importance of a wide and committed membership. Unions can gain recognition and widespread coverage through the processes of the system. When this is combined with the closed shop and procedural devices such as the check-off system it removes even the financial incentives to recruit and retain membership. This can create the indirect problem of union complacency.

An alternative way to state the issue is not to belatedly recognise the 'indirect problem of complacency', but to point out that the current system places a level of trust in the union delegates that would be preposterous in any other business context: no contractual obligations, no auditors, no creditors, no fiduciary duties, and no competition for members either in the form of recruitment or in the form of alternative unions being able to attract away one's members.

New Zealand also supplies some preliminary evidence about the effects of lifting compulsory unionism. Perhaps the most fundamental provision of the Employment Contracts Act 1991 (ECA) was to allow employers and employees freedom of choice over union representation. Boxall and Haynes (1992:228) provide a characteristic statement of the problems experienced by employees under the old compulsory system:

> The reasons being cited for disaffection include a belief that the unions have done too little for their membership fees in the past, a feeling of alienation from wider trade union politics, the belief that they will achieve better bargaining outcomes than those recommended to them by their union officials or a fundamental agreement with the employer that certain changes which the unions have opposed are in fact sensible and fair in the specific company context.

They also conclude that the ability of employees to choose whether or not to retain union status has not yet resulted in a wholesale destruction of the union sector. Rather:

> It might be said that the ECA has had certain positive impacts on the unions.
>
> First, in many situations, the ECA has made free riding a more dangerous activity. Workers who took the benefits of awards without contributing fees now face the possibility of exclusion from a collective whose strength they may actually need to obtain and defend reasonable wages and conditions. This helps to account for the rising level of union density on certain sites.
>
> Second, those employers who have been exhibiting harsh bargaining behaviours have often driven groups of workers back into the arms of the unions. Not only in certain parts of the private sector, but also in the state sector, harsh bargaining postures are stiffening the resolve of various worker groups to resist certain kinds of employer initiative and strengthening union organisation.
>
> Third, as in the United States . . . the unions are becoming increasingly adept at media campaigns, customer boycotts and shareholder challenges at AGMs that are designed to shame anti-union employers and harsh bargainers. Those employers who haven't thought of the link between their industrial relations practices and their product market image are particularly vulnerable.
>
> Fourth, the general public perception of trade unions may well be improving as voluntary unionism shifts the basis of union legitimacy from historical registration to worker choice. Unions, in effect, are seen to have a right to exist based on the free decision-making of the workforce. That commands greater public respect than compulsion. (1992:230)

Chapter 11

Conclusions

The textbook model of the labour market is hostile to almost any labour market policy or formal institution. Such arrangements simply represent distortions to an otherwise free and efficient market for labour. The newer approaches to labour markets surveyed in Part Two provide substantially more insight into, and respect for, such policies and institutions. The key element of the standard model that remains, however, is the insistence that features of employment agreements be mutually voluntary. Employers and employees can agree, for example, to restrict entry into internal labour markets in order to support ongoing employee commitment and training. Unions and other expressions of collective worker voice may also arise naturally.

What is much harder to rationalise even under the richer contractual approach are government policies that mandate particular structures or outcomes. This approach can be justified theoretically only on the grounds of market failure, that is, by establishing conditions that generally lead transacting parties to adopt features that are not in their own best interests or in the interests of society as a whole. In practice, it seems that many apparent market failures are in fact due to government policies. The main impediment to training is not the inherent inability of workers and firms to structure contracts that share the costs and benefits of such investments appropriately. Similarly, the free rider problem that is used to justify compulsory unionism exists mainly because the direct solution would undermine the monopoly power of unions, a move that would be desirable in its own right.

The economic model is focused on the creation of wealth through exchange between free parties. Unless monopoly power is actually exerted at the contract formation stage, it matters little that one party may be 'larger' than another. Unless we are willing to adopt the paternalistic position that a worker does not understand his or her own interest, there is no justification for viewing exchange as 'unequal'. Unless one side is actually defrauded or coerced into an 'agreement', outcomes appear unequal only because the parties entered the agreement with unequal wealth positions; both were made better off by the agreement. If we wish to address the issues of unequal wealth positions, then this should be done in an up-front way through tax or

other explicit policies rather than turning over social welfare decisions to the dictates of trade unions.

Simple policies can be judged on their merits, that is, on the desirability of taking wealth from one group and transferring it to another group. The notion of 'comparative wage justice' that, at least formally, underpins the Australian wage system (Dabscheck & Niland, 1981), appears deliberately obscurantist as well as inefficient. That is, by legislating a set of labour market outcomes, we make many wealth transfers implicit (the difference between what one receives and what one could have received from competing employers) rather than explicit (when one's taxes are raised to pay another person, employed or otherwise). If workers and consumers really valued equality in wage outcomes, then freely negotiated agreements would include a degree of such equality. Indeed, many organisations that have access to essentially free labour markets exhibit a degree of pay equality that cannot be adequately explained by similarities in productivity (Medoff & Abraham, 1980; Lazear 1989b).

If this monograph were addressed to researchers, I would end it on this note, urging both an appealing and entirely justified modesty on the part of economists while highlighting an exciting set of future research questions. But we can and need to say more for the purposes of policy. In particular, we need to stress again the importance and ubiquity of the invisible hand in driving parties to make good contracts and to set up workable relationships and governance structures (Williamson, 1985). Although economists' current state of understanding allows us only a limited set of insights and prescriptions into the workings of internal labour markets and the management of human resources, Hayek's (1978) point that the individuals who actually make the arrangements know a great deal more than anyone else about their individual circumstances and pay for any mistakes or shortcomings in the structuring of such arrangements remains compelling. Moreover, the parties have access to experienced consultants, lawyers and researchers from other fields, who may actually know more about some relevant issues than economists do! There is a market for these services as well.

The alternative to an imperfect market is not an ideal set of 'centralised' agreements. Rather, it is an imperfect system administered by people who do not and cannot fully comprehend the particular circumstances that individual employers and employees face. Worse still, they do not, like the individuals involved, foot the bill for any errors they commit. The 'free choice' perspective does not need to

maintain that employees are omniscient. All that is required is that they are better aware of their own interests and situation than the average member of the Industrial Relations Commission. Recall, also, that collective representatives can be appointed if parties feel they would gain from their expertise. The invisible hand also extends to the market for knowledge and expert representation.

Employers can hire more employees, hire better employees at the same cost to themselves, and so forth, by efficiently structuring their contracts and internal labour markets, Only two assumptions are required for this outcome. First, employers and employees actually must be free to vary terms of the agreement (including union representation, fringe benefits, and even the degree to which managerial prerogative is exercised). Second, employees must not be systematically duped by employers, or, milder still, they are better placed to judge their own best interest than are members of the industrial relations bureaucracy, whom they did not even appoint.

Notes

1. In the current discussion there is no justification for the opprobrium attached to 'poaching', because we are dealing with the choice of whom an employee should begin to work for. There are subtleties involved when the employee has been at work for some time with a particular employer. We will deal with these at length in Part Two.
2. There is also the problem of ex post power exercised by an employer, that is, power that an employer has to redistribute wealth from an employee who has already agreed to work for the employer. This sort of bargaining power has radically different implications from the sort of bargaining power considered in this section and will be dealt with in Part Two.
3. This statement does not apply to the sporting arena, where the presence of a draft for rugby league players is explicitly aimed at keeping employers from bidding up wages!
4. It is quite irrelevant that our apparent 'competitiveness' would be increased, for example if the extra hours produced extra exports. If measured competitiveness declines because workers and employers jointly negotiate shorting working hours then one must question the value of the competitiveness notion in the first place as a measure of social welfare.
5. Even if this were established, it must also be established that legally mandating a particular outcome is the best solution to the problem. In many ways the mandatory choice is as extreme as saying that since automobiles pollute the atmosphere by burning petrol we will, rather than taxing petrol to sufficiently raise the price, require all autos to have a minimum petrol efficiency.

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