

LABOUR LAW AND ECONOMIC THEORY: A REAPPRAISAL

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## Abstract

This paper reassesses economic arguments for and against labour law regulation in the light of recent developments in contract theory, institutional economics, and the theory of the firm. Early analyses of labour law in the 'law and economics' tradition took a position which was largely hostile to labour market regulation. A consensus developed according to which the solution to 'rigidities' caused by labour law lay in 'deregulation'. However, economic theory has been rediscovering some of the benefits of market regulation. A sophisticated view of contract suggests that in unregulated markets, there are significant barriers to both static and dynamic efficiency in situations of repeated or long-term exchange. In particular, where workers invest in firm-specific skills, an appropriate incentive structure should incorporate a degree of protection of the employee against arbitrary treatment by management and some guarantee of continuing employment. Such a view implies that the issue of regulation versus deregulation cannot be decided *a priori*, but requires instead a more detailed empirical analysis of the sources of transaction costs and of impediments to contractual cooperation. This new labour market theory has the potential to influence public policy at an important juncture in the debate over labour flexibility and the future of the welfare state.

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# LABOUR LAW AND ECONOMIC THEORY: A REAPPRAISAL

## 1. Introduction

This paper reassesses economic arguments for and against labour law regulation in the light of recent developments in contract theory, institutional economics, and the theory of the firm. Early analyses of labour law in the law and economics tradition took a position which was largely hostile to labour market regulation. It was argued that trade unions used labour law to cartelise the labour market (Posner, 1984) and that employment protection legislation interfered with efficient incentive structures operating at the level of the individual contract of employment (Epstein, 1984). These arguments were linked to the wider public-choice critique of state action (Rowley 1985) and to libertarian attacks upon attempts to legislate for social justice (Hayek, 1979), as well as to macro-economic models which saw labour market regulation as a cause of unemployment. The critique of labour law therefore spanned a range of theoretical positions. A consensus developed according to which the solution to 'rigidities' caused by labour law lay in 'deregulation', the removal of all or part of the legislation of the welfare state, and the encouragement of labour flexibility. These policies have been practised, to varying degrees, in most advanced economies in the 1980s and 1990s.

However, economic theory has been rediscovering some of the benefits of market regulation. A sophisticated view of contract suggests that there are significant barriers to both static and dynamic efficiency in situations of repeated or long-term exchange. Where workers invest in firm-specific skills, an appropriate incentive structure should incorporate a degree of protection of the employee against arbitrary treatment by management, and some guarantee of continuing employment. This has highlighted certain efficiency-enhancing effects of legislation governing termination of employment (Levine and Parker, 1995) and workforce representation (Rogers and Streeck, 1994). Similarly, formal analyses of strategic behaviour have shown

that in the presence of asymmetric information, private bargaining will not necessarily produce optimal outcomes (Aghion and Hermalin, 1992). From the broader perspective of evolutionary and institutional theories of the firm (see Hodgson, 1998), there is a need for a deeper understanding of the institutional preconditions of economic exchange and learning, which include a role for the important but ill-defined notion of 'trust' (Deakin and Wilkinson, 1996).

As in the 1970s and 1980s, a number of different theoretical perspectives may again be converging around a new consensus concerning regulatory policy in the labour market. This is to the effect that a good case for public-regulatory intervention in the labour market can be made, given the limited capacity of private contracting to generate certain static and dynamic efficiencies. This would be consistent with Coase's view 'that there is no reason why, on occasion... governmental administrative action should not lead to an improvement in economic efficiency' (Coase, 1960: 119). Such a view implies that the issue of regulation versus deregulation cannot be decided *a priori*, but requires instead a more detailed empirical analysis of the sources of transaction costs and of impediments to effective contracting in particular contexts. There should also be a clearer acknowledgement of the the importance of non-market institutions as solutions to coordination problems, and of the need of such institutions for legal underpinning. This new labour market theory has the potential to influence public policy at an important juncture in the debate over labour flexibility and the future of the welfare state.

## **2. Labour Law as a Form of Market Regulation**

For present purposes we define 'labour law' as a type of regulation of the employment relationship which derives principally from the state, in the form of social legislation and of private law, and from conventional sources, such as collective agreements or arbitral awards. Much of labour law has a protective purpose, although there is disagreement as to how far this protective element forms an essential

part of labour law (see Mitchell, 1995). Labour law is distinct from the private law of property, contract and tort. Although these private law concepts continue to play an important role both in guiding the courts and in providing a definitional structure for legislation, public regulation has ensured that labour law has achieved a qualified autonomy from the private law of obligations (Wedderburn, 1987).

Three related features of labour law regulation illustrate its separation from private law. The first is the recognition of the employment relationship, or contract of employment, as a distinct *object of regulation*. The contract of employment is subjected to norms which are specific to that contract, as opposed to contracts of a different type (such as sale, lease, and so on). This does not necessarily mean that the general principles of contract law cease to have any role at all in constituting the contract of employment; however, their influence is reduced in favour of norms of a more specific kind. As a result of the separation of the contract of employment from general contract law, it is necessary for labour law to develop criteria of identification (such as 'control', 'integration' or 'economic reality' (see Deakin and Morris, 1995: ch. 3)) which serve to define the relationships to which these specific norms apply.

The second feature is the emergence of distinctive *forms of regulation*, known as *labour standards*. Labour standards can be thought of as being either substantive, procedural or promotional in nature (Mückenberger and Deakin, 1989; Sengenberger, 1994; Deakin and Wilkinson, 1994). Substantive standards are those which directly regulate the individual employment relationship (Kahn-Freund, 1983), for example by setting minimum wages, maximum working hours, basic health and safety standards, and so forth. It is normal for these standards to take the form of a 'floor of rights' or set of minimum provisions on which other, conventional sources of terms and conditions can improve, but from which they may not derogate, except under prescribed conditions (Wedderburn, 1992).

Procedural standards - referred to by Kahn-Freund as 'indirect regulation' - do not govern directly the terms and conditions under which labour is contracted, but instead provide legal support for mechanisms of collective negotiation and/or representation of workers and employers. These would include laws enabling trade unions to operate free of the doctrine of restraint of trade and of the economic torts; laws providing for arbitration or conciliation of labour disputes; laws placing employers under a duty to bargain with certain representatives of the workforce, or to consult with them over certain decisions; and laws providing for co-determination.

Promotional standards are concerned with enhancing labour market opportunities through training, job creation and other forms of 'active labour market policy'. These may take the form of subsidies to employers, targeted expenditure, and adjustments to the social security and tax systems (Sengenberger, 1994). They span the divide between the core, juridical forms of labour law intervention, on the one hand, and instruments of public economic governance, on the other.

The third element in the emergence of labour law is the existence of institutions which are specific to that field of regulation, which operate to produce, monitor and enforce labour standards. Such institutions include specialised labour courts, trade unions, employers' associations, machinery for the determination of pay, conciliation and arbitration mechanisms, and a variety of other forms.

### **3. Labour Standards and Regulated Competition**

Labour standards undoubtedly aim to regulate competition in the labour market, and for some this would be a sufficient basis to condemn them on grounds related both to efficiency and to fairness (Heldman, Bennett and Johnson, 1981; Epstein, 1983, 1984; Posner, 1984). However, it is important to clarify at the outset an important feature of labour standards, which is that they rarely displace contractual autonomy completely. The scope for statutory standards which are truly

'inderogable' is quite limited in most systems. Where legislation sets basic substantive standards on such matters as working hours which govern a whole economy or a particular industry, it is often possible for the collective parties at plan or enterprise level to derogate from such standards in the interests of flexibility (Wedderburn and Sciarra, 1988; Mundlak, 1997). In this way labour law effectively sets procedural standards, thereby creating a space for collective bargaining. Except in some insolated instances (such as under the US National Labor Relations Act, which in this respect is highly unusual) neither collective bargaining nor legislation prevent individual bargaining improving upon the basic terms laid down by a collective agreement, although individual derogation downwards is rarely permitted (Wedderburn, 1992). Even where a nominally inderogable standard is fixed, such as a minimum wage which has the effect that employers cannot seek to reduce costs by depressing pay, the standard in question does not rule out other options for cost reduction, such as enhancing productivity by improved training and utilisation of labour. By ruling out one option, others are encouraged. In all these respects, then, labour standards may *guide or channel* contractual outcomes, but rarely predetermine them in a rigid way.

Standards which *are* rigidly binding, in such areas as health and safety or equality of treatment, normally indicate a very high policy priority in favour of obviating particular forms of private cost to employees. However, many of these standards also have economic purposes. In particular, they may function to limit divergencies between social and private costs which arise from high transaction costs or externalities (see further below).

The mere fact that most labour standards guide or redirect competition, rather than restricting it altogether, does not mean that the resulting outcomes are efficient. Welfare economics sees market exchange as the principal means by which resources are allocated to their most efficient use, and the wealth of society thereby maximised. From one point of view, anything which interferes with free market exchange could be

seen as harmful to efficiency. Many labour law interventions are plainly motivated by considerations of equity, broadly understood, and not by arguments drawn from economic efficiency (although, as we shall see, this is by no means always the case). There may well be, as a result, short-run conflicts between equity and efficiency; however, the same forms of labour market regulation may provide a basis for long-run dynamic efficiency (Boyer, 1994). These are described in more detail in the text below. The essential point is that in unregulated labour markets, market failures of various kinds limit the scope for efficient resource allocation through private ordering.

#### **4. Labour Law and the Coase Theorem**

The economic analysis of legal rules typically starts with the proposition known as the 'Coase theorem' (Coase, 1960). This can be stated as follows:

*the allocation of legal rights makes no difference to efficiency in a world of zero transaction costs, since agents are able to recontract until the resources in question reach their most efficient use.*

In such a world, the legal decision to allocate a property right to one agent or another, or to impose a private cost in the form of a liability rule on one agent or another, clearly has *distributional* consequences: one side is left better off than the other. However, in a world characterised by pure competition, perfect rationality and foresight and perfect information, there are (by definition) no impediments to the set of exchanges needed to ensure a Pareto-optimal outcome: efficiency, and hence the overall wealth of society, are maximised, regardless of the initial allocation of rights.

The world of zero transaction costs is such an unusual place that one might think that the Coase Theorem has little or no relevance to practical policy-making. A world in which economic actors have



perfect knowledge of all future contingencies is one in which, as Coase has remarked (1988: 15), 'eternity can be experienced in a split second'. The practical policy significance of the Coase theorem can only lie in its application to a *real* world in which transaction costs are not negligible. The term 'transaction costs' may be understood to mean, in a narrow sense, the costs of writing, monitoring and enforcing contracts, but in a broader sense it may be taken to embrace all costs arising from the scarcity of information, the possibility of opportunism or strategic action, and the bounded rationality of economic agents (see Dahlman, 1979).

Three separate (and potentially contradictory) interpretations have been offered for the Coase Theorem (see Cooter, 1990; Deakin and Michie, 1997). The first interpretation suggests that:

*where markets are either competitive or contestable to some significant degree, the efficiency implications of legal norms are limited, leaving policy-makers free to pursue distributional goals.*

This approach assumes that the Coase theorem has a potentially broad application in the real world of positive transaction costs. The necessary preconditions for the theorem may be met, in practice, as long as markets are competitive in the sense of achieving a broadly acceptable level of effective rivalry between competing sellers and between competing buyers. Alternatively, it may be enough that the market in question is contestable, in the sense that entry and exit costs are close to zero, thereby facilitating the entry of new competitors into the market to compete with incumbents.

This strong assertion of the real-world *existence* of competitive or contestable markets is, curiously, quite compatible with an extensive system of labour law regulation designed to redistribute power and resources in favour of employees at the potential expense of other groups (such as managers and shareholders). This is because the presence of a labour law regulation (such as a minimum wage law) or a

liability rule (such as a rule of employer's liability for certain work-related accidents) with a redistributive effect would not, in itself, prevent recontracting to ensure Pareto-efficient outcomes. The end result would still favour certain groups over others; but the Pareto principle, in itself, has nothing to say about the justice of particular initial distributional configurations.

Consider a law mandating maternity leave entitlements for employees. This does not, in itself, rule out recontracting which might result in a Pareto-efficient allocation. Employers might seek compensation for the imposition of such a rule, either by reducing wages or other benefits for all employees (assuming such reductions cannot lawfully be targeted on to women employees, by virtue of laws outlawing sex discrimination), or by reducing their employment of women of child-bearing age, or by increasing the value of the employment package at the expense of dividends paid to shareholders (see Gruber, 1994). The effect would be a series of wealth transfers between various groups: women employees who become pregnant would gain at the expense of employees as a whole; or at the expense of women employees who cannot find jobs; or at the expense of shareholders. However, it is not clear *a priori* that the outcome would be *inefficient*; nor is it clear on what *economic* grounds society should be prevented from making a political choice to protect maternity in this way. The actual judgement can only be based on empirical research.

The generally prevailing view is that labour law regulations probably *do* make a difference to efficiency, since the market for labour is not *so* competitive that agents can easily contract around regulations of this kind. Regulations themselves can be seen as an exogenous source of transaction costs. This gives rise to the second of the three interpretations of the Coase theorem referred to above:

*since efficiency depends above all on the capacity of agents to contract at low cost, the law should seek to reduce barriers to*

*exchange and to give as wide an ambit as possible to unqualified property rights and to freedom of contract.*

This implies a legal regime of minimal regulation, since any constraint on freedom of disposition and on freedom of contract can be seen as reducing competitive intensity and hence as creating rigidities. This view is consonant with a position taken by public choice theory, to the effect that the regulatory state is the origin of the most significant market inefficiencies. Public regulation is seen as the outcome of rent-seeking activities by organised private groups (Heldman, Bennett and Johnson, 1981; Rowley, 1985). Implicit in this position is the (questionable) view that private markets, if left alone, work reasonably effectively, but that the market for political goods (of which legal regulation is one) is irredeemably flawed by sectional interests.

The third interpretation, conversely, stresses the role of legal intervention in overcoming private market failures:

*unregulated markets are characterised by high transaction costs which derive from limited information and the bounded rationality of economic agents, and which produce mismatches between effort and reward. The law has a role to play in underpinning institutions of various kinds (not just markets) in order to facilitate effective coordination of economic resources.*

At one level, the legal allocation of property rights serves to overcome basic transaction costs, leaving the parties free to make their own exchanges; at another level, liability rules of tort and contract may be needed to 'mimic' the market by allocating rights to the agent who values them most highly and who would, therefore, have purchased them in the absence of barriers to exchange. But these private law solutions may not be enough. Certain contracting problems may have to be resolved through vertical integration (Coase, 1937) or through public regulation. As Coase has repeatedly acknowledged (1960: 119;

1996: 106), there is nothing in his approach to the analysis of legal rules which rules out state intervention on *a priori* grounds.

It is often claimed by both critics and supporters of Coase (e.g. Stiglitz, 1994: 11, and Easterbrook and Fischel, 1990: 17, respectively) that the normative meaning of the Coase theorem is that the law should do what it can to promote free exchange, in particular by establishing property rights which can be the subject of transfer between economic agents. As a result, the most usual reading of Coase is that the law should avoid placing limits on freedom of disposition and freedom of contract. But this seems to be based on a misunderstanding or misreading of 'The Problem of Social Cost'; at best, as we have just seen, it is only one plausible interpretation of the Coase theorem. A better view is that the Coase theorem does not dictate any particular position with regard to the efficiency of labour law regulation. It certainly does not point with any clarity to deregulation as the preferred option. That option can only be completely compatible with efficiency if deregulation results in a zero or low-transaction cost world, in which private ordering can generate efficient outcomes. A broader analysis of the origins of structural inefficiencies in labour markets, together with a consideration of the preconditions for effective regulatory design, would suggest that this is an implausible position. In the context of the labour market, regulation is often necessary on grounds related to economic efficiency, as opposed to the social justice considerations which are most often adduced. But to make this argument, we first have to examine the bases of the economic critique of labour legislation which has been so influential in directing public policy since the late 1970s.

## **5. Labour Competition and Wage Inequality**

The case made by orthodox free market economists against the establishment of centrally coordinated labour standards is that both equity and efficiency are best secured by allowing the labour market to operate freely. It is argued that competition between workers for jobs and employers for workers ensures that the overall level of pay is

determined by the available techniques of production and by the scarcity of labour relative to capital. The resulting wage differentials reflect variations between workers in skill and work effort, and hence differences in their value contribution. The persistence of very low levels of pay in many advanced industrial economies, even in periods of labour scarcity (see Deakin and Wilkinson, 1991), and the widespread evidence of wide wage variations, even within narrowly defined occupational, industrial or geographical groups (see Rubery and Wilkinson, 1995), would appear to confound these predictions. But these apparent anomalies are accounted for by free market theory in a variety of ways which leaves intact the central core of that theory. These explanations can be divided into differences between jobs (other than in the skill and effort they require); differences between individuals; the presence of costs of hiring, training and acquiring information; and other, 'artificial' obstacles to the free working of the labour market.

### *Differences between jobs*

Jobs vary, it is argued, in amongst other things, by the degree of risks they involve, the conditions under which they are undertaken, their intrinsic interest, and the degree of responsibility which they require; these attributes result in compensating wage differentials (Smith, 1986, chapter 10). Notwithstanding overwhelming evidence to the contrary - empirical studies find little evidence of compensation for poor and dangerous working conditions unless there is high risk to life (Duncan and Leigh, 1980) - this theory predicts that boring, risky jobs undertaken in unpleasant working conditions will be paid more than interesting, safe jobs in pleasant surroundings.

### *Differences between individuals*

It is also argued that individuals vary in earning power because of differences in the investments which they make in acquiring skill (their human capital) and in their ability to work hard and effectively

(Becker, 1964). Skills require training and experience which incur cost and are undertaken only if a rate of return on this investment, in the form of an increment over the wage for unskilled work, can be expected. As individuals differ in innate ability, degrees of risk aversion, and preferences for consumption today rather than tomorrow, the amount of human capital which they acquire also varies widely. At the same time, because individuals differ in their 'exertion of ability and efficiency' (Marshall, 1947: 456), it is 'efficiency-earnings' - that is, earnings per 'efficiency unit' - which the market tends to equalise. Therefore, wage variations between workers in similar jobs are also explained by differences in how hard and effectively they work.

### *Information costs*

The costs of acquiring information also provide explanations for wage variations which are not directly attributable to the characteristics of workers or of jobs. Labour mobility may be deterred unless the expected wage increase defrays the cost of search. Similarly, the absence of full information about potential recruits leads to the use by firms of social and other characteristics - such as age, sex, race, qualifications, dress, and deportment - as *signals* of labour quality (Spence, 1973). Firms may lack information about workers' productivity, and even about the jobs which they do: since workers' skills and efficiencies are enhanced by the interaction between learning by doing and the technical, organisational and economic progress of the firm, there is no reason to believe that management has full information concerning job content and performance.<sup>1</sup> Therefore, the absence of perfect information about the full potential of recruits and of job content may result in a range of *different* earnings for workers of *comparable* skill and efficiencies.

### *'Artificial obstacles'*

Finally, orthodox theory explains wage differentials by the operations of trade unions and other institutions which 'impede' the 'free'

workings of the labour market. On the supply side, trade unions organise in order to monopolise access to routes into advantaged jobs and to shut down the supply of labour through strikes and other forms of industrial action, thereby raising barriers to entry on the part of both firms and workers. The support of the state through labour legislation is seen as essential in propping up collective labour organisation, which would otherwise be undermined by the threat of competitive entry in the manner of other cartels (Posner, 1984). The result is a distortion of the wage structure, which results in the expulsion of workers from sectors of the labour market where wages and conditions of work have been raised above the market clearing level, and their crowding into unemployment or into more competitive sectors where pay and working conditions are consequently depressed. The victims of labour legislation, then, are the low paid and the unemployed.

In seeking to explain the structuring of labour markets, even some of the more sophisticated institutionalist economists have also tended to fall back upon one or more of the traditional arguments to account for inter-sectoral wage inequalities. For Doeringer and Piore (1971), advanced technology, specific skills, on-the-job learning, labour quality, secure product markets and effective trade union organisation explain the relatively high pay of workers in the primary sector or internal labour market. By contrast, workers in the low paid secondary sector are said to be characterised by low levels of skill, and as having a low degrees of work commitment. Hicks adopted a similar quality categorisation when differentiating between regular and the casual trades, and noted that 'casual labour is often badly paid, not because it gets less than it is worth, but because it is worth so appallingly little' (Hicks, 1962: 82).

So from Adam Smith onwards, economists have found theoretical explanations for the persistence of apparently anomalous wage inequalities, without departing too far from their central contention that the market provides an effective valuation of labour. It is market competition and the market clearing effects of price which establish

what Marshall described as a 'true' standardisation of work and wages (1947: 588). Obstacles to market forces, described by Adam Smith as those 'not leaving things at perfect liberty' (Smith, 1986: 222), produce 'false' standardisations of work and wages (Marshall, op. cit.). Where social discrimination arises in the form of employers' 'tastes' for employing members of one gender or ethnic group in preference to another, the market responds in the form of competition from employers who do not suffer from these forms of prejudice (Becker, 1957). Contemporary critics of labour law have theorised that it is, above all, the activity of powerfully placed groups, with their ability to limit entry and to exercise control over specialised skills to raise their wages above the market clearing rate, which are responsible for producing distortions in the labour market. The result of their activities is that the less fortunate outsiders are crowded into unemployment or into sectors where competition is unrestricted, and where wages are low and conditions of employment poor. Hence the outcomes of 'false' labour standards include greater inequality and allocative inefficiency.

## **6. The Economic Nature of the Contract of Employment**

The orthodox position has been challenged by theoretical perspectives which question any automatic tendency towards efficiency in a 'free' or unregulated labour market. The starting point for this alternative point of view is to be found in analyses of the distinctive properties of the contract of employment, and in particular its 'incompleteness'. Labour lawyers tend to justify protective regulation of the employment relationship on the grounds of the inequality of power and resources between employer and employee; the classic exposition of this theme is by Otto Kahn-Freund in chapter one of *Labour and the Law* (1983). Economists tend to reject the blanket application of the notion of power in this context as being too imprecise (see Williamson, 1985: chapter 9). However, most branches of economic theory now accept the idea that the employment relationship has distinctive and particular characteristics which set it apart from other transactions, and which render inapplicable certain aspects of orthodox free market analysis.



The classical economists, Adam Smith included, recognised that labour cannot be alienated from the person of the worker, and that, as a result, the distribution of risk within the employment relationship was not symmetrical: labour power cannot be stored and is perishable, so that the capacity of the worker to hold out for better terms is limited; and there are fewer employers than there are prospective employees. As a result,

It is not... difficult to foresee which of the two parties must, upon all ordinary occasions, have the advantage in the dispute and force the other into a compliance with their terms... Many workmen could not subsist a week, few could subsist a month, and scarce any a year, without employment. In the long run, the workman may be as necessary to his master as his master is to him; but the necessity is not so immediate (Smith 1986: 169).

The same idea underlies the marxian distinction between labour and labour power: the form of the employment contract is such that the employee undertakes not to supply a given quantity of work, but, rather, to labour under the directions of the employer for a certain period of time (Marx, 1976: ch. 7). Marx's analysis is notable for the sharp distinction it draws between the realm of the market, in which the contracting parties negotiate under conditions of juridical equality, and the realm of production, within which the hierarchical relation of 'master and servant' holds sway.

The asymmetrical quality of the employment relationship does not necessarily mean that the risk, or conversely the 'power', is all on one side. Modern contract theory abstracts from the broader legal and social background to the exchange of wages for labour power, and sees the employment relationship as raising problems of monitoring, information and strategic behaviour which are common to many contractual settings, and do not necessarily call for specific regulation aimed at protecting the employee. This is the area of principal-agent

theory and game theory. From this perspective, it is often assumed that it is the *employee* just as much as the employer in whom economic power is vested. As 'agent', he or she has the opportunity for 'shirking' or underperforming at the expense of the employer. This arises because of presence of 'limited or hidden information' - the employer (principal) cannot effectively 'screen' potential employees (agents) for their skills and aptitude for work prior to entering into the contract, and, once performance has begun, cannot fully monitor what the employee is doing. The problem is intensified where both parties make relation-specific investments (Williamson, 1985). This means that the value of the assets which each brings to the exchange cannot be fully realised except within the context of that relationship; redeploying them elsewhere is costly. To that extent, each of the parties (and not just the employee) is subject to the threat of 'hold up'.

The solution to opportunism is seen to lie, in part, in the use of incentive structures which may be arrived at through private contractual ordering. In this context, Epstein (1984) stresses the importance of both parties to the contract having the option of costless or low cost exit from the relationship, so as to be able to deploy an effective sanction - dismissal or quitting - in response to the other's opportunism. It is argued that an employer which acts in breach of undertakings or understandings towards its employees will be penalised by loss of reputation in the market, and that this makes a legal remedy of damages or reinstatement unnecessary. Such remedies, in so far as they make employers reluctant to dismiss under-performing workers, or give rise to speculative and costly litigation, may be efficiency-reducing. Employment at will - which allows either side to exit from the relationship without the obligation to give notice or to give reasons for termination - should therefore be the courts' preferred default option when construing the contract of employment (Epstein, 1984).

But other contributions to this debate are sceptical about the use of exit as an effective sanction for opportunism in the context of the employment relationship. Where the parties make relation-specific

investments, then recourse to the market or to reputation as disciplining devices is, by definition, costly (Williamson, 1985). Examples include investments by employees in firm-specific skills, know-how and expertise, which are of limited value in other organisational settings, or which are expensive to acquire anew in another employment. The problem is particularly acute where exit costs are higher for one party than for the other. There is no necessary reason to assume that it is only the employer which can exercise credible threats; it seems plausible to assume that, from time to time, changing circumstances may give the employee the chance to do so. But the question of which of the two parties tends to be the more powerful is less important, in the present context, than the idea that the parties are locked into a relationship which is insulated from the market for a certain time and space, and that under these circumstances a specialised governance structure is required to ensure optimal contractual performance.

In the case of the employment contract, elements of a governance structure are often made explicit. Employers frequently make express and detailed promises to employees concerning seniority rights and pension entitlements which reward long-term performance (see generally Lazear, 1995). Transaction cost analysis recognises that it is often in employers' self-interest to introduce many of these benefits in order to elicit long-term co-operation (Williamson, Wachter and Harris, 1975). The commitments made also need to be made 'credible' (Williamson, 1983) if the employee is not to withhold cooperation. If they are not, either the employee would not enter into the contract in question, or extra transaction costs would be incurred in providing the employee with contractual compensation for the additional risk. Where such undertakings are broken, the opportunity costs to the employee may well be considerable. An extreme, but not unknown case, is the dismissal of employees a matter of days or hours before the vesting of pension or other occupational benefits; corporate 'downsizing' following restructuring is a more common one.

Whether employers are effectively deterred from opportunistic action by a market sanction - the harm done to their reputation - is, in our present state of knowledge, a matter for speculation. A more specific loss can be inflicted on the employer if the parties agree, in advance, for the provision of 'hostages', such as collateral or security interests, which raise the costs of exit (Kronman, 1985). But these analyses are not able, in themselves, to show that legal enforcement of contractual promises is of no economic importance. After all, many commitments given by employees - such as promises made under 'restrictive covenants' not to compete with their employer - are routinely enforced by courts even after the contract of employment has come to an end, with only limited grounds for invalidating such agreements for being in restraint of trade. This type of enforcement is not compatible with the argument that reputational effects suffice to penalise opportunism.

The wider issue in this debate is whether legal regulation which is specific to the employment contract, in the form of implied contract terms and mandated benefits, is justifiable on efficiency grounds. One possibility is that these forms of intervention play an important role in protecting *implicit* elements of contractual governance. 'Implicit' contracts arise in circumstances where formal or explicit agreements are incomplete; they can be thought of as understandings about cooperation which, because of uncertainty about the future and the costs of making such understandings explicit, are too costly to formalise and to enforce as contract terms in the normal way (Cornell and Shapiro, 1987).

The 'incompleteness' of the contract of employment is widely recognised to be the consequence of its long-term orientation and the structural uncertainty over future performance which this induces (Mückenberger and Deakin, 1989; Brown and Rea, 1995; Jeammaud, Kirat and Villeval, 1996). In the case of most contracts of employment, it is unclear when the employment relationship is to end; the precise content of the employee's obligation to work is rarely specified; and the intensity of work effort is also left unstated. These elements are

normally left to be worked out as the relationship proceeds; but they are also subject to normative influences which range from implicit understandings to workplace rules ('custom and practice') and more formal, third party regulation. It is not simply a matter of fairness, but it is also economically efficient for private ordering to be supplemented by labour law regulation in this way. The normative framework supplied by labour law may therefore, be not just an important means of reducing transaction costs, but also of promoting cooperation based on *trust*.

The vast majority of contemporary labour law systems have either never applied the concept of the contract at will to the employment relationship, or have fundamentally departed from that model at some point in the past 100 years. So far from the 'ubiquity' of the rule of employment at will indicating its 'survival' value, it is in fact a highly exceptional approach to the legal regulation of the employment relationship which persists only in particular jurisdictions of the United States.<sup>2</sup> Rather than regarding the employment relationship as the juridical equivalent of a black hole, which is the effect of the default rule of employment at will, most systems of labour law supply to the employment relationship a set of standardised terms, some of which are optional in nature of default rules and others of which are mandatory; these in turn generally supplement a body of formal terms which are most often laid down in an external sources, such as a collective agreement or, exceptionally, agreed by the individual parties themselves. At some risk of over-generalisation, we may define the distinctive features of this regulatory framework as two-fold: the employment contract (1) underpins the employer's power of direction, the 'managerial prerogative', while at the same time (2) granting the employee certain expectations of continuing employment and income security.

## *Managerial prerogative*

Most juridical conceptualisations of the contract of employment recognise an area in respect of which the employee implicitly cedes to the employer a degree of authority over the pace and organisation of the work which he or she undertakes to do, in common with the theoretical models of Coase (1937) and Simon (1951). To this extent, it is not simply the distribution of property rights between employer and employee prior to the contract which is normally unequal, but the terms of the contract itself which are asymmetrical and which engender economic power. The effect is that employer does not need to gain the consent of the employee to any and every change in the way the job is carried out; 'functional' or internal flexibility is built into the legal definition of the relationship, in the form of the employee's implied obligations of obedience, cooperation and care (Deakin and Morris, 1995: 296 et seq.). This residual power which vests in the employer can be seen as a layer of status 'beyond contract', or at least beyond the explicit terms of the parties' agreement (Fox, 1974).

The essential institutional feature of the contract of employment, then, is that the employer has a *unilateral*, residual right of control which, while ill-defined, distinguishes the contract of employment from others (such as sale or rent) in which a unilateral right of this kind is not present (see Masten, 1988; Marginson, 1993). To speak of employment as a continuous process of 'renegotiation' or renewal of contracts between parties to a continuing relationship (Alchian and Demsetz, 1972) is to ignore this essential feature: the employer's implicit rights enable it, up to a point, to dispense with the need for regular renegotiation.

## *Protection of employee expectations*

The open-endedness of the employee's commitment can be seen as providing the basis for the flexibility needed to ensure co-operation between a large number of agents in the productive process. In Coasean

terms, this would account for the efficiency of the firm as against the decentralised market; it is, in part, because continuous renegotiation between large numbers of agents would be highly costly that the firm comes into being at all (Coase, 1988; chapter 2). But the question then is how the employment contract can persist despite this fundamental inequality within exchange. Why would it be in the employee's interests to enter into such a contract? One explanation might be that lack of access to capital gives most prospective employees little choice over the matter. But there may also be more positive aspects to the employment relationship.

From the point of view of a rational choice analysis, the employee might be expected to demand from the employer some compensation for granting the employer an area of discretion in directing the way in which the work is to be carried out (see Simon, 1951). Equally, from an institutional and historical perspective, it is plausible to suggest that the persistence of the employment relationship is attributable to norms which create a second layer of status to add to that provided by the employer's implicit powers of direction, namely norms of employment and income protection deriving from labour legislation and collective bargaining between trade unions and employers (Mückenberger and Deakin, 1989; Streeck, 1992). Within the firm, bureaucratic rules which determine the position of employees within the system of ranks and identify the holders of managerial and supervisory serve to regulate the exercise of power. The internal norms of the organisation are supported, in turn, by those external norms which grant legal force (up to a point) to employees' expectations of job and income security and underpin their right to collective representation at the workplace.

Rules of this kind, by institutionalising power, seek to render its exercise less personal and hence more predictable and legitimate; by doing so, they offer an important basis for long-term cooperation which enhances the productive potential of the employment relationship (Ménard, 1994). As Coase recognised, the power of the employer to direct the employee is a power which only operates 'within certain

limits' (1988: 39). These limits are necessary not just because continual renegotiation is highly costly, but also because, in a relationship characterised by asymmetries of information and power, the ever-present possibility of renegotiation may undermine cooperation. Conversely, the establishment of external controls over managerial prerogative may help to foster trust.

From this point of view, certain characteristic features of labour law (as found in virtually all systems other than those of the United States), which include the legal imposition of mandatory minimum labour standards, statutory support for collective workplace representation, and a high level of standardisation of terms and conditions of employment, can be seen as performing an important economic role. For example, an employer's agreement to enter into a relationship of collective bargaining with an independent trade union, precisely because it is costly, can be an important signal to its workforce of a 'credible commitment' to the maintenance of cooperative relations. Equally, statutory support for employee representation may in certain circumstances help to overcome the divergence between the private gains which employers can make by resisting collectivism and the loss to society in terms of wasted opportunities for cooperation (Rogers and Streeck, 1994). The 'just cause' standard in dismissal law, because it creates an area of protection for the employee which cannot be renegotiated during the life of the contract, may assist the employer in making 'credible' promises of fair treatment in the course of the employment relationship (Büchtemann, 1994).

The employment relationship offers many other similar illustrations of the idea that formal legal restraints on private contract may be justified on efficiency grounds. The essential point is that in a world characterised by radical uncertainty, gains from cooperation between economic agents may not be attainable through private ordering alone. Collective restrictions on freedom of contract *may* therefore be efficient. In particular, the presence of asymmetric information - one party having greater access to relevant information than the other -



increases the risk of strategic behaviour, that is to say, behaviour designed to enhance the position of one party directly at the other's expense (Aghion and Harmalin, 1990; Ayres and Gertner, 1992).

This is a slightly different way of expressing the labour lawyer's traditional concern for 'abuse of power'. The concepts used by economists do not have the effect of taking us full circle, back to the position that all labour law interventions can be justified simply by designating the employee as the 'weaker party'. The approach taken is more discriminating than that, and notes that if cooperation is mutual, so is the possibility of 'defection'. But at the same time, we have come a long way from the position that free exchange *must* be efficiency-enhancing, and external regulation efficiency-reducing.

## **7. Efficiency Wages, Insider Power, and Labour Regulation**

The insights of contractual analyses have been extensively developed in recent years within efficiency wage theory and insider-outsider theory. These approaches seek to explain why wages in internal labour markets are relatively rigid, in the sense that they are slow to respond to external shifts in supply and demand, if they respond at all. There are two aspects to this phenomenon: firstly, employers are slow to cut wages in response to a fall in the demand for labour; and, secondly, workers are reluctant to undercut generally prevailing notions of the 'fair' or 'going' wage, even at the cost of remaining unemployed. The starting-point is the observation that wages tend to be set not solely or even predominantly by reference to external conditions in the labour market, but as part of a process of bargaining over the 'rent' or surplus which is realised through cooperation within the firm. The idea is to be found in the writings of Marshall, who used the term 'quasi rent' to refer to 'the income derived from machines and other manufactured appliances for production made by man' (1947: 74). The amount of the quasi-rent is determined by market conditions at the time the asset is operating, and not by the cost of producing that asset; however, bargaining over the division of quasi rents between labour and capital

is influenced in part by firm-specific factors, since the 'workmen would lose a great deal of their wages by going away, and at the same time injure the firm seriously' (Marshall, 1947: 626, fn. 2). Hence:

in some cases, and for some purposes, nearly the whole income of a business may be regarded as a quasi rent, that is an income determined for a time by the state of the market for its wares, with but little reference to the cost of preparing for their work in it. In other words, it is a *composite quasi rent* divisible among the different persons in the business by bargaining, supplemented by custom and notions of fairness.

The essential point here is that there is no external market referent for the firm-specific element of earnings, since they are, *ex hypothesi*, unique to the conditions in that firm.

Within efficiency wage theory, explanations for the existence of a firm-specific element in wages include skills (Oi, 1962), privileged access to information, and difficulties in monitoring and securing performance (Akerlof and Yellen, 1986). What drives this model is, again, the 'incompleteness' of the contract of employment: the wage is now seen as a mechanism for eliciting cooperation and raising the productivity of the worker during performance beyond what was explicitly contracted for; hence, the wage rate is a *productive factor* as well as a cost to the employer (Solow, 1990: 34). The employer, then, has an incentive to offer a wage which is above the market clearing rate, or, put slightly differently, above the rate which the employer would be prepared to pay if the envisaged employment relationship contained no firm-specific elements.<sup>3</sup>

Hence the role of the external market in determining the wage paid to the worker is not eliminated, but it differs from the role which is accorded to it by the traditional orthodox account. It is suggested that a principal means by which the employer can elicit cooperation is through the threat of dismissal if the employee 'shirks' or acts wilfully

under-performs. For this threat to be meaningful, however, there must be a significant gap between the wage paid to the employee and the income which he or she would receive in the event of losing that employment. Such income could be derived either from employment in a secondary sector of low paid work, or from unemployment. As a result, both the level of wages paid in the secondary sector and the level of unemployment benefits, as well as the conditions attached to those benefits, influence the rates of wages paid within primary sector firms.

More generally, the efficiency wage model offers an alternative explanation for the persistence of low pay and long-term unemployment as 'worker discipline devices'. According to this point of view, there is an equilibrium level of unemployment which is that needed to ensure an optimal level of performance from workers. It also follows that such unemployment is *involuntary*, in the sense that even if unemployed persons made themselves available for work at wages below the going rate, it would not be in the interests of employers to hire them (Bulow and Summers, 1986). One way of thinking about this phenomenon is that contractual arrangements which are *privately* efficient for the parties or agents immediately concerned - primary sector employers and their employees - may give rise to an externality or wider social cost in the form of persistent unemployment. Although the idea that private contracting can give rise to an inefficient outcome in this way goes against the grain of the traditional general equilibrium approach, but it is precisely because that approach assumes full information and costless contracting that it has little relevance in this context.

Insider-outsider theory seeks to explain why workers might not offer themselves for employment at below the going (insider) rate. Here, the existence of firm-specific rents provides incumbent workers with 'insider power' which they can exploit to their own advantage. The insiders can signal to the employer their intention not to cooperate with any 'outsiders' who take jobs in breach of normal expectations governing terms and conditions of employment; this will reduce both

the incentive of the outsiders to underbid the insiders, and the incentives of the employer to hire the outsiders on these terms (Lindbeck and Snower, 1988). From a slightly different perspective, the outsiders can be seen as observing social norms concerning the going rate as part of a cooperative game which they play with the insiders (Solow, 1990). Both groups wish to retain a labour market in which competition is managed or regulated, since the alternative is a market based on 'Hobbesian competition' in which life is nasty, brutish and short, where employers can enforce conditions of employment at the competitive market rate. It would be in the interest even of an unemployed 'outsider' not to deviate from the norm of recognising the going rate, since he or she would be better off staying unemployed but with the prospect of future employment at the going rate, than taking a job at the lower, market rate in the knowledge that that rate would then prevail indefinitely.<sup>4</sup> This model predicts a range of equilibria, according to the extent to which the individual outsiders are indifferent to their future prospects:

For any given rate of discounting the future, there is a range - an interval - of wage rates any one of which can be an equilibrium market wage for this game, with accompanying persistent unemployment. The higher the wage, the more unemployment there will be. Within that range there will no undercutting on the part of the unemployed, because the reversion to Hobbesian competition will be unfavorable for everyone, including them. (Solow, 1990: 48).

A number of consequences follow from the stories told by efficiency-wage and insider-outsider theory which place in question the conventional way of presenting the workings of the labour market (see generally Stiglitz, 1986, 1994; Solow, 1990). Firstly, competitive forces will not necessarily produce a single market-clearing price for labour. Depending on the strategies adopted by individual firms and workers it is possible to envisage a number of equilibria in which the market stabilises around different wage levels and different levels of

unemployment and unemployment duration. It also follows that there is no single 'natural' rate of unemployment for a given level of inflation.

Secondly and relatedly, there is no necessary tendency for the market to arrive at a state which is Pareto-efficient through the operation of competitive forces. The labour market is, in this sense, an illustration of the general tendency for the presence of asymmetric information and contractual incompleteness to remove the conditions under which both the first and second theorems of welfare economics can be said to hold (Stiglitz, 1990: chs. 3 and 4): even 'slight perturbations in the standard information assumptions drastically [change] all the major results of standard neoclassical theory' (Stiglitz, 1990: x).

Thirdly, as already noted, both low pay and persistent involuntary unemployment may result from the workings of an 'unregulated' market. In other words, there is no 'natural' tendency to full employment in a free market.

In themselves, these conclusions might give pause for thought for those who advocate deregulatory solutions to the problems of contemporary labour markets. More generally, they are of interest for opening up a range of possibilities for policy which were closed off by the primacy accorded to the free market model: since 'persistent unemployment need not be voluntary or "efficient"... there is at least an opportunity for policy to improve the state of the economy' (Solow, 1990: 50). At the same time, it is far from clear which policy interventions might have the effect of enhancing labour market efficiency. In general, efficiency wage theorists tend to argue that legislation regulating termination of employment, for example, reduces the potency of the threat of dismissal through which the employer exercises labour discipline, thereby raising the level of the efficiency wage and so producing an increase in unemployment. Similarly, the payment of unemployment benefits based on a proportion of previous earnings can be seen as reducing the intensity of search for work by the unemployed at the same time as mitigating the effects of job loss for those in primary

sector employment. By extension, the efficiency wage will also be raised by minimum wage legislation and other forms of employment protection which aim at raising the standard of terms and conditions of employment in the 'secondary' sector. Insider-outsider theory, in pointing to the need to limit the 'power' exercised by insider groups (Lindbeck and Snower, 1990), can be read as offering support for legislation limiting the right to strike and the ability of unions to organise for the purposes of collective bargaining.

But not all models suggest that social legislation increases unemployment rates. The empowerment of 'outsiders' may take numerous forms which do not involve the removal of protections for 'insiders': 'it is one thing to strengthen the hand of outsiders relative to insiders and quite another to strengthen the hand of employers relative to insiders' (Solow, 1990: 76). One possibility here is the *extension* of mechanisms and procedures of collective representation, so as to ensure representation for groups in the 'secondary' market as well as the unemployed (Solow, 1990: 77). In institutional terms, this would imply a strengthening of collective bargaining and/or consultation at sector level, as well as a role for neo-corporatist bargaining or social dialogue between the state and representatives of employers and trade unions.

More generally, these analyses suggest that in the context of the labour market, transaction costs are sufficiently high to prevent optimal allocations being achieved through private contracting. This may create a space for regulation which seeks to realign incentives in such a way as to bring about 'static efficiency', in the sense of Pareto-superior allocations of resources:

economic policy may be able to move the labor market from one possible equilibrium to another. There is a sense in which policy can create artificial initial conditions, an alternative history almost, and thus alter the equilibrium configuration without really needing to cause a change in tastes or technology... (Solow, 1990: 60).

For example, the impact upon firm behaviour of unjust dismissal legislation has been formally modelled by Levine (1991) from within a broad efficiency-wage perspective. His insight is that any firm offering a contract to the effect that dismissal shall only be for good cause in a world where many other firms do not, and where workers have heterogenous skills and aptitudes for work, might expect to attract a disproportionate number of workers whose efforts are sub-standard, who are attracted to the prospect of a contractually secure job. In other words, there is an externality arising from an 'adverse selection' effect. If all firms had a just-cause rule, the benefits might outweigh the costs of protecting some sub-standard employees; but no one firm will act to introduce such measures on its own.

The existence of multiple equilibria arising out of contractual incompleteness also means that legislators might be justified in choosing one state of the world over another on *equity-related* grounds. For example, Levine and Parkin (1995) model the effects of terminations for redundancy, in situations where one firm's decision to dismiss workers affects the costs of other firms (and hence their behaviour). Where all firms dismiss workers in a downturn, the intensity of a recession is deepened, and this increases the costs, in terms of risk, for those firms continuing to train. Firms have an incentive not to train, but to dismiss instead. Where, by contrast, all firms adopt no-redundancy policies, recessions are less intense, and this in itself lowers the costs of training. In either case there is an equilibrium, but the implications are very different in terms of society's overall goals. The view taken of efficiency cannot, in this approach, be divorced from consideration of the fundamental political choices which are made by a given system.

## **8. Labour Standards, Trust, and Dynamic Efficiency**

Efficiency wage theory points the way towards regulatory intervention which largely addresses static or allocative inefficiencies. However, a

broader view would focus on dynamic efficiency, and specifically on the conditions both for effective cooperation and learning within the firm (Hodgson, 1998) and for innovation and technological development at the level of the market or system as a whole (Sengenberger, 1994).

In its emphasis upon labour *discipline* as the means by which cooperation of workers is elicited, efficiency wage theory is reminiscent of Fox's seminal analysis (1974) of low-trust employment relationships. Fox identified six main features of *low trust syndrome*: workers perceive themselves as not being trusted and are closely supervised; workers obey formal rules in carrying out their tasks; the co-ordination of worker's tasks is seen as an exclusively managerial function; technological and managerial constraints and monetary rewards are seen as more important than self-imposed standards or internalised for determining the pace of work; failure to meet standards results in punishment, increased numbers of rules, tighter supervision or some combination of these measures; and conflicts between management and workers are handled on a group basis through bargaining processes. Within this environment, industrial relations come to be premised upon a 'behavioural acceptance of divergent purpose' (Fox, 1974: 29). Because workers and management are seen as having opposed ends or values, a precisely balanced exchange in the short term is required under which both sides carefully estimate the costs and benefits of concessions. Sharing of information is limited and sanctions are readily imposed in the event of any default on obligations (Fox, 1974: 362).

According to evolutionary game theory, a degree of cooperation may be enforced by the threat of retaliatory defection by one side against the other, even under circumstances of unrestrained self-interest (see Axelrod, 1984). Within *actual* labour law systems, low trust employment relations tend to be the consequence of a particular history and practice of managerial organisation, on the one hand, and of resistance to managerial control on the part of workers, on the other.



Even from such antagonistic beginnings, collective bargaining may emerge to provide the basis for rules which fulfill a 'peace treaty' role, regulating the issuing of threats and counter-threats. The type of trust which develops under these circumstances is a form of *calculative trust* which arises from the strategic interaction of parties who only remain in the relationship as long as they regard it to be in their immediate interest to do so. In such circumstances, the primary function of collective employee representation becomes the regulation of conflict rather than the encouragement of cooperation.

Calculative trust rests on a *low-risk* strategy in the sense that each party reserves for itself the possibility of retaliation in the face of non-cooperation, but at the same time it is a *high-cost* strategy in the sense that each side has to be prepared to bear the costs of periodically meting out sanctions and in turn having them exercised against it. A further cost arises by virtue of the relative rigidity with which rules and norms are enforced: if the contracting parties are unwilling to perform beyond the letter of the agreement, flexibility is lost and potential gains from trade are sacrificed (Lorenz, 1998). Finally, there is the opportunity cost involved in foregoing the potential gains which could be achieved through innovation based on more open-ended cooperation. By contrast, a strategy based on *goodwill trust*, which involves both parties being willing to perform over and above the literal terms of their contract, can enhance productivity based on long-term productive investments in skills and technology. According to Sako (1992: 39), goodwill trust arises where 'someone... is dependable and can be endowed with high discretion, as he can be entrusted to take initiatives while refraining from unfair advantage taking'. While calculative trust ensures, at best, that expectations are met within existing technical and contractual specifications, the role of goodwill trust extends, in Fox's terms, 'beyond contract', to encompass a degree of open-ended cooperation with expected returns only being realised over a long period. But although goodwill trust offers a potential solution to the problem of contract incompleteness, it also exposes each party to a high risk of opportunism - because the degree of lock in is

greater, each side has more to lose, and the opportunities for effective retaliation may well be more limited, than is the case with calculative trust.

The question is, given the high-risk strategy which is implicit in the pursuit of goodwill trust, how is it achieved? While reputational effects will undoubtedly be significant (Epstein, 1984), these cannot, by definition, rest solely or even predominantly on a parity of threats or sanctions against defection, since this would undermine the flexibility or 'give and take' which is one aspect of goodwill trust. Other factors which are important in creating positive expectations of future performance may be expected to include fairness of treatment, job satisfaction, high quality of work environment and, particularly, income and job security. The scope for determining these can be factors depends both on the conditions within a given employment unit, and on those within the wider environment consisting of the firm, its supply chains, the markets in which the firm operates, and the wider economy of which it forms a part. From this perspective, *the issue is not simply whether regulatory intervention can cure particular market failures, but rather how successful the regulatory framework is in creating an environment which is favourable to the emergence of high-trust employment relationships.* More specifically, the question is how far labour standards, by providing the conditions for investments in labour quality, may contribute to dynamic efficiency in the sense of the capacity of a firm or other productive system to respond effectively to changes in its trading environment, and in particular in the sense of its capacity for innovation.

Here, an important insight of labour market segmentation theory is in an unregulated or 'free' labour market without effective labour standards, wage rates are only weakly linked, at best, to the comparative productivity of workers (Craig *et al.*, 1985). Inequality is less the consequence of differences between individuals in terms of aptitude and skills, and more the result of structural factors which are inherent to both the supply side and the demand side of the labour

market. On the supply side, the labour market is segmented through the effect of social norms which reproduce conventional understandings of 'fair wages' and set the conditions upon which particular groups enter (or re-enter) the active labour force, while on the demand side, firms are ranked according to their degree of access to finance and to the more advanced machinery and processes.

The effect of segmentation is that workers with comparable skills and efficiencies are undervalued to varying degrees because they receive different wages per 'efficiency unit'. The persistence of structural inequality opens up the possibility of 'predatory' strategies by firms which seek to tap sources of undervalued labour. Individual employers adjust their wage costs to their ability to pay by either shifting their demand for labour to a more disadvantaged segment or because their workers, trapped in their respective segment, are unable to resist a decline in their relative wage (Wilkinson, 1991). By being in a position to increase the degree of undervaluation of the workers they employ, firms can avoid more radical remedies such as the restructuring of production, managerial reorganization and the replacing of obsolete equipment with new technology. The direct relationship between wage rates and the ability of the firm to pay in a structured labor market also has the effect of discouraging innovation by more creative entrepreneurs, who find it difficult to expand their share of the market because of the difficulties of dislodging technically and managerially inefficient firms which can remain profitable in the short term by employing undervalued labour. The overall result is a lower average level of productivity in the economy both because managerial practices and obsolete equipment which should be scrapped remain in existence and because of slow rate of introduction of new techniques. Salter's classic description remains highly apposite:

The argument that an industry cannot 'afford' higher wages is, in the long run, very dangerous. If it were accepted and wages were based on the 'capacity to pay' employment would be perpetuated (unless labour deserted them) in industries which should properly

decline to make way for more vigorous industries. Equally dangerous is the argument that industries which are prosperous because of new techniques have 'the capacity to pay high wages. (Salter, 1966: 153).

Price competition based on low wages also serves to reinforce economic inefficiency by fostering an obsolete product structure. The process of competition based on the development of new, and the modification of existing, products has the effect of continuously shifting product market boundaries. A firm's success in product innovation depends on the establishment of new needs amongst consumers. But once this has happened the new demands require satisfying, so that while producers may capture the market they are also captured by the market. Failure by other firms to respond to this change leaves them behind in declining market niches, and although they may remain viable by cutting labour costs and capturing a larger share of a reduced demand this can only be a short term expediency (Rubery, Tarling and Wilkinson, 1987). The long term depends on product rather than price competition, and this requires an emphasis on research and development and product design and quality; these are strategies unlikely to be compatible with the exploitation of undervalued labour.

In a market environment in which competition is based on process and product development, a low pay strategy designed to retain the profitability of increasingly obsolete equipment and product lines can bring only temporary respite. There is a limit to how far wages can be reduced in even the most segmented market, but no such limit to cost reductions from technical improvements. Similarly, at some point a product becomes so obsolete that it cannot be sold at any price. For firms and economies trapped in this downward spiral, expectations become increasingly short term and survival more and more dependent on cost cutting.

Labour standards are important, then, because the ability of any one firm to adopt a high-productivity route to competitive success is limited

if its rivals are able to compete on the basis of low pay and poor working conditions. Basic levels of protection in such areas as wages, working time and conditions of employment aim to forestall destructive competition by setting a floor below which terms and conditions may not fall. Effective labour standards constitute a form of discipline for firms, requiring them to engage in continuous improvements to products and techniques in order to stay competitive. By contrast, the existence of a pool of undervalued labour offers a means by which firms can compensate for organisational and other managerial inadequacies.

Labour standards do not simply permit but also effectively require firms to adopt strategies based on enhancing the quality of labour inputs through improvements to health and safety protection, training and skills development. Low pay and poor working conditions and the absence of job security also have a negative impact on incentives for training. One orthodox explanation for low pay is that it is the result of a lack of training and skill, and that an increase in pay will further discourage employers from providing training. But a closer examination reveals again a quite different direction of causation. Firstly, low paying employers are the least likely to train. Inefficient low payers require undervalued labour to subsidise poor management or keep obsolete equipment in production and cannot afford to train except in the narrowest sense. Secondly, skill is to an important degree a social category and jobs with poor terms and conditions of employment are unlikely to be afforded high status whatever their skill level. Employment status as well as the content of jobs determines the willingness of individuals to acquire the necessary entry qualifications by undertaking education and training.

The theory of labour law and the labour market which we have offered here, then, turns orthodoxy on its head by suggesting that in a 'free' labour market, wages are unable to perform the allocative and incentive functions which are traditionally ascribed to them, and that labour market regulation is necessary in order to restore both equity and

efficiency. Our understanding of 'efficiency' refers not just to allocative efficiency in the static sense, but rather to efficiency in the sense of a *dynamic process* of economic growth, carried on under conditions conducive to innovation and economic sustainability.

## 9. Conclusion

In this paper we have traced the main lines of the orthodox economic critique of labour legislation which has played a major part in the promotion of policies of greater labour market flexibility and deregulation. We saw that orthodox law and economics analyses have relied somewhat uncritically on general equilibrium analyses of the market process. When a contractual perspective is taken, which takes into account incomplete contracting and asymmetries of information, the conclusions of general equilibrium analysis are almost immediately undermined: free markets cannot be relied on to produce full employment, nor will they allocate rewards from employment in proportion to contributions. From a theoretical perspective, a new space is created for regulatory policy, as well as a different focus on the role of social norms. Institutional and evolutionary approaches take us still further away from the standard law and economics analysis. Here, normative and institutional factors are seen as structuring economic activity. A 'free' labour market, if not simply a contradiction in terms, is one in which the absence of labour standards creates the conditions for persistent inequality and unemployment, and for productive inefficiency.

For reasons of space, we have not considered here issues of empirical evidence concerning the effects of labour standards on productivity and economic performance,<sup>5</sup> nor have we sought to discuss the libertarian critique which argues against social legislation *even* where it is undertaken in an attempt to cure allocative inefficiencies arising from market failures (Hayek, 1979, vol. 1: 50-51; for a discussion see Mückenberger and Deakin, 1989). We have not attempted to argue that market intervention is in any sense straightforward, or cost free. We

have, however, sought to cast doubt on the conventional wisdom that economic theory is necessarily hostile to labour market regulation. We would suggest that if the insights of a range of theoretical advances within economics are to be taken seriously, the focus of policy must begin to shift away from deregulation and towards the design of labour legislation with economic policy goals in mind. This would mean abandoning the sterile opposition of rights and efficiency, and exploring in greater detail the complementarities between labour law and economic development. The implications of our analysis for the study of 'law and economics' are also far reaching: nothing less than a comprehensive institutional analysis of the 'embeddedness' of economic activity in legal and social norms is needed, if this interdisciplinary endeavour is to contribute effectively to policy formation.

## Notes

1. In modern neoclassical theory, this is related to ability of 'insiders' to block the access of 'outsiders' to this information, and so require the firm to pay job incumbents a wage premium if it is to benefit from these forms of productivity increases. See further our discussion of insider-outsider theory, below.
2. The reasons for the persistence of employment at will in the United States beyond the point when it was abandoned, for example, in Britain, may well be political and institutional in nature rather than related to efficiency. On the British case, see Deakin, 1998.
3. It is not clear what the 'market clearing rate' would be in efficiency wage models, or even whether it makes any sense to refer to that concept. For discussion of these and related difficulties with efficiency wage theory, see Wilson, 1996.
4. This assumption may be regarded as questionable: it would only be in the self-interest of an unemployed individual to refrain from wage competition if he or she thought that they had a realistic chance of obtaining the 'insider' wage, in which case the distinction between 'insiders' and 'outsiders' begins to collapse. Solow's argument is nevertheless of interest for present purposes for showing how, from rational choice assumptions, multiple equilibria are generated (with the policy implications discussed in the text) from the starting point of contractual incompleteness.
5. Suffice to say that there is empirical evidence to support both sides of the regulation vs. deregulation debate. See the essays collected in Addison and Siebert, 1997.



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