

# **THE EMPLOYMENT CONTRACTS ACT AND UNJUSTIFIABLE DISMISSAL**

## **The Economics of an Unjust Employment Tax**

**Charles W Baird, PhD**

**Professor of Economics and**

**Director, TheSmithCenter for Private Enterprise Studies**

**California State University, Hayward**

**NEW ZEALAND BUSINESS ROUNDTABLE**

**NEW ZEALAND EMPLOYERS FEDERATION**

**AUGUST 1996**

### **TABLE OF CONTENTS**

**Executive Summary v**

**I Introduction 1**

**II Two Flaws in the Employment Contracts Act 1991 3**

### **III The Principal Deficiency of the ECA - Unjustifiable**

#### **Dismissal 5**

The at-will doctrine and its exceptions 5

A brief history of unjustifiable dismissal in

New Zealand 6

The simple analytics of unjustifiable dismissal 7

a Voluntary exchange 7

b The division of knowledge 9

c The fallacy of unequal bargaining power 10

d General effects of unjustifiable dismissal

restrictions 13

e The hiring decision 14

f The demand for labour 16

g Effect of unjustifiable dismissal on the demand

for labour 19

h The supply of labour 20

i Effect of unjustifiable dismissal on the supply

of labour 22

j Labour market effects of unjustifiable

dismissal 23

k Significance of elasticities of demand and supply 25

### **IV Empirical Studies in the United States Applied to**

#### **New Zealand 29**

Income distribution 29

Effects on real compensation (wages) 37

Effects on employment 39

**V *The OECD Jobs Study, 1994* 45**

**VI Conclusion 47**

**Technical Appendix 49**

## **About the Author**

Charles W Baird received his PhD from the University of California, Berkeley, in 1968. He then spent five years on the faculty of UCLA. He has been a Professor of Economics at California State University, Hayward, since 1976. He has also been a Visiting Professor at Stanford University and the University of Witwatersrand in Johannesburg, South Africa. He is the founding Director of the Smith Centre for Private Enterprise Studies at California State University, Hayward. The principal mission of the Smith Centre is to foster a better understanding of free market principles and their application to public policy.

Professor Baird is a contributing editor of *The Freeman*, a magazine published by the Foundation for Economic Education, Irvington-on-Hudson, New York. He is also on the editorial boards of three other academic journals. He has published four textbooks, four public policy monographs, and over 60 articles in several professional journals and magazines. His research specialty is the law and economics of labour relations. He has also written on topics including environmentalism, the economics of politics, the tax system and the Austrian School of economics.

## **EXECUTIVE SUMMARY**

The Employments Contracts Act 1991 (ECA) was a giant step toward the restoration of freedom of contract in New Zealand labour markets. Unlike American workers, New Zealand workers are now free from compulsory unionism and mandatory 'good faith' bargaining between unions and employers.

However, the ECA has some deficiencies. Two of them are:

- jurisdiction over labour disputes was placed in the hands of a specialist court whose judges, holdovers from the old Labour Court, are dedicated to treating employment contracts as different from other contracts. Inasmuch as the purpose of the ECA was to bring labour relations under the common law of contract, this was a most unfortunate blunder; and
- the ECA did not repeal certain 'minimum codes' such as legal minimum wages.

The principal deficiency of the ECA is its mandate for unjustifiable dismissal restrictions in all employment contracts, collective and individual. Prior to the ECA, only unionised workers were 'protected' by mandatory unjustifiable dismissal restrictions.

Under the common law of contract, employment is assumed to be at will unless there are explicit contractual terms to the contrary. At-will employment means that either the employer or the employee can sever the employment relationship at any time, for any reason or for no reason. Under unjustifiable dismissal regulations only the employee can sever the employment relationship at will. An employer who does so may be subject to severe legal penalties.

The imposition, by law, of unjustifiable dismissal restrictions in employment contracts is, in effect, a reassignment of job property rights away from employers to employees.

Like many of the special privileges given in the past to labour unions, the imposition of unjustifiable dismissal restrictions in employment contracts is motivated by the hoary myth of labour's unequal bargaining power.

In order to understand the effects of unjustifiable dismissal restrictions in New Zealand labour markets it is necessary first to understand three basic concepts and tools of economics: voluntary exchange, the division of knowledge, and demand and supply of labour.

The predictable effects of the imposition of unjustifiable dismissal restrictions include less efficiency in the management and deployment of labour resources, higher information costs in labour markets, the founding of fewer start-up firms and the expansion of fewer existing firms, fewer employment opportunities in general, the hiring of fewer high risk employees, diminished opportunities for entry level work and on-the-job training, decreased productivity of many already-hired workers, lower real compensation paid to workers, and increased inequality in the distribution of income.

The imposition of unjustifiable dismissal restrictions is evaluated as a tax on employers and as a benefit (increased job security) for workers. The interaction of shifts of both supply and demand curves in the labour market demonstrates that employees will bear a portion of the unjustifiable dismissal tax in the form of lower compensation (wages) and fewer employment opportunities.

Workers for whose labour services employers have elastic demands and whose own labour supplies are inelastic will bear a larger portion of the unjustifiable dismissal tax in the form of lower compensation than workers with the opposite elasticities.

Workers for whose labour services employers have an elastic demand are those who are easy to replace. This includes the least skilled, the least experienced, and the least able. Workers who have inelastic labour supplies are those with few alternative employment options. One group with that characteristic consists of the least skilled, the least experienced, and the least able.

Two empirical studies undertaken in the United States attempt to measure the magnitude of the effects of the imposition of unjustifiable dismissal restrictions. No similar studies have been carried out in New Zealand. While it is impossible to know whether the US results are precisely applicable to New Zealand or not, they illustrate what could be the consequences of those restrictions in New Zealand.

Such illustrative results are a 10 percent increase in the New Zealand Gini coefficient (a measure of the degree of inequality in the distribution of income), an 18 percent decrease in the mean income received by households in the lowest income quintile, a decrease of over 7 percent in real compensation paid to workers who continue to work, and a decline of overall employment (depending on the assumptions made) of from 1.5 percent to 3 percent. Since employment in New Zealand was 1,653,000 in December 1995, that amounts to between 19,000 and 47,000 jobs.

When courts impose punitive damages as well as compensatory damages on employers who violate the unjustifiable dismissal restrictions, the percentage reduction in employment in the United States was higher than 12 percent. The ECA explicitly authorises compensation for subjective harms (e.g. hurt feelings and psychological damage) from unjustifiable dismissals. This is only one short step away from full punitive damages.

Even the OECD has warned of the negative effects of unjustifiable dismissal restrictions in employment contracts.

Freedom of contract should be restored to all New Zealand employment relationships. In a freedom of contract environment there will be a multitude of individual approaches to the issue of unjustifiable dismissal. At-will or on-notice contracts should not be prescribed or legislatively favoured, but nor should they be outlawed. It is illogical and destructive for the government to impose one-size-fits-all rules for this aspect of employment contracts.

## **I INTRODUCTION**

On 15 May 1991, parliament enacted the Employment Contracts Act 1991 (ECA). Parts I and II of the ECA abolished all forms of compulsory unionism in New Zealand, and took bold steps toward restoring the common law of contract, property and tort to New Zealand labour markets. Unlike the status quo in the United States, in New Zealand all workers are now free individually to choose between an individual or a collective employment contract and, if they opt for a collective contract, whether to be represented by a union for the purpose of negotiating employment contracts. Workers may, if they choose, represent themselves or be represented by another person, group or non-union organisation for that purpose. Unlike American workers, New Zealand workers cannot be forced to join or pay dues to any labour union. There is no forced 'good faith' bargaining between unions and employers, unlike in the United States. While employers must recognise unions that have been designated as bargaining agents by individual employees, employers do not have to bargain with those agents. All bargaining is wholly voluntary. For all of these reasons, the ECA is an excellent model for other countries to follow as they move toward deregulation of their own labour relations systems.

However, the ECA is not perfect. It has at least three faults that should be mended. In the second section of this paper I will briefly explain my views on two of those faults - one of commission and one of omission - and in the third section I will begin a fuller analysis of the third - the imposition, in Part III of the ECA, of unjustifiable dismissal restrictions on all employment contracts. Section IV of the paper presents some empirical evidence on the economic consequences of unjustifiable dismissal restrictions. Section V notes the treatment of this issue in *The OECD Jobs Study* published by the OECD in 1994, and Section VI presents a conclusion.

## **II TWO FLAWS IN THE EMPLOYMENT CONTRACTS ACT 1991 (ECA)**

As Penelope J Brook has put it, the ECA is 'an incomplete revolution'. In my view, its principal defect is the requirement that all employment contracts include unjustifiable dismissal restrictions. I will begin to discuss this issue in the next section. Another major defect is found in Part VI of the ECA which creates a specialist court, the Employment Court, which is given exclusive authority to interpret and enforce the Act, subject only to review by the Court of Appeal on questions of law. In

other words, labour market disputes are not heard by the ordinary courts like all other disputes. They are heard by a court whose judges are specialists in labour law. Under section 188 of the Act the personnel of the old Labour Court became the initial personnel of the Employment Court.

Parts I and II of the ECA were enacted by parliament in order to deregulate the labour market so that it would once again be governed by the common law of contract, property and tort.

If labour relations law is supposed to be just like ordinary law, the last thing parliament should have done was to leave labour relations in the jurisdiction of a specialist court that is a direct descendant of the Labour Court. This was a huge mistake, for the Employment Court judges were and are dedicated to treating labour relations in a unique way. They were and are the least well qualified to launch a new era of legal equality for labour relations.

The merits of specialist versus generalist courts, with specific reference to the problem of the Employment Court, have been carefully weighed by Bernard Robertson. The interpretative gymnastics performed by the judges of the Court in dealing with cases under the ECA coming before them were examined by Colin Howard in a 1995 study.

The second fault is a sin of omission. The ECA does not deal at all with several issues of labour market regulation that need to be redressed. Perhaps the most important of these is legally mandated minimum wages. The consensus among reputable economists is that legal minimum wages hurt the least productive, least experienced, least capable workers in an economy. They are valuable only to politicians who use them to signal their compassion for the poor and hide their inability to come up with any real solutions to the problem of poverty.

But the Employment Court and legal minimum wages are not my principal concern in this study. My focus is on the issue of unjustifiable dismissal.

### **III THE PRINCIPAL DEFICIENCY OF THE ECA - UNJUSTIFIABLE DISMISSAL**

Section 26(a) of the ECA states that all employment contracts *must* include an effective personal grievance settlement process. Section 27(a) explicitly includes unjustifiable dismissal as a personal grievance. Section 147 proscribes contracting out of the provisions of the ECA. Taken together, these features of the ECA completely abolish the at-will employment doctrine in New Zealand. Actually, in this regard, the ECA makes matters worse than they were under the Labour Relations Act 1987. Prior to 1991 it was still possible for individual, non-union workers to be employed on an at-will basis. The original version of the ECA imposed the unjustifiable dismissal doctrine only on collective contracts. In the version that became law, unjustifiable dismissal was imposed on *all* employment contracts.

#### **The at-will doctrine and its exceptions**

Under the common law of employment contracts, in the absence of an agreement between an employer and an employee to the contrary, either party could terminate the employment relationship at will. That is, an employee could quit a job at any time and for any reason or for no reason. Similarly, an employer could dismiss an employee at any time and for any reason or for no reason. In the United States this at-will employment doctrine had been in effect since the 1840s. It was not unusual for actual employment contracts to have a notice provision for one to four weeks, but no law mandated such a provision. The at-will doctrine was modified by Title VII of the Civil Rights Act of 1964 which barred employers from dismissing employees on the basis of race, religion, and gender. Employees, however, were still free to quit their jobs for any reason at all or for no reason. They still are.

The civil rights exceptions to at-will employment proved to be the camel's nose under the tent. Beginning in the late 1970s and continuing strongly throughout the 1980s, state courts began to

impose other exceptions to the at-will doctrine. These exceptions fall into three categories: (1) public policy, (2) implied contracts and (3) a covenant of good faith and fair dealing.

As explained by Dertouzos and Karoly, there is both a narrow and a broad public policy exception. The narrow exception says that an employee cannot be dismissed for refusing to violate a statute or for exercising a right that is guaranteed by statute. For example, in those states where courts have declared this exception, an employee cannot be fired for serving on a jury or for refusing to falsify records. In states with the broad public policy exception, employees have the same protection as that afforded by the narrow exception and in addition they cannot be fired for refusing to violate professional codes of ethics and non-statutory administrative rules and regulations.

The implied contract exception has been imposed by courts in which judges have found that, although there is no explicit contractual agreement between an employee and an employer that spells out exceptions to the standard at-will contract, such exceptions are implied by statements in employee manuals, as well as oral and written statements by supervisors to the effect that if the employee keeps up a good work record, the job will be safe. There have been instances of judges finding that a compliment to an employee by a supervisor implies an employment contract that says dismissal can only be for good cause.

The implied covenant of good faith and fair dealing is the most open-ended of all. In New Zealand this is called the implied term of mutual trust and confidence. Whatever it is called, it is lawyer-talk which permits a judge to impose just about any substantive and procedural requirements on just about any termination of an employment relationship. Worse, in the United States, allegations of breach of good faith and fair dealing are sometimes heard in tort rather than contract. The remedy in contract is the award of economic compensatory damages. Remedies in tort also include compensation for subjective harms (e.g. hurt feelings) and explicit punitive damages.

## **A brief history of unjustifiable dismissal in New Zealand**

Prior to 1970 most employment in New Zealand, including employment covered by collective bargaining contracts, was subject to the English common law under modified at-will terms. Reasonable notice of termination was an implied term. This was confirmed in the leading British case of *Addis v Gramophone Co Ltd* [1909] AC 488. In 1970 parliament amended the Industrial Conciliation and Arbitration Act to give 'wrongful dismissal' protections to unionised at-will employees. In doing so, parliament hoped to put an end to the increasing use of strike action where employees had been dismissed. However, New Zealand courts interpreted 'wrongful dismissal' to mean dismissal that was contrary to the explicit terms of a contract or without sufficient notice. These restrictions were always understood to be implied by the *Addis* decision, so parliament's attempt to create an exception to the at-will rule for unionised workers failed. In 1973 parliament tried again. The amended legislation protected unionised workers from 'unjustifiable dismissal', and made very clear that dismissals hitherto permitted under *Addis* could be challenged if they were not fair. That is, courts were told to do more than examine the legality and explicit terms of employment contracts. They were instructed to inquire into the justice of employers' decisions to terminate employment relationships. From 1973 to 1991 only collective bargaining contracts included mandatory unjustifiable dismissal restrictions. During this period there was an increasingly heavy emphasis on procedural rather than substantive fairness. That is, even when an employer had a good substantive reason to fire an employee - e.g. for repeated tardiness, drunkenness, violent behaviour etc. - unless the employer followed the correct procedure to do so - e.g. gave appropriately worded warnings - dismissals were held to be unjustifiable.

In 1991 parliament had a choice between three options. It could restore all employment relationships to an at-will basis, limit mandatory unjustifiable dismissal restrictions to collective contracts, or impose at-will restrictions on all employment relationships. In the event, parliament chose the third and worst option. Since then the Employment Court has continued to emphasise procedural rather than substantive fairness. For example, in *Burgess v Multiwool Packaging Ltd* [1994] the Employment

Court ruled that the employer unjustifiably dismissed a chronically tardy employee because in a letter of warning the employer said the employee 'could' be dismissed rather than 'would' be dismissed.

The usual explanation of why parliament chose to impose universal unjustifiable dismissal restrictions was that it is necessary to set minimum standards. Prior to the ECA it was said that unions protected their workers from unjustifiable dismissal. Since the ECA significantly reduced the power of unions, that protection had to be afforded by regulation at the individual level. But this argument overlooks the principle (discussed below in subsection b), that individual employees and employers know best what contractual arrangements suit their unique circumstances of time and place. In an unfettered labour market there will be a wide variety of contractual arrangements. No regulator can possibly know enough to design a one-size-fits-all substitute.

## **The simple analytics of unjustifiable dismissal**

In order to understand the economic consequences of substituting the unjustifiable dismissal doctrine for the common law doctrine of employment at will, several principles of economics must be examined.

### *a Voluntary exchange*

An exchange is a reciprocal giving and receiving between two or more people. Some exchanges are involuntary - e.g. the military draft and robbery - and others are voluntary - e.g. the exchange of labour services for a wage on terms mutually agreed to by both the employee and the employer. Most of microeconomics is about the intended and unintended consequences of voluntary exchanges among people. Any market is simply all the voluntary production and exchange activities of human beings with respect to a particular product or service, including the service we call labour. In a market system people interact by entering into written and unwritten voluntary exchange contracts with each other.

Voluntary exchange contracts meet four criteria:

#### *(i) Entitlement*

All parties to the contract must either own that which they offer to exchange, or they must be acting as the authorised agent of the owner(s). In employment contracts, workers own their labour and employers own the job (in the sense that they own or lease the plant and equipment and site at which the job is done). Workers and employers are free to hire or not hire agents to represent them in the labour market.

#### *(ii) Consent*

All parties to the contract must agree (i) to enter into the contracting relationship - i.e. to bargain with each other - and (ii) the terms at which any actual exchange takes place - i.e. the final outcome of the bargaining. No forced bargaining can result in a voluntary exchange contract.

#### *(iii) Escape*

All negotiating parties must be able to turn down any offers they do not like and walk away from the bargaining process without losing anything to which they are entitled. There is no requirement that bargaining continue until a satisfactory deal is made or that either side must make concessions.

#### *(iv) No misrepresentation*



No party to the contracting may defraud any other parties. That is, no one can tell a lie. This leaves room for honest error. I can make any claim that I believe to be true when I make it, even if it turns out later to be incorrect. Moreover, this criterion does not require the parties to tell all they know. It merely proscribes any person saying something he or she knows to be false.

Clearly, the intent of Parts I and II of the ECA is to assure that all employment contracts are voluntary exchange contracts. All parties are free to choose whether to employ representatives, and if so what kind of representatives. All parties are free to choose whether to seek exchange partners on an individual or collective basis. All parties are free to choose whether to bargain with any other person or group or their representatives. And all parties are free to choose whether or not to affiliate with a union. If it were not for Part III and section 147 of the ECA, all parties would be free to choose whether to bargain with others over the at-will versus unjustifiable dismissal options. Some employers may be willing to afford unjustifiable dismissal protections to employees in order, for example, to get those employees to be willing to acquire firm-specific skills. Some employees may be willing to forgo the job security of unjustifiable dismissal in exchange for higher pay or other perquisites. In a voluntary exchange setting there would be a wide variety of job security arrangements in employment contracts - some with a lot, some with none. Whatever is mutually acceptable to the contracting parties will emerge.

### *b The division of knowledge*

The knowledge that is necessary to achieve a coordination of the diverse production and exchange plans and actions of all the individuals in an economy exists nowhere in its entirety. Each person attempts to make the best of every situation he or she confronts. People attempt to apply the means at their disposal to achieve ends that they consider to be worthwhile. But the plans and actions of person A may be inconsistent with the plans and actions of others on whom A depends. For example, employer A may plan to hire 20 employees to do a particular job at a particular wage rate. But A may not be able to find 20 workers who are willing to accept the offered employment at the offered terms. Perhaps this is because workers have what they perceive to be better opportunities elsewhere, or perhaps it is because there are no workers who are aware of the employment alternative who have the requisite skills to do the job. Whatever the reason, employer A's plans are uncoordinated with the plans of sellers of labour. At the same time, another employer who is successful in hiring the quantity and quality of labour he or she seeks may have selling plans that are uncoordinated with the buying plans of consumers.

What kinds of knowledge are relevant to the coordination of economic activities? Among them are knowledge of tastes and preferences, knowledge of individuals' productive abilities and interests, knowledge of resource availabilities, and alertness to production and exchange possibilities that have hitherto not been noticed by others (crude oil was not a resource until someone noticed that it was possible to refine it into kerosene). This knowledge is widely dispersed throughout an economy. Individuals have bits of it - the bits that apply to them and perhaps a few bits that apply to people with whom they are closely associated - but no one has all of the relevant knowledge. Moreover, most of the relevant knowledge is frequently changing, subjective, and often tacit. (Managers may instinctively know how to deal effectively with particular labour and production problems, but if they cannot articulate that knowledge it cannot be used by a regulator to design rules.)

No central planner or regulator can possibly know enough to create a plan or a regulation that is suitable to the wide variety of local circumstances of time and place. The only way all of the relevant knowledge can be brought to bear on production and exchange plans and actions is if all individuals can formulate their own plans and actions on the basis of their individual bits of (frequently contradictory) knowledge. In an environment of voluntary exchange, people will naturally adapt their own plans and actions to those of others as they discover the different terms at which those others are willing to exchange. Unfettered competition is a perpetual discovery procedure guided by price and profit signals.

The significance of this principle of the division of knowledge for the topic of this study should be obvious. Individual employees, job seekers and employers will attach their own values to increased job security for employees. Optimal tradeoffs between increased job security and lower rates of real compensation can only be discovered at the local enterprise level. Any imposition of regulations in this regard must be formulated in ignorance of the tastes and preferences, opportunities and interests of the individuals involved.

### *c The fallacy of unequal bargaining power*

Perhaps the hoariest myth of all is that unions are necessary because workers have an inherent bargaining power disadvantage relative to employers. Even today, some in the Labour Party, the unions and their sympathisers in New Zealand still argue that compulsory collective bargaining with unions must be restored because of this alleged disadvantage. For example, in a paper calling for the restitution of mandatory good faith bargaining in New Zealand, Lorraine Skiffington says that the basic philosophical flaw of the ECA is that it fails "to acknowledge the inherent disparity of bargaining power between employer and employee".

The durability of the bargaining power myth can only be explained by its superficial plausibility. An individual worker does seem small relative to a large manufacturing firm. Surely there must be a bargaining power disadvantage? This is all the argument ever given in support of the myth. But the argument is a *non sequitur*. Consider it in another context. When an individual shopper goes into a New World store to purchase bread, surely that person must have a bargaining power disadvantage because New World is so much bigger and more influential? Here the fallacy is laid bare. The bread shopper is not at the mercy of New World, because of competition. It is the same in labour markets.

In any market, whether for labour, cars or bread, sellers compete with other sellers, and buyers compete with other buyers. Sellers do not compete with buyers. They bargain with each other over the actual terms of exchange, but every voluntary exchange yields gains to both the buyer and the seller. Voluntary exchange is a form of cooperation, not competition. The subject of bargaining is who gets what portion of the total gains such cooperation makes possible.

When buyers and sellers come together to bargain, their bargaining power depends on their alternatives. For example, with a given number of workers (sellers) seeking work of a particular type, any one worker has more bargaining power with any one employer when there are many employers (buyers) competing with each other to hire these workers than would be the case if there were only one employer seeking to do so. Similarly, with a given number of competitive employers (buyers), any one employer has more bargaining power with any one worker when there are many workers (sellers) seeking such employment than would be the case if only one worker were doing so. Workers (sellers) hate competition from other workers (sellers), but they love competition among employers (buyers). Similarly employers (buyers) hate competition from other employers (buyers), but they love competition among workers (sellers).

An employer will have a perception of an upper limit on what it is worthwhile to pay a worker for a given increment of labour services. That 'demand price' is the worker's net marginal revenue (discussed below in subsection e) to that employer. Workers will have a lower limit on what they will accept in payment for supplying an increment of labour to an employer. That 'supply price', or 'reservation wage', depends on a worker's options and on his or her subjective evaluation of the work to be done. The actual wage agreed to in the hiring contract depends on the extent of the two kinds of competition - among employers and among workers. For a given amount of competition among employers, the wage will be higher with weak competition among workers than it will be with strong competition among workers. (That is why unions want to eliminate competition among workers.) For a given amount of competition among workers, the wage will be higher with strong competition among employers than it will be with weak competition among employers.

At some times particular workers will have a bargaining power advantage relative to their employers, and at other times particular employers will have a bargaining power advantage relative to their employees. So long as an employer is not responsible for a worker's poor employment options, the employment does not exploit the worker by taking advantage of his or her weak bargaining power. Would employers be doing workers a favour by not offering them jobs at rates justified in a competitive market? Only by allowing exchanges on this basis to happen can labour supply be matched with labour demand and full employment be achieved. Similarly, so long as a worker is not responsible for the lack of workers competing for a job, the worker does not exploit an employer by taking advantage of his or her weak bargaining power.

Exploitation is a much abused concept. It does not include making voluntary exchange offers to someone based on perceptions regarding that person's bargaining power. We don't say that a buyer of a car exploits the seller of a car by offering to pay a low price because the seller happens to have an excess supply of cars on hand. The only meaningful definition of exploitation is the imposition by one person of involuntary exchange on another person. The criteria for voluntary exchange do not require that all parties to the exchange like the offers they get. They merely require that all parties must be free to accept or reject those offers.

In competitive labour markets today there are few, if any, examples of successful collusion among employers to withhold from workers alternative employment opportunities (i.e. to deny them their voluntary exchange rights). On the other hand, the *sine qua non* of unions in the twentieth century has often been to try to shut out non-union workers from employment opportunities. In other words, unions are in the business of trying to exploit non-union workers. As Morgan Reynolds points out, real wages and worker-initiated job switching in the United States were both steadily increasing throughout the nineteenth century before there was any significant unionism. Moreover, throughout the nineteenth century large firms (alleged to have strong bargaining power) paid higher wages than small firms (alleged to have less bargaining power).

However, it is easy to understand why, in litigation, judges are prone to subscribe to the unequal bargaining power myth. Every case involves a particular employment relationship. There is an individual worker pitted against an employer. The employer is almost always wealthier than the employee. The broader perspective, based on an appreciation of how a market system works, is rarely an issue in such cases. Neither plaintiffs nor defendants frame their arguments in market process terms.

#### *d General effects of unjustifiable dismissal restrictions*

Under the at-will employment doctrine, employers had absolute flexibility over the quantity, skill-composition and deployment of employees. Employers could compliment employees without worrying that doing so granted them property rights to their job. Employers could write employee manuals that explained employee responsibilities without fear that an employee who went by the book but who did not fit into planned changes in technology, location, product-mix and marketing strategies, could not be replaced by someone who did. Employers were willing to hire high-risk employees - e.g. young, inexperienced, unskilled people who had bad luck at other jobs, and people who needed retraining to re-enter the labour force.

Unjustifiable dismissal restrictions increase information costs in labour markets. From a job seeker's point of view, offering to work at will is a way of signaling confidence that the person can learn the job and perform satisfactorily into an indefinite future. High-risk employees especially need to communicate that message in order to be given opportunities to prove their abilities and to improve their skills. In an at-will regime, an employee's job turnover record is another signaling device. An employee with a record of few job changes is more likely to be a reliable worker than one with the opposite record. With unjustifiable dismissal restrictions, low job turnover is much more difficult to interpret. Furthermore, in an at-will environment employers are able to signal to job seekers that they

want a stable, high quality workforce by offering to include unjustifiable dismissal restrictions in their employment contracts. When the law imposes such restrictions they don't carry the same message.

Under the unjustifiable dismissal doctrine, every person soon becomes next to impossible to fire without going through the costs and perils of litigation. Thus, employers are going to be slow to hire when they want to expand and slow to fire when they want to contract. They will not be able to manage their workforces efficiently. Some prospective entrepreneurs, seeing the litigation and liability perils of hiring, firing, laying off, promoting, demoting, deploying and redeploying workers, may simply opt not to go into business. Existing employers will increasingly rely on independent contractors, temps, and part-time workers.

The political attractiveness of many government-imposed restrictions in the labour market - e.g. the legal minimum wage and the unjustifiable dismissal doctrine - is based on the fact that the benefits of the restrictions are received by a few, so on a per person basis they are high, and the benefits are always visible. On the other hand, the costs of the restrictions are widely dispersed and almost always invisible. Many people who suffer from the restrictions are totally unaware of the source of their misfortunes. A person who keeps his or her job when the legal minimum wage is increased, or a person who gets a judge to forbid an employer to lay that person off, receives a significant and visible benefit. Such workers may even be interviewed by journalists and researchers. A person who is disemployed because of a minimum wage increase suffers a significant personal cost, but soon becomes invisible. He or she isn't there when the journalists and researchers come to collect their data and take their pictures. A person who is unable to find a job because some entrepreneur was dissuaded from starting a business is never interviewed. Such a job seeker could not know the reason why finding a job is impossible - a journalist cannot take a picture of what doesn't happen. US Labor Secretary Robert Reich never ceases lamenting the growth of so-called contingency (fixed-term, temporary and part-time) employment at the expense of full-time, long-term employment. It never occurs to him or to most journalists and politicians that much of the problem is due to the very regulations that Reich has promoted or promulgated over the years.

Finally, legally mandated unjustifiable dismissal restrictions adversely affect the productivity of already-hired workers. The restrictions significantly increase employers' firing costs. When a worker knows that it is very costly for an employer to lay off staff, shirking is encouraged up to the point where the losses to the employer from the shirking exceed the employer's firing costs. In an at-will environment, voluntary contracts that include unjustifiable dismissal restrictions must be renewed periodically, so the costs of shirking are higher than they are with legally mandated restrictions.

### *e The hiring decision*

The key to understanding a profit-seeking employer's hiring decisions is what economists call the net marginal revenue of hiring labour (NMR). This is such an important concept, and union apologists deny its significance so often, that the idea and its implications need to be rigorously developed. Readers who already understand these basic principles can skip this and the next subsection.

Suppose an employer already has a workforce of 50 people doing a particular job, and is considering hiring an additional 10 people for the job while not changing the firm's plant and equipment. At first, assume that each of the 60 workers, the 50 already hired and the 10 who may be hired, are equally productive. The employer will first estimate how much additional output the hiring of 10 additional people makes possible. Say that is 70 extra units of output per day. The employer really cares about how much additional revenue will be harvested from customers when those 70 units are sold. Say that is \$3,500. Now, in order to produce the extra 70 units each day some extra raw materials, energy and supplies will have to be used. Say these other - i.e. non-labour - incremental costs amount to \$2,300. The costs associated with the fixed plant and equipment are the same whether the 70 additional units are produced or not, so they are irrelevant to the hiring decision. The net incremental revenue attributable to the hiring of the 10 additional workers will, then, be  $\$3,500 - \$2,300 = \$1,200$  per day. The NMR, which is always expressed on a per extra worker basis, will be \$120 per extra

worker per day. If the workday is eight hours, the hourly NMR would be \$15 per extra worker per hour.

That hourly NMR is the employer's demand price for each hour of labour services from the 10 additional workers. A demand price is the highest price that a buyer is willing to pay to obtain a product or a service. At any wage less than \$15 per hour, it would be profitable for the employer to hire the 10 extra workers. For example, suppose the wage that must be paid to get the workers willing to accept the employment offer is \$10 per hour. Then, the employer's profit contribution (the difference between gross receipts from sales and all incremental costs) would be increased by \$5 per extra worker per hour, or \$40 per extra worker per day, or \$400 per day altogether. Remember, all the non-labour incremental costs have already been subtracted out to get NMR. When incremental labour costs are subtracted out from NMR, the remainder must be incremental profit contribution. Any increase of profit contribution is an increase of profit because the difference between profit contribution and profit is fixed costs. Fixed costs are not affected by the hiring decision.

Note that even if the hourly wage that must be paid to get the 10 additional workers in the above example is \$14.99, profit contribution would still be enhanced by hiring those workers. Incremental profit contribution would be one cent per additional worker per hour, or eight cents per additional worker per day, or 80 cents per day altogether. Some addition to profit contribution is better than none. At a wage of \$15 per hour, the employer would be indifferent to hiring the additional workers, and at any wage greater than \$15 per hour the employer would not hire them.

The basic logic of the hiring decision is not changed when we recognise that not all workers are equally productive. Under those circumstances a different NMR for each worker would be compared with the wage that had to be paid to secure his or her services. NMR would still be the upper limit on what the employer would be willing to pay in each case. It is this idea of the demand price for labour, the upper limit on what a profit-seeking employer will be willing to pay, that is crucial to understanding the effect of the unjustifiable dismissal doctrine on the demand for labour.

*f The demand for labour*

Consider Table 1. The columns indicate the number of workers employed (L), the extra revenue the employer harvests from customers when the extra output that results from hiring an additional worker is sold (DR), non-labour incremental costs (OIC), net marginal revenue (NMR), and the change of profit contribution (DPC). All the numbers are expressed on an hourly basis, and the hourly wage rate is \$20. With no workers, nothing is produced and profit contribution is zero. If one worker is hired something will be produced, and when it is sold the revenue that results is \$100. The non-labour incremental costs are \$40, leaving a NMR of \$60. The worker is paid \$20, adding \$40 of profit contribution. Since there was no profit contribution to begin with, the level of profit contribution is also \$40. If two workers are hired the *additional* revenue will be \$80. (That means the total revenue per hour when two workers are working is \$180, which is \$80 above what it used to be.) The *additional* OIC is \$25. (This means that each hour when two workers are working the total amount of non-labour variable costs is \$65, which is \$25 above what it used to be.) The NMR is \$55. (This means that each hour when two workers are working the total revenue net of the non-labour incremental costs is \$115, which is \$55 above what it used to be.) The DPC is \$35. (This means that each hour when two workers are working the total amount of profit contribution is \$75, which is \$35 above what it used to be.)

**Table 1**

	DR	OIC	NMR	DPC
L	\$	\$	(DR - OIC)	(NMR-\$20)
			\$	\$

1	100	40	60	40
2	80	25	55	35
3	60	20	40	20
4	40	15	25	5
5	20	5	15	-5
6	0	0	0	-20

Continuing to interpret the numbers in the table in this manner, we see that an employer would prefer to hire three workers rather than only two, because adding a third worker adds \$20 per hour to profit contribution (bringing the level of hourly profit contribution up to \$95). Going further, the employer would prefer to hire four workers rather than only three, because adding a fourth worker increases hourly profit contribution by \$5 (bringing the level of hourly profit contribution up to \$100). This employer will not hire a fifth worker because to do so would be to decrease hourly profit contribution by \$5 (dropping the level of hourly profit contribution back to \$95). For this employer, at the \$20 wage rate the optimal size of workforce is four workers.

Consider Figure 1 on the next page. It is a diagram that depicts the relationship between the first and fourth columns of Table 1 and the wage rate. The solid steps that decline from left to right depict the NMR figures from Table 1. The solid horizontal line at \$20 depicts the unchanging wage rate paid to each worker each hour. It is worthwhile for the employer to hire a first person because the first NMR step is above the wage line. The same is true of a second, third and fourth worker. Adding a fifth or sixth worker would not be worthwhile because the corresponding NMR steps are below the wage line. Adding a fifth worker would decrease the level of hourly profit contribution by \$5, and adding a sixth would decrease that level by \$20. Note that the total level of hourly profit contribution with four workers is the area underneath the NMR steps and also on top of the wage line - i.e.  $\$40 + \$35 + \$20 + \$5 = \$100$ . If a fifth and sixth worker were hired, the total level of hourly profit contribution would be the positive area between NMR and the wage for four workers minus the negative area where NMR steps are below the wage line for the fifth and sixth workers - i.e.  $\$40 + \$35 + \$20 + \$5 - \$5 - \$20 = \$75$ .

The declining NMR steps in Figure 1 constitute the employer's demand for this sort of labour. Economists usually draw demand curves as smooth lines that are downward-sloping from left to right. Such smooth line pictures just represent the pattern that actual numerical examples such as Table 1 illustrate. In any numerical example there will be steps; in any general theoretical discussion the custom is to use smooth lines.

**Figure 1**

Finally, in anticipation of a typical union apologist's objection that the above analysis merely assumes that labour demand curves are downward-sloping from left to right, consider Figure 2 (on the next page) which shows a smooth NMR curve that rises and then falls. (It *must* eventually fall because, in the context of fixed plant and equipment, as more and more workers are hired the extra output produced when an extra worker is hired will fall as space and equipment becomes more and more crowded.) The hourly wage rate is OW. What is the optimal quantity of labour to hire? Is it L1 or is it L2? If the employer stopped at L1, the profit contribution would be negative because the wage is greater than NMR in the area labeled B. If the employer went all the way out to L2, the result would be a level of profit contribution equal to positive area A (where NMR exceeds the wage) minus negative area B. (In order to reach L2 the employer first had to go through L1.) In other words, the only relevant intersection between an NMR curve and the wage line is in the negatively-sloped portion of the NMR curve. If the negative profit contribution area (B) were larger than the positive profit contribution area (A), the optimum size of workforce would be zero.

**Figure 2**

### *g Effect of unjustifiable dismissal on the demand for labour*

Dertouzos and Karoly have demonstrated that in the United States the employers' burden of direct legal costs of unjustifiable dismissal litigation are relatively modest - about 0.1 percent of the total wage bill. But this only includes court costs, lawyer costs and settlement costs. The main burden of the unjustifiable dismissal doctrine is in all of the defensive measures that employers have to take to protect themselves against unjustifiable dismissal liability. Dertouzos and Karoly estimate these indirect costs to be 100 times greater than the direct costs. In other words, the imposition of the unjustifiable dismissal doctrine amounts to the imposition of an additional employment tax on employers. Vedder and Gallaway estimate this tax to be 8.79 percent of the normal compensation of labour in the United States in 1989. Whatever the percentage size of the tax, what does this do to the demand for labour?

Consider Figure 3 which depicts two smooth, straight line demand curves for labour. Initially the schedule of NMR (the demand for labour) is D1. The imposition of the unjustifiable dismissal tax has the same effect as an increase in any of the other non-labour incremental costs. The unjustifiable dismissal tax will be subtracted from the NMR to determine the new schedule of employer demand prices for labour. The diagram assumes the unjustifiable dismissal tax amounts to \$AC per worker. Thus the new NMR schedule (the new demand for labour curve) will be D2. Before the imposition of the unjustifiable dismissal tax, at wage rate W1, the quantity of labour employers would want to hire would be L1. After the imposition of the tax, the only way that employers would want to hire the same quantity of labour as before would be for the wage to decline to W2. They would want to be reimbursed for the employment tax by paying lower compensation (in the form of lower benefits and/or lower direct wages) per employee. If the compensation rate remained at W1, none of the employers' unjustifiable dismissal tax would be reimbursed, so the effective cost of hiring labour would increase to  $W^{\wedge}$ , and the quantity of labour employers would want to hire would fall to L2. The wage, exclusive of the unjustifiable dismissal tax, would be W1, and employers would be at point B on the new NMR schedule.

**Figure 3**

### *h The supply of labour*

Just as employers have demand prices for labour services they buy, workers have supply prices for the labour services they sell. A worker's supply price (reservation wage) for labour services in a specific employment - i.e. the lowest wage that will be accepted for doing the specific job in question - depends on two factors. First, it depends on the alternatives available. Suppose a worker is applying for a job with employer X, and that he or she already has a job offer from employer Y at a wage of \$10 per hour. If the worker regards the two employments as equivalent in every respect except the wage, an offer from employer X that is less than \$10 per hour will not be accepted. More generally, the worker will not accept an offer from any employer who offers less than the highest wage that has already been offered for equivalent work. Furthermore, it is not just employment alternatives that determine supply prices. Non-employment alternatives count as well. Suppose a worker is applying for a job with employer X, and has no prospect of any other job offers. The worker's supply price will be higher if unemployment simply means living off private or public welfare than it would be if unemployment meant that the person would be homeless and hungry. Put differently, a worker's bargaining power improves along with employment and non-employment alternatives.

The second determinant of a worker's supply price in a specific employment is his or her subjective appraisal of the nature of the job. For example, other things being equal, a risk-averse worker will have a higher supply price for a risky job than for a safer job. A risk-averse worker with a job offer from employer Y at \$12 per hour will have, say, a \$10 supply price in dealing with employer X if job Y is perceived to be riskier than job X. Other subjective evaluations of a job's characteristics - e.g.

prestige, job security, and flexibility - will affect a worker's supply price. In general, the more attractive the characteristics of the job to the worker, the lower will be the supply price.

Just as an employer's demand prices for labour can be represented as a demand curve for labour, the supply prices of workers in a specific labour pool can be represented as a supply curve for labour. Consider Figure 4 which depicts such a supply curve. It is drawn assuming a given set of worker subjective evaluations of job characteristics. If an employer hiring labour from this labour pool offered wage rate  $W_1$ ,  $L_1$  units of labour services would be offered for hire. (Labour services are usually measured as labour-hours. Two people each working eight hours is a supply of 16 labour hours.) The workers that would accept the job would be those whose supply prices were less than or equal to  $W_1$ . If the employer offered wage rate  $W_2$ ,  $L_2$  units of labour services would be offered for hire. The increase would come from two sources. First, and most importantly, additional workers would accept the wage offer. There are more workers with supply prices less than or equal to  $W_2$  than workers with supply prices less than or equal to  $W_1$  (the latter is a subset of the former). Second, workers usually are willing to work longer hours at higher wages.

**Figure 4**

*i Effect of unjustifiable dismissal on the supply of labour*

To the extent that the unjustifiable dismissal doctrine is perceived by workers to increase their job security, and to the extent that workers, other things being equal, prefer more job security to less job security, the adoption of unjustifiable dismissal restrictions in employment contracts will lower workers' supply prices. In other words, such workers are willing to trade some job compensation for increased job security. Consider Figure 5 which shows two labour supply curves. Initially the supply curve is  $S_1$ , the wage rate is  $W_1$ , and the quantity of labour offered for hire is  $L_1$ . Then the unjustifiable dismissal doctrine is made mandatory in all employment contracts. If workers evaluate the increased job security as  $\$AB$ , their supply prices in terms of benefits and direct wages will decline by that amount.  $L_1$  units of labour would be offered for hire at a wage rate (including benefits and direct wages) equal to  $W_2$ . At the old wage rate there would be a higher quantity of labour offered for hire ( $L_2$ ) because the effective wage rate would be  $W^{\wedge}$  which is  $W_1$  plus  $AB$ .

**Figure 5**

*j Labour market effects of unjustifiable dismissal*

Now that we have the necessary pieces, we can make some pattern predictions regarding the consequences of mandatory unjustifiable dismissal in employment contracts. (In Section IV, I will present some American empirical studies and, for purposes of illustration, apply them to New Zealand.) Consider Figure 6. This diagram represents the aggregate demand and supply of labour in a market. The initial demand and supply of labour curves are  $D_1$  and  $S_1$  respectively. The market-clearing wage rate, which is determined by the intersection of those two curves at point  $c$ , is  $W_1$ , and the quantity of labour employed is  $L_1$ . Mandatory unjustifiable dismissal which is evaluated by employers at  $gb$  per worker is imposed. Vedder and Gallaway call this imposition an unjustifiable dismissal tax. The demand for labour falls to the curve labeled  $D_2$ . But the supply of labour curve will also shift because workers are likely to place a positive value on the apparent increased job security.

**Figure 6**

Figure 6 shows a vertical shift down of the labour supply curve by  $jb$ , which is less than the downward shift of demand ( $gb$ ). In other words, I have asserted that the employers' evaluation of unjustifiable dismissal as a cost is larger than the workers' evaluation of unjustifiable dismissal as a



benefit. This must be the case because of the Coase Theorem. According to Ronald Coase, the 1991 Nobel Laureate in economics, if transactions costs are sufficiently low to allow voluntary exchange to take place, a property right will always end up in the hands of the parties that value it most highly. The at-will employment doctrine in effect gives employers a property right to the jobs they hire workers to fill. Employers cannot force workers to stay on the job, but they can terminate the employment relationship at any time. Insofar as unjustifiable dismissal makes it legally perilous for an employer (but not an employee) to terminate an existing employment relationship, it can be said that unjustifiable dismissal regulation amounts to a transfer of the property right to the job from employers to workers. If workers evaluated this property right more highly than employers did, voluntary exchange would already have reallocated the right from employers to workers. Workers would have already voluntarily agreed to accept lower wages in exchange for the increased job security. For example, if workers evaluated the increased job security at \$4 per hour, and employers evaluated the ability to fire at will at \$2 per hour, workers and employers would both be better off if workers were given increased job security in exchange for a wage cut of, say, \$3 per hour. (I assume in this example that all such mutually beneficial exchanges are made before the imposition of unjustifiable dismissal restrictions by law.)

When an unjustifiable dismissal tax is imposed, workers must evaluate it as a benefit at a lower dollar amount than employers evaluate it as a cost. Thus, in Figure 6 the downward shift of the demand curve exceeds the downward shift of the supply curve. The intersection of the new demand for labour (D2) with the new supply of labour (S2) at point b determines a new market-clearing wage (W2) and a new level of employed labour (L2). Part of the employment tax has been shifted on to workers in the form of lower wages ( $W1 - W2 = eb$ ). The part that employers cannot shift to workers (eg) is a net uncompensated increase in the cost of hiring workers, and that causes employers to hire fewer workers (L1-L2).

Note that the combination of lower wages and less employment depends on the magnitude of the shift of the labour supply curve. If it didn't shift at all - i.e. if workers evaluated the increased job security at zero, the intersection of supply and demand would be at point f, the wage would only fall from W1 to w0, but employment would fall from L1 to L0. At the other extreme, if workers and employers placed the same value on unjustifiable dismissal, the supply curve would shift to the dashed line labelled S3, the wage would fall from W1 to w3, and employment would remain at L1. Employers would be fully compensated for the unjustifiable dismissal tax by the decline in wages, so they wouldn't cut back on employment. In general, for any size of the unjustifiable dismissal tax (and therefore the downward shift of the demand curve), smaller supply curve shifts will cause smaller wage decreases but larger employment cuts.

### *k Significance of elasticities of demand and supply*

The price (wage) elasticity of demand for labour is a measure of employers' sensitivity to changes in the wage rate when other factors, such as production technology, are held constant. Wage increases (decreases) cause employment decreases (increases). But by how much? When the wage (which includes benefits as well as the direct wage) increases, do employers change their hiring plans a lot or a little? If the percentage change in employment exceeds the percentage change (in the opposite direction) in the wage, demand is elastic. If the percentage change in employment is less than the percentage change in the wage, demand is inelastic. The wage elasticity of demand is defined as the percentage employment change divided by the associated percentage wage change. Since the direction of the employment change is always the opposite of the direction of the wage change (demand curves are negatively sloped), the wage elasticity of demand will always be negative. But 'high' or 'low' elasticity always refers to the absolute value of the ratio (the negative sign is ignored).

The price (wage) elasticity of supply of labour is a measure of workers' sensitivity to changes in the wage rate when other factors, such as their subjective evaluations of the nature of the work, are held constant. Wage rate increases (decreases) cause workers to increase (decrease) the amount of labour they prefer to offer for hire. Again, by how much? When the wage changes, do workers change their

offers for hire a lot or a little? If the percentage change in the labour offered for hire exceeds the percentage change in the wage, supply is elastic. If the opposite is true, supply is inelastic. Since labour supply curves are positively sloped, wage elasticity of supply is positive.

The mathematics and geometry of elasticities of demand and supply are worked out in the technical appendix to this paper. Here it is sufficient to note that for any two demand curves that intersect at a specific wage rate, the flatter one will be more elastic than the steeper one. The flatter one shows a bigger employment response to a given change from the wage rate at which they intersect than the steeper one does. Similarly, for any two supply curves that intersect at a specific wage, the flatter one will be more elastic than the steeper one.

Consider Figure 7. At point A the solid demand curve, D11, is less elastic than the dashed line demand curve, D21. The initial equilibrium is at point A, with the wage equal to W1 and and employment equal to L1. Since I am focusing on how the unjustifiable dismissal tax

### Figure 7

affects wages and employment with different demand elasticities, given the supply elasticity, I keep the supply curve fixed. Assume that the initial demand curve is D11 (the less elastic demand) and that an employment tax equal to AB is imposed. The demand curve shifts to D12. With a fixed supply curve the wage falls from W1 to W12, and employment declines from L1 to L12. If the initial demand curve is D21 (the more elastic demand), the unjustifiable dismissal tax shifts demand to D22. With a fixed supply, the wage falls from W1 to W22, and employment falls from L1 to L22. In general, for any given supply elasticity, the larger the demand elasticity the greater will be the wage and employment decline.

To see the significance of different elasticities of supply, consider Figure 8. Again, the initial equilibrium is at point A. Since I am concerned with the effects of an unjustifiable dismissal tax, I must shift the demand curve; but since I want to isolate the effects of the tax with different supply elasticities, given the demand elasticity, there is only one pair of demand curves. If the initial supply curve is S1 (the more elastic supply), the unjustifiable dismissal tax will reduce the wage from W1 to W12, and employment will fall from L1 to L12. If the initial supply curve is S2 (the less elastic supply) the tax will decrease the wage from W1 to W22, and employment will fall from L1 to L22. In general, for any given demand elasticity, the smaller the elasticity of supply the larger will be the wage decline and the smaller will be the employment decline.

### Figure 8

The formula that gives us the percentage of the unjustifiable dismissal tax that is shifted to workers in the form of lower wages is:

$$\% \text{ of Tax} = \frac{ED}{ED + ES} \cdot a$$

ED is the absolute value of the elasticity of demand, ES is the elasticity of supply, and a is the size of the downward supply shift divided by the size of the downward demand shift (which is the unjustifiable dismissal tax). If  $a = 1$ , 100 percent of the tax will be shifted on to workers in the form of lower wages. (This is shown in Figure 6 with the supply shift to the dashed line S3.) I will derive this formula in the technical appendix, but for now note that a must be less than 1 because the value of unjustifiable dismissal to workers as a benefit is less than the burden of unjustifiable dismissal as a cost. Thus for any given ES, the higher the value of ED the greater will be the share of the tax borne by workers. (Given ES and a less than 1, the numerator is smaller than the denominator, and a higher ED will increase the ratio.) Similarly, for any given ED, the smaller the value of ES the greater will be the share of the tax borne by workers. (The effect of a change of ES will be bigger on the denominator than on the numerator because a is less than 1.)

In sum, workers will tend to bear more of the unjustifiable dismissal tax in the form of lower wages when demand elasticity is large and when supply elasticity is small than they would with small demand elasticities and large supply elasticities. Who are the workers whose labour demand elasticities are large? Those whom it is easiest to replace with technology - the least skilled, least experienced, least able workers. Who are the workers whose labour supply elasticities are small? One group is those who have very few employment alternatives - the least skilled, least experienced, least able workers. The unjustifiable dismissal tax discriminates against such workers. As a result, unjustifiable dismissal regulation will make the distribution of income less equal than it would otherwise be.

Another way that unjustifiable dismissal restrictions might increase income inequality is through the increased use of overtime work from existing employees as a substitute for hiring additional employees during periods of increasing customer demand. Although overtime wage rates are usually higher than regular wage rates, they could well seem to an employer like a good alternative to incurring increased legal liability for unjustifiable dismissal of new employees.

#### **IV EMPIRICAL STUDIES IN THE UNITED STATES APPLIED TO NEW ZEALAND**

There are two especially significant empirical studies of the effects of unjustifiable dismissal regulation on the American economy. Such studies, based on regression analysis, are made possible by the gradual process of adoption of various exceptions to the at-will employment doctrine by various states starting in the mid 1970s and continuing through the 1980s. (These exceptions are, as discussed above, public policy, implied contracts, and the covenant of good faith and fair dealing.) For example, in 1980 only 13 states recognised exceptions; by 1989 45 states had. The two studies were done by Dertouzos and Karoly (1992) and Vedder and Gallaway (1995). I will report their results as to the effects of unjustifiable dismissal on income distribution, real compensation (wages), and employment.

No similar studies have been done for New Zealand. Inasmuch as there were no geographic differentiations in the spread of unjustifiable dismissal restrictions in New Zealand as there were in the United States, such a method of estimation is not available. Moreover, it cannot be claimed that American empirical results are directly applicable to New Zealand labour markets. There may be sufficient differences in the two legal and economic contexts to modify the results. On the other hand, there are no grounds for assuming that the general picture presented by these studies does not apply in New Zealand. *For purposes of illustration only*, in order to indicate the *possible* empirical magnitudes of the theoretical effects discussed above, I demonstrate what the American empirical results would, if they were applicable, amount to in a New Zealand context.

#### **Income distribution**

Using aggregate time series data, Vedder and Gallaway have estimated the effects of the unjustifiable dismissal doctrine on income distribution in the United States during the 1980s. By including an unjustifiable dismissal independent variable with the independent variables usually used in regression studies of income distribution, they estimated the effects of unjustifiable dismissal on US Gini coefficients and lowest quintile mean family incomes. Their unjustifiable dismissal variable was the number of states in any year that by then had adopted one or more of the three exceptions.

The Gini coefficient is one way of measuring the degree of inequality of the distribution of income. It is based on the so-called Lorenz curve. Figure 9 shows a hypothetical Lorenz curve. The vertical axis measures the percent of total personal income, and the horizontal axis measures the cumulative percent of the population. The Lorenz curve is the heavy line that starts at the origin and rises at an increasing rate up to point X. That point represents the truism that 100 percent of the population together must receive 100 percent of all the income received by the population. Point T on the Lorenz

curve indicates that, in the hypothetical economy represented by the diagram, the lowest 50 percent of the population together receives 20 percent of the total income. With a perfectly equal distribution the lowest 50 percent of the population would receive 50 percent of the total income. The Lorenz curve would be the dashed diagonal line between the origin and point X. Point Z, and any other point on the diagonal, indicates that equality. The area between the diagonal and the Lorenz curve from the origin up to point X is labelled area G. It is the extent to which the actual Lorenz curve deviates from the perfect equality indicated by the diagonal. The area underneath the Lorenz curve from the origin out to the 100 percent mark on the horizontal axis is labelled area R.

**Figure 9**

The Gini coefficient is  $\frac{G}{R}$ . With perfect equality, area G would not exist so the Gini coefficient would be zero. With perfect inequality area R would not exist (one person would receive 100 percent of the total income) so the Gini coefficient would be one. The Gini coefficient can be thought of as a measure of inequality in the distribution. As the Gini coefficient declines, there is less inequality.

Through their regression equation for Gini coefficients, Vedder and Gallaway calculated what US Gini coefficients would have been in each year had there been no implementation of the unjustifiable dismissal doctrine, and they compared these hypothetical Gini coefficients with the actual coefficients for each year. Their results, in tabular form, are in Table 2. Their hypothetical Ginis were, in each year, lower than the actual ones. In other words, in the absence of the unjustifiable dismissal doctrine there would have been less inequality. The 'discount' column indicates the ratio of the hypothetical to the actual Ginis in each year. In 1989, for example, inequality would have been 10 percent lower than it actually was. Notice that the impact of unjustifiable dismissal grew year by year. This is because over time more and more states adopted exceptions, and some states that already had adopted one exception added further exceptions.

**Table 2**

**US Data**

YEAR	ACTUAL GINI A	HYPOTHETICAL GINI B	DISCOUNT = B/A
1980	.365	.358	.98
1981	.365	.357	.98
1982	.369	.359	.97
1983	.380	.365	.96
1984	.383	.358	.93
1985	.389	.357	.92
1986	.392	.358	.91
1987	.393	.358	.91
1988	.395	.358	.91
1989	.401	.363	.90

Source: Vedder and Gallaway.

The same data are represented in bar chart form below. The steadily growing impact of the unjustifiable dismissal doctrine is very visible in the chart. The actual amount of income inequality is much higher than what it would have been in the absence of unjustifiable dismissal, and the gap gets bigger year by year.

Applying the Vedder-Gallaway discounts to actual Gini coefficients for New Zealand during the 1980s gives the hypothetical New Zealand Ginis reported in Table 3. Of course, conditions in New Zealand during this time interval were different from those in the United States. Mandatory unjustifiable dismissal was imposed only in unionised occupations. In the case of non-union individual contracting, there was no mandatory unjustifiable dismissal. Moreover, unlike in the United States, mandatory unjustifiable dismissal regulations were not appreciably increasing in New Zealand during the 1980s. The big growth in unjustifiable dismissal restrictions in New Zealand occurred in 1991 with the enactment of the Employment Contracts Act which, for the first time, mandated unjustifiable dismissal in *all* New Zealand employment contracts. In order to measure the impact of an independent variable (e.g. unjustifiable dismissal) on a dependent variable (e.g. Ginis) through regression analysis, it is necessary that the independent variable change over the study period. That did not happen with unjustifiable dismissal in New Zealand during the 1980s. Nevertheless, the possible effects of unjustifiable dismissal can be illustrated in New Zealand by applying US results to New Zealand dependent variables. Chart 2 depicts illustrative actual and hypothetical Ginis for New Zealand during the 1980s in bar chart form. If the unjustifiable dismissal doctrine has the same strong negative effect in New Zealand as it does in the United States, income inequality in New Zealand will be greatly exacerbated as a result of the personal grievance provisions of the ECA.

Source: Vedder and Gallaway.

**Table 3**

**Illustrative New Zealand Data**

YEAR	ACTUAL GINI	VEDDER AND GALLAWAY DISCOUNT	HYPOTHETICAL GINI
1980	.393	.98	.382
1981	.394	.98	.386
1982	NA	.97	NA
1983	.391	.96	.375
1984	.390	.93	.362
1985	.391	.92	.359
1986	.394	.91	.358
1987	.400	.91	.364
1988	.404	.91	.367
1989	.407	.90	.366

Source (of actual Gini figures): George Barker, 'Income Distribution in New Zealand', paper presented at Seminar No 1, Income Distribution and Social Policy Programme, Institute of Policy Studies, Wellington, 1995, p. 25.

The second way that Vedder and Gallaway measured the impact of unjustifiable dismissal on income distribution was to construct hypothetical mean family income levels for families in the lowest quintile of the US income distribution. They used the same set of independent variables here as they did in their Gini calculations, but they changed the dependent variable to lowest quintile incomes. Their results are shown in Table 4. Again, unjustifiable dismissal is seen to have a powerful negative effect on income distribution. By 1989, lowest quintile income would have been 18 percent higher without unjustifiable dismissal than it actually was. The same data, in bar chart form, appear in Chart 3. Getting rid of unjustifiable dismissal would benefit the people at the bottom end of the income distribution.

## Chart 2

### Illustrative Actual and Hypothetical Gini Coefficients

#### for New Zealand

Source: George Barker, 'Income Distribution in New Zealand'.

**Table 4**

#### Effect of Unjustifiable Dismissal Doctrine on Mean Real Family Income in

#### Lowest Quintile

#### US data

YEAR	ACTUAL INCOME	HYPOTHETICAL INCOME	GAIN RATIO
1980	10,506	10,809	1.03
1981	10,497	10,874	1.04
1982	9,535	10,010	1.05
1983	9,514	10,322	1.08
1884	9,835	10,961	1.11

1985	9,966	11,446	1.15
1986	10,291	11,930	1.17
1987	10,157	11,853	1.17
1988	10,197	11,979	1.17
1989	10,359	12,253	1.18

Source: Vedder and Gallaway, p. 14.

### Chart 3

Source: Vedder and Gallaway.

When these Vedder and Gallaway results are applied to lowest quintile incomes in New Zealand during the 1980s, the result is the illustrative figures in Table 5. The same illustrative results, in bar chart form, are in Chart 4.

**Table 5**

**Effect of Unjustifiable Dismissal Doctrine on Mean Real Family Income in  
Lowest Quintile**

**Illustrative New Zealand Data**

YEAR	ACTUAL INCOME	VEDDER AND GALLAWAY GAIN RATIO	HYPOTHETICAL INCOME
1980	NA	1.03	NA
1981	13,905	1.04	14,461
1982	12,376	1.05	12,995
1983	12,887	1.08	13,918
1984 *	12,610	1.11	13,997
1985	11,698	1.15	13,453
1986	12,015	1.17	14,058
1987	10,278	1.17	12,025
1988	12,709	1.17	14,870
1989	12,553	1.18	14,813

Source (of actual income figures): Statistics New Zealand, Household Economic Survey.

\* Change in survey method

### Chart 4

**Illustrative Actual and Hypothetical Mean Family  
Income Bottom Quintile for New Zealand in 1993 (NZ\$)**

Source: George Barker, 'Income Distribution in New Zealand'.

## Effects on real compensation (wages)

It will be recalled from the theoretical discussion above that since the imposition of unjustifiable dismissal by force of law amounts to an unjustifiable dismissal tax from the point of view of employers, the demand for labour curve shifts down. In addition, to the extent that employees see mandatory unjustifiable dismissal as a benefit in the form of increased job security, the supply for labour curve also shifts down. Therefore, unjustifiable dismissal unequivocally causes real compensation (direct wages plus benefits) to decline. Vedder and Gallaway estimated the percentage decline in real compensation in the United States by using real compensation as the dependent variable and time, together with their unjustifiable dismissal variable, as the independent variables in a regression equation for the years 1970-1989. The resulting coefficient on time gives the slope of the trend line in real compensation that would exist without unjustifiable dismissal, and the coefficient on the unjustifiable dismissal variable indicates how unjustifiable dismissal reduces real compensation below the trend. Their results, for the 1980s, are depicted in Chart 5. The zero line is the trend.

Chart 5

### Percent Decline of Real Compensation from Trend Due to Wrongful Termination Doctrine

Source: Lowell Gallaway by fax. A different graph of the same data is in Vedder and Gallaway, p. 11.

By 1989 average real compensation in the United States was 7.47 percent below what it would have been without unjustifiable dismissal.

This decline in real compensation is the form in which employees bear a portion of the unjustifiable dismissal tax imposed on employers. A 7.47 percent decline in real compensation is a very large portion of the unjustifiable dismissal tax. To see how large a portion it is, recall that the percentage of the tax that shows up as a decline of compensation is calculated as  $\frac{a}{a + ES}$ , where  $a$  is the ratio of the employees' evaluation of unjustifiable dismissal to the employers' evaluation of it,  $ES$  is the elasticity of supply, and  $ED$  is the absolute value of the elasticity of demand. Vedder and Gallaway assumed that  $a = 0$  - i.e. that the supply of labour curve doesn't shift because employees don't place a positive value on unjustifiable dismissal. They estimate that in the United States  $ED = .83$  (remember this is the absolute value; the actual value of elasticity of demand is  $-.83$ ), and that  $ES = .15$ . Thus, the percent of the tax that shows up as reduced compensation is  $\frac{0}{0 + .15} = 0$ . Therefore, the percentage rate of the unjustifiable dismissal tax in 1989 must have been 8.79 percent because 7.47 (the percentage fall of compensation) is 85 percent of 8.79.

We know that  $a$  must be some value between 0 and 1. Suppose it is  $.5$  - i.e. workers value unjustifiable dismissal (as a benefit) one-half as much as employers do (as a cost). The percent of the tax that is passed on to employees in the form of reduced compensation would be  $\frac{.5}{.5 + .15} = .77$ . Since employees are willing



to accept a wage cut because they place a positive value on unjustifiable dismissal (the supply curve shifts), they will bear a larger share of the tax in that form. The tax rate would be 8.12 percent because 7.47 is 92 percent of 8.12.

The very few estimates of labour market elasticities in New Zealand are not considered to be very reliable. However, the best estimates are  $ED = .71$  (absolute value) and  $ES = .38$ . Therefore, if  $a = 0$  the percent of the tax passed on to employees would be . Assuming the percentage decline of compensation is the same in New Zealand as it was in 1989 in the United States - 7.47 - the New Zealand unjustifiable dismissal tax rate would be 11.49 percent, much higher than the 8.79 percent in the United States.

If  $a = .5$ , the percent of the tax passed on to employees would be . Again, because employees are willing to accept wage cuts because they place a positive value on unjustifiable dismissal, the percentage of the tax they will bear in that form will increase. The unjustifiable dismissal tax rate would be 9.11 percent.

In sum, the imposition of unjustifiable dismissal by force of law in New Zealand, or anywhere else, is not an unmixed blessing to workers who receive such 'protection'. They pay for that protection through lower compensation. No government minister can know whether any specific worker who continues to work will regard the tradeoff as worthwhile.

## Effects on employment

Not all workers do continue to work after the imposition of the unjustifiable dismissal doctrine. Recall from the theoretical discussion above that, in addition to declining compensation for those who continue to work, the total quantity of labour hired also declines. As we saw in the previous section, Vedder and Gallaway inferred an 8.79 percent unjustifiable dismissal tax from their calculation that the percentage compensation decline in 1989 was 7.47 percent. This means that there was a 1.32 percent ( $8.79 - 7.47$ ) increase in the employers' marginal cost of hiring labour. Since demand curves are downward-sloping, this means that fewer people will be hired. The percentage decline in hires equals  $.83(1.32\%) = 1.10$  percent. Vedder and Gallaway adjusted this figure, to take into account that only 90 percent of the states have implemented unjustifiable dismissal, to 1.235 percent. Applying that percent reduction in employment to 1993 employment data for the individual states, they estimated that the total loss of jobs in that year for the United States was 1,325,000. The loss for California alone was 171,000.

Employment in New Zealand in December 1995 was 1,653,000. In the previous section we saw that if  $a = 0$ , the New Zealand unjustifiable dismissal tax rate would be 11.49 percent. If  $a = .5$ , it would be 9.11 percent. Assuming that the percentage decline in compensation was 7.47 percent, in the first case the employers' marginal cost of hiring labour increased by  $11.49 - 7.47 = 4.02$  percent, and in the second it would be  $9.11 - 7.47 = 1.64$  percent. Multiplying each by the absolute value of New Zealand's elasticity of the demand for labour gives  $.71(4.02) = 2.85$  percent, and  $.71(1.64) = 1.16$  percent. The decline in New Zealand employment in 1995 due to the unjustifiable dismissal tax would be  $.0285(1,653,000) = 47,110$  jobs in the former case and  $.0116(1,653,000) = 19,174$  jobs in the latter.

The Dertouzos and Karoly study focused on the employment effects of the unjustifiable dismissal tax. They used state-based data and regression analysis to estimate those effects. They classified the exceptions to the at-will doctrine in two different ways. Their first taxonomy was (i) narrow public policy (PP), (ii) broad PP or good faith (GF) tort, and (iii) implied contract (IC) or GF as contract. Their second taxonomy was (i) tort and (ii) contract. The former was concerned with the three types of exceptions - PP, IC and GF. The latter was concerned with the type of legal remedy allowed - contract (only compensatory damages) or tort (compensatory and punitive damages) - in judgments against employers.

Their results, looking at total employment with the first taxonomy, are shown in Table 6. States with just the narrow PP exception suffered no decline of employment due to unjustifiable dismissal. This suggests employers rarely fired workers for serving jury duty or refusing to break the law. However, in states that had either the broad PP or the GF exception treated as a tort aggregate, employment was 2.1 percent lower than it would have been if the state did not recognise those exceptions to at-will employment. States that recognised only the IC exception or treated GF claims under contract law suffered only a 1.4 percent decline in aggregate employment.

When Dertouzos and Karoly used their second taxonomy their results were as shown in Table 7. In states allowing punitive damages along with compensatory damages, total employment was 2.9 percent lower than it would have been with no unjustifiable dismissal. States that allowed only compensatory damages suffered only a 1.8 percent reduction in employment. One might expect that the greater liability in tort cases than in contract cases would make employers fire people less often. That is probably true, but the proposition relates only to the employment effects on workers already hired. It ignores the hires that never take place because of the heightened legal liability.

**Table 6**

**Total Employment**

**First Taxonomy**

TYPE OF WRONGFUL TERMINATION DOCTRINE	PERCENTAGE DECLINE IN EMPLOYMENT
Narrow PP	0
Broad PP or GF tort	-2.1
IC or GF as contract	-1.4

Source: Dertouzos and Karoly, p. 50.

**Table 7**

**Total Employment**

**Second Taxonomy**

TYPE OF LEGAL REMEDY	PERCENTAGE DECLINE IN EMPLOYMENT
Tort	-2.9
Contract	-1.8

Source: Dertouzos and Karoly, p. 50.

Dertouzos and Karoly then used their second taxonomy to measure the employment effects of unjustifiable dismissal by industry. Those results are shown in Table 8. Neither tort nor contract remedies had any employment effects in manufacturing and in wholesale trade. States with the tort remedy suffered a 5.5 percent loss of employment in the service sector and a whopping 7.2 percent

loss of employment in finance. Retail was not affected. States that allowed only compensatory damages suffered a 4.9 percent loss of employment in the service sector and a 2.5 percent loss in retail. Finance was not affected.

**Table 8**  
**Percentage Employment Losses Due to**  
**Unjustifiable Dismissal by Industry**

LEGAL REMEDY	manuf.	service	retail	wholesale	finance
tort	0	-5.5	0	0	-7.2
contract	0	-4.9	-2.5	0	0

*Source:* Dertouzos and Karoly, p. 56

Finally, Dertouzos and Karoly used their second taxonomy to measure the employment effects of unjustifiable dismissal by firm size. Those results are shown in Table 9. With both remedies the percentage reduction of employment, compared to what it otherwise would be, is greater in large firms than in small firms. In fact, the contract remedy had no measurable effect in small firms, but it reduced employment by 5.2 percent in large firms. The effect of the tort remedy was very strong in large firms (-7.6 percent) and significant in small firms (-3.8 percent).

**Table 9**  
**Percentage Employment Losses Due to**  
**Unjustifiable Dismissal by Firm Size**

LEGAL REMEDY	At Least 250 Employees	Less than 250 Employees
tort	-7.6	-3.8
contract	-5.2	0

*Source:* Dertouzos and Karoly, p. 60.

Why should the effects of unjustifiable dismissal be stronger in large firms than in small firms? Dertouzos and Karoly say that most of the difference is due to the changing size distribution of firms when employment falls. That is, when employment falls for all firms due to unjustifiable dismissal, some of the firms that hired at least 250 employees will fall into the category of firms with fewer than 250 employees. This decline in the number of large firms will show up in the data as if all the employees in the hitherto large firms lost their jobs. Actually, only some of them did, but those still working will now be included in the small firm data. Therefore, the employment losses in the large firm category will be overstated, and those in the small firm category will be understated. Because of this measurement problem, Dertouzos and Karoly conjecture that the employment effects of unjustifiable dismissal are neutral with respect to firm size. The important figure, they say, is the total of large firm and small firm employment decline. For tort that is almost 13 percent, and for contract it is 5.2 percent.

The data are unequivocal that the legal remedy of tort has much larger negative effects on employment than the legal remedy of contract. The ECA does not provide for punitive damages *per se*. However, section 40(1)c allows awards to employees to include compensation for 'humiliation, loss of dignity, and injury to the feelings of the employee'. This section opens the door to tort remedies. Can explicit punitive damages be far behind?

## V THE OECD JOBS STUDY, 1994

Mandatory unjustifiable dismissal is not just a problem in New Zealand and the United States. It has wreaked havoc throughout the OECD and beyond. Even the OECD bureaucracy, which historically has been sympathetic to the unionist agenda, has expressed misgivings. While it does not endorse completely free contracting on the issue, it clearly recognises many of the problems discussed above, and it urges member countries to back away from 'stringent' legislation. The official OECD position is stated as follows:

Employment protection legislation is designed to discourage dismissals by raising the cost to employers of releasing workers. But it can also make employers more reluctant to hire new workers. Countries, mainly in Europe, which have particularly stringent legislation generally have a high rate of long-term unemployment, and employers frequently resort to temporary contracts and other 'non-standard' forms of employment to meet their needs for greater work-force flexibility.

At the same time legislated employment security, along with job guarantees negotiated by collective bargaining, also bring benefits. Employment security through long-term contracts can encourage investment in on-the-job training that is hindered by high labour turnover.

A balance has to be struck between allowing employers greater freedom in decisions to hire and fire, and ensuring both sufficient employment security for workers and firms to be willing to invest in long-term training and protection for workers against unfair dismissal.

I would say that the best balance can be achieved not at the level of legislation (which the OECD does not necessarily imply) but at the level of the workplace by allowing complete freedom of contract on unjustifiable dismissal versus at-will employment. Profit-seeking, loss-avoiding employers voluntarily offer unjustifiable dismissal protections to their employees when it is beneficial to do so - e.g. to encourage workers to invest in firm-specific skills and to reduce labour turnover. They don't need government action to force them to do so. Similarly, individual workers are best placed to decide on the tradeoffs they prefer between wages, job security and other employment conditions.

Later in the *Jobs Study*, its authors explicitly recommend that governments "Loosen mandatory restrictions on dismissals in countries where current provisions appear seriously to hinder economic restructuring and the hiring chances of new labour force entrants." Because they had several competing interests to assuage, the OECD authors couldn't name specific offending countries. Moreover, they had to appear to be moderate. I would argue that all mandatory unjustifiable dismissal restrictions should be abolished, not just loosened. But at least the OECD has moved substantially away from mindlessly endorsing coercive regulations in the labour market.

## VI CONCLUSION

The Employment Contracts Act 1991 is a giant step toward the restoration of freedom of contract in New Zealand labour markets. It has totally abolished compulsory unionism and the special privileges that unions unjustifiably enjoyed in New Zealand since 1894. In no other advanced country in the world, including the United States, has the legislature been willing to challenge the hegemony of trade unions to such an extent.

Unions were granted their special privileges and immunities throughout the developed world largely because of the almost universal myth of labour's bargaining power disadvantage. Even in New Zealand, however, that hoary myth is still influential. It is behind the whole idea that government must impose and enforce minimum restrictions in the labour market. With some exceptions, such as well-designed health and safety regulations, such restrictions are unjustified and benefit neither firms nor workers in general. Legal minimum wages are one example of such restrictions, and mandatory unjustifiable dismissal restrictions in all employment contracts are another.

While the proponents of those restrictions may have been well-intentioned, the economic effects of the regulations are lamentable. On purely theoretical grounds we can infer that the economic effects of unjustifiable dismissal regulation include:

- less efficiency in the management and deployment of labour resources;
- higher information costs in labour markets;
- the founding of fewer start-up firms and the expansion of fewer existing firms;
- the hiring of fewer high risk employees;
- diminished opportunities for entry level work and on-the-job training;
- decreased productivity of many already-hired employees;
- lower real compensation paid to workers;
- less employment opportunities in general; and
- increased inequality in the distribution of income.

The New Zealand parliament made a huge mistake in 1991 when it chose to impose mandatory unjustifiable dismissal restrictions on all employment contracts. The large proportion of the labour force - probably a majority - who were on individual employment contracts and not union members managed perfectly well without the 'protections' of unjustifiable dismissal restrictions before the ECA. No one, including those with collective employment contracts, needs those 'protections' to be forced upon them in 1996.

The remedy is clear. Freedom of contract should be restored to all employment relationships. This does not mean that all employment relations will be at will, for individual employers and employees can negotiate whatever contractual terms they wish. Given the principle of the division of knowledge, in a freedom of contract environment there will be a multitude of individual approaches to the issue of unjustifiable dismissal. It is illogical and destructive for the government to impose one-size-fits-all rules for this aspect of employment contracts.

## TECHNICAL APPENDIX

The formula for any price elasticity of demand or supply is

which is the ratio of the percentage change in quantity demanded or supplied to the percentage change in the price of the product or service that is demanded or supplied, with all the other variables that might affect Q held constant. In the case of demand, the direction of the change in Q will be the opposite of the direction of the change in P. In the case of supply the changes are in the same direction. That ratio can be rewritten as

That says that the (absolute value of) the elasticity equals the reciprocal of the slope of the demand or supply curve times the ratio of the starting price to the starting quantity. Consider Figure A-1.

### Figure A-1

The (absolute value of ) price elasticity at point a is

Now consider Figure A-2, which shows the effects of the imposition of the unjustifiable dismissal doctrine on the supply and demand for labour. Using ED for the absolute value of the wage elasticity of the demand for labour and ES for the wage elasticity of the supply of labour, the formula for the percentage of the unjustifiable dismissal tax that is passed on to employees in the form of reduced wages is derived in the following way.

### Figure A-2

Lemma I

Proof:

Since appears in each elasticity, it will cancel out. Therefore

QED

Lemma II

Proof:

Since appears in each elasticity, it will cancel out. Therefore

QED

Now:

Therefore:

, where a =