RESEARCH NOTE

Nothing Costs Nothing: Why unjustified dismissal procedures should not apply to the highly paid

THE NEW ZEALAND INITIATIVE

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Introduction

The personal grievance provisions of the *Employment Relations Act 2000* (**ERA**) prevent an employer from firing an employee without good cause. Instead, dismissals must be justified. Employers must both show cause and act in a procedurally fair way.[1]

Personal grievance procedures were designed to guard the jobs of ordinary workers from "unjustified dismissals". The premise was that the common law of contract lacked sufficient safeguards for workers against capricious or arbitrary conduct by management. Long gone are the days when a boss could simply give an employee contractual notice (two weeks or otherwise).[2]

But these provisions create difficulties for businesses when applied to highly paid managers and executives. As countless boards and business owners will attest, constraining firms from firing poorly performing, high-earning managers is a handbrake on boosting productivity and overall performance. The difference between C-grade and A-grade managers may very well be the difference between business success or failure. Between preserving the jobs of ordinary workers or losing them. Yet mediocrity is no longer enough to justify a dismissal.

Consequently – and paradoxically – laws introduced to protect the jobs of ordinary workers may be placing those jobs at risk.

If not placing jobs at risk, to the extent employment protection laws constrain business owners from dismissing underperforming managers, those laws act as a constraint on firm productivity and therefore on workers' wages. Indeed, in "An International Perspective on New Zealand's Productivity Paradox" (2014), the Productivity Commission singled out the low quality of managerial capabilities as a cause of the country's poor productivity growth record.[3]

Nor are highly paid managers themselves immune from the harm caused by the ERA's unjustified dismissal procedures. Because employment protection laws make it costlier to fire an employee, employers are more cautious about hiring new staff. This makes it harder for the marginal manager to gain employment. And firms pay staff less because firms carry the burden of the employment arrangement going wrong – with the associated costs of complying with the statutory dismissal procedures.

Society also suffers from excessive employment protections. Stringent job dismissal regulations adversely affect productivity growth and hamper both prosperity and overall wellbeing.

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Across the Tasman, Australia deals with the unjustified dismissal paradox by excluding employees earning above a specified "high-income threshold" from the protection of its unfair dismissal laws.[4] In New Zealand, a 2016 private members' Bill tried to permit firms and high-income employees to contract out of the unjustified dismissal regime.[5] However, the mechanisms proposed were unwieldy and the Bill was voted down following the change in government later that year.[6]

This research note:

- tells the history of New Zealand's unjustified dismissal provisions and explains their effect;
- outlines the economic case for narrowing the application of unjustified dismissal rules; and
- recommends amendments to the ERA to address the issues listed here.

History of unjustified dismissal in New Zealand

Today, the concept of unjustified dismissal is as entrenched within New Zealand's industrial relations landscape as it is highly contested. An employer can only fire an employee for good cause and then only if the employer has acted in a procedurally fair way, dotting every "i" and crossing every "t". Anything less risks the employer inviting a personal grievance claim alleging unjustified dismissal.

Yet, until the early 1970s, the concept of unjustified dismissal was foreign to New Zealand law. Employers could dismiss any employee by giving the requisite period of notice in the employment contract. If no notice period was specified, the courts required "reasonable notice." Employers had no obligation to offer reasons for dismissing a staff member. And they did not need to justify any reasons that were given. The only recourse for workers was to bring a common law claim for wrongful dismissal – with their rights largely restricted to arguing that their employer had not complied with the notice provisions of their employment arrangements.

For unionised workers covered by an industrial award or agreement, the position changed with the *Industrial Relations Act 1973* (**IRA**). All industrial awards and agreements were required to contain a procedure for settling "personal grievances," including claimed unjustified dismissals. The IRA standardised the procedure, which became almost universally adopted. It provided for an employee's union representative to "mediate" the grievance with the employer. If the dispute was not resolved, the union (not the individual employee) could refer the matter to the courts.

When first introduced, the personal grievance procedure under the IRA was by no means universal. It did not apply to non-unionised employees. Nor did it apply to those whose work was not covered by an award or agreement. And it was limited in scope to disputes over industrial matters. Consequently, the employment relationships of a considerable number of employees – including managers and highly paid employees earning above award ceilings – were governed by their employment agreements. Workers had to wait until 1987 for the statutory personal grievance procedure to be broadened to include unjustifiable dismissal and unjustifiable disadvantage claims.[7]

In 1991, when the Bolger-led National government repealed compulsory unionism, its *Employment Contracts Act 1991* (**ECA**, the predecessor to the ERA) extended personal grievance procedures for unjustified dismissal to *all* employees. The ECA was aimed at promoting an efficient labour market and represented a significant change away from the existing industrial and labour relations framework. However, for the first time, businesses needed to jump through all the hoops of the unjustified dismissal regime even when considering the employment status of non-unionised senior management.

All New Zealand employees have been covered by personal grievance procedures for unjustified dismissal since 1991 - unlike in Australia, where high-income workers have been exempted from equivalent statutory protections since the mid-1990s.[8]

Consequently, even before firing an underperforming chief executive, since 1991, the unjustified dismissal regime has required boards of directors in New Zealand first to develop a performance improvement plan, then consult with the CEO about that plan, and then monitor the CEO's performance over an extended period before dismissal can be justified. No matter that, in the meantime, both the business and the jobs of ordinary workers might be in jeopardy.

Costs and benefits of unjustified dismissal protections

The rationale for the unjustified dismissal reforms is employment security.[9]

For most workers – especially for low-skilled workers – employment security is a prerequisite to financial security. In introducing protection from unjustified dismissal, Parliament can be taken to have judged it is more important to protect workers from having their employment terminated without "justification" than to allow employers to terminate workers' employment on notice.

The principle of employment protection is also incorporated into the International Labour Organization (ILO) Convention on Termination of Employment at the Initiative of the Employer (**Convention 158**), although, unlike Australia, New Zealand has never ratified the convention.[10]

Yet few, if any, regulatory interventions are costless. Economic studies show employment protection regulations come with costs for employees, reducing wages and salaries, reducing employment rates, or at least increasing the duration of unemployment.[11]

The harder it is for firms to dismiss employees, the greater are the costs to employers of making poor hiring decisions. All else being equal, firms will look to share this cost by paying lower wages.[12] Since firms anticipate higher dismissal costs when taking on staff, firms will also find it optimal not to hire the marginal worker, raising barriers for the marginal worker to enter the workforce.[13]

Overly stringent job dismissal regulation can also harm productivity. Higher dismissal costs mean firms will choose to retain unproductive workers for longer. This can occur through several channels. Importantly, by lowering job and worker flows, labour markets become less efficient at responding to economic change. In particular, overly stringent regulation leads to below optimal levels of productivity-enhancing worker reallocation from low to high productivity firms and reduced firm entry and exit,[14] which has been shown to be productivity enhancing in New Zealand.[15]

As well as between-firm productivity growth, within-firm productivity growth that depends upon investment and innovation in a firm can also be hurt by overly stringent dismissal regulations. This is because both productivity enhancing investment and innovation may be depressed due to the higher actual and anticipated costs for firms. While the empirical evidence on investment is mixed, most studies find innovation activities are reduced, leading to weaker multifactor productivity growth.[16]

Protecting an unskilled or low-skilled worker against unjustified dismissal is less likely to affect a firm's productivity than constraining the firm's ability to dismiss senior management whose performance may be poor, but not so poor as to justify dismissal. Such constraints help explain the findings in the Productivity Commission's 2014 report, which singled out the low quality of managerial capabilities as a critical factor in New Zealand's poor record of productivity growth.[17]

Putting barriers in the way of a firm from dismissing underperforming senior management also jeopardises the jobs of unskilled or low-skilled workers. The difference between the success or failure of a firm – or of a division within a firm – may, at the margin, depend on the quality of its senior management. Consequently, if a firm's board or owners are constrained by unjustified dismissal laws from dismissing underperforming management, then this may be contrary to the interests of the low-skilled, low-paid workers whose welfare employment protection laws are designed to protect.

A solution from across the Tasman

Since 1994, Australia has solved the threats unjustified dismissal laws pose to productivity growth and business failure by precluding "high-income earners" from relying on them.[18]

Regulations under the *Fair Work Act 2009* (Commonwealth) (**FWA**) specify a "high-income threshold," currently AU$153,600, which includes both a worker's annual earnings and other benefits – but not bonuses or incentive payments which cannot be determined in advance.[19] The high-income threshold is adjusted annually on 1 July of each year under FWA regulations.[20]

High-income earners are automatically excluded from the FWA's "unfair dismissal" regime (the equivalent of New Zealand's unjustified dismissal provisions) unless an applicable award or enterprise agreement confers unfair dismissal rights on the high-income earner.

The ILO's Committee of Experts on the application of Convention 158 has accepted that Australia can exclude high-income earners from the ambit of the unfair dismissal protections because they comprise "persons in executive positions or positions of responsibility or trust."[21]

Consequently, Australian employers have much greater freedom than their Kiwi counterparts to fire underperforming senior managers. This flexibility may go some way to explain the productivity gap between the Australian and New Zealand economies.

A New Zealand solution

The Employment Relations (Allowing Higher Earners to Contract Out of Personal Grievance Provisions) Amendment Bill (**the Bill**) tried to introduce Australian-style flexibility for high-income earners.[22] Introduced in 2016, the Bill proposed giving a high-income earner the right to contract out of the personal grievance provisions of the ERA in return for negotiating a more generous severance package. In turn, the employer would gain the certainty of mutually agreed exit terms without the threat of a personal grievance claim, thereby avoiding the time and cost involved in resolving the claim.

The Bill survived the Select Committee process – albeit in a much amended form[23] – but not the change of government after the October 2017 election. It failed at its second reading later that year.[24]

The Bill's demise was a lost opportunity for employees and firms alike – and the wider economy. Had the Bill passed into law, the adverse effects of unjustified dismissal laws on salaries, unemployment and productivity could have been averted.

But all is not lost. Parliament can and should consider the issue anew. In doing so, Parliament should address the concerns raised in relation to the Bill. Rather than adopt the approach of the former Bill (at least as initially proposed), Parliament should follow the approach of the FWA in Australia.

This would involve:

- excluding high-income earners from relying on the unjustified dismissal provisions of the ERA, and instead reinstate the right for high-income earners to bring actions for wrongful dismissal at common law; and
- giving effect to the exclusion by deeming legislation, rather than the failed Bill's cumbersome contracting out mechanism. The legislation should define a "high-income threshold," with regulations permitting the threshold to be adjusted annually to track increases in New Zealand's median income.

To address criticisms made before the select committee that the high-income threshold was too low, the minimum remuneration threshold could be set such that it would only cover senior management – and not inadvertently catch "mid-tier" management. We recommend $250,000, the starting salary for Ministers of the Crown,[25] who serve at the Prime Minister's pleasure and can be dismissed without cause.[26] This threshold would capture less than the top 1% of income earners,[27] while capturing the CEOs and senior managers of New Zealand's largest businesses.

Conclusion

Unjustified dismissal protections are a fundamental aspect of New Zealand's industrial relations landscape. And for obvious reasons. No one wants vulnerable workers being unjustifiably dismissed.

But nothing costs nothing. Unjustified dismissal protection comes at a cost. Employees receive lower incomes. Work is put at risk. And society is poorer due to the adverse effects of unjustified dismissal laws on productivity.

Economic theory suggests these latter costs are higher for high-income earning employees. To address this risk, Australia has exempted high-income earners from the protection of unjustified dismissal laws. New Zealand should follow suit.

Endnote

[1] Employment Relations Act 2000 (ERA), sections 103(1)(a) and 103A(2).

[2] For a discussion of the development of New Zealand's unjustified dismissal laws, see Gordon Anderson and John Hughes, *Employment Law in New Zealand* (2nd edition) (Wellington: LexisNexis, 2017), 280–281 [9.3]. For an alternative view, see Richard Epstein, "In Defense of the Contract at Will," *University of Chicago Law Review* 51:4 (1984), 947.

[3] Productivity Commission, "An International Perspective on the New Zealand Productivity Paradox" (Wellington: New Zealand Government, 2014). See especially 19–21.

[4] Fair Work Act 2009 (Commonwealth), section 382.

[5] Employment Relations (Allowing Higher Earners to Contract Out of Personal Grievance Provisions) Amendment Bill.

[6] Ibid.

[7] See Labour Relations Act 1987.

[8] See section "A solution from across the Tasman" below.

[9] See Gordon Anderson and John Hughes, *Employment Law in New Zealand*, op. cit. 280–281 [9.3].

[10] International Labour Organization (ILO), "C158 - Termination of Employment Convention, 1982 (No. 158)," Website.

[11] For the adverse effect of employment protection on employees' incomes, see in particular, Marco Leonardi and Giovanni Pica, "Employment Protection Legislation and Wages," European Central Bank (ECB) Working Series 778 (2007) and Edward Lazear, "Job Security Provisions and Employment," *The Quarterly Journal of Economics* 105:3 (1990), 699–726.
For the adverse effects on the duration of unemployment, see, for example, OECD, "Good Jobs for All in a Changing World of Work: The OECD Jobs Strategy" (Paris: OECD Publishing, (2018) and John P. Martin and Stefano Scarpetta, "Setting It Right: Employment Protection, Labour Reallocation and Productivity," *De Economist* 160 (2012), 89–116.

[12] Marco Leonardi and Giovanni Pica, "Employment Protection Legislation and Wages," op. cit.

[13] Over the course of the economic cycle, some studies suggest that employment protection legislation may lead to firms retaining more staff in a downturn they would otherwise have done, leading to an offsetting of overall effects on employment levels. For a discussion of these offsetting effects, see Samuel Bentolila and Giuseppe Bertola, "Firing Costs and Labour Demand: How Bad is Eurosclerosis?" The Review of Economic Studies 57:3 (1990), 381–402. For a contrary view suggesting employment protection legislation leads to an overall reduction in employment levels, see Edward Lazear, "Job Security Provisions and Employment," op. cit.

[14] See, for example, Dan Andrews and Federico Cingano, "Public Policy and Resource Allocation: Evidence from Firms in OECD Countries," *Economic Policy* 29:78 (2014), 253–296; Anna Bottassoa, Maurizio Conti and Giovanni Sulis, "Firm Dynamics and Employment Protection: Evidence from Sectoral Data," *Labour Economics* 48 (2017), 35–53; Albert Bravo-Biosca, Chiara Criscuolo and Carlo Menon, "What Drives the Dynamics of Business Growth? *Economic Policy* 31:88 (2016), 703–742; and David H. Autor, William R. Kerr and Adriana D. Kugler, "Does Employment Protection Reduce Productivity? Evidence from US States," *The Economic Journal* 117:521 (2007), F189–F217.

[15] David Law and Nathan McLellan, "The Contributions from Firm Entry, Exit and Continuation to Labour Productivity Growth in New Zealand," Working Paper 05/01 (Wellington: Treasury, 2005).

[16] Eric J. Bartelsman, Pieter A. Gautier and Joris De Wind, "Employment Protection, Technology Choice, and Worker Allocation," *International Economic Review* 57 (2016), 787–826 and Rachel Griffith and Gareth Macartney, "Employment Protection Legislation, Multinational Firms, and Innovation," *The Review of Economics and Statistics* (MIT Press) 96:1 (2014), 135–150.

[17] Productivity Commission, "An International Perspective on the New Zealand Productivity Paradox," op. cit. 19–21.

[18] The exemption was introduced by the *Industrial Relations Reform Act 1993 (Commonwealth*) and is now contained in Fair Work Act 2009 (Commonwealth), section 382.

[19] See Fair Work Commission, "Unfair dismissals benchbook: An overview of legal procedure & case law," Website.

[20] Fair Work Regulations 2009, reg 3.05.

[21] International Labour Organization (ILO), *Protections Against Unjustified Dismissal*, ILO Committee of Experts on the Application of Conventions and Recommendations (1995), [25].
[22] Employment Relations (Allowing Higher Earners to Contract Out of Personal Grievance Provisions) Amendment Bill.
[23] Employment Relations (Allowing Higher Earners to Contract Out of Personal Grievance Provisions) Amendment Bill (225-2).
[24] Employment Relations (Allowing Higher Earners to Contract Out of Personal Grievance Provisions) Amendment Bill – Second Reading.
[25] Parliamentary Salaries and Allowances Determination 2017.
[26] Cabinet Office, "Cabinet Manual" (Wellington: New Zealand Government, 2017), [2.18]–[2.19].
[27] Inland Revenue (IRD), "Income distribution of individual customers 2001 to 2019," Website.

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