CONTRACTUAL SOLUTIONS FOR EMPLOYMENT LAW PROBLEMS

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It is my very great pleasure to speak at this general session of the Federalist Society on the vexing topic of employment law. It is a subject in which I have had a long-term interest, and on which I have done a fair bit of legal and theoretical work. In a previous talk, Commissioner Chai Feldblum of the Equal Employment Opportunity Commission emphasized the importance of empirical work in order to get a grip on how the system works. Her implicit assumption is that we should be skeptical of theoretical accounts of the determinants of success and failure in labor markets. No one should of course turn a blind eye to empirical information, but the emphasis that is attached to it all too often becomes a recipe for total and absolute stasis. The data is always incomplete. The studies are often too esoteric. The chains of inference are long and disputed. Rival interpretations are often inconsistent, and hence those who like the status quo ante use the claim for empirical research as a barrier against a revisiting of policies that I regard as far too interventionist in labor markets. No one did any empirical research to introduce the current mélange of employment law. No one needs to do a great deal of empirical work to start down the road to dismantling the structure.

In making this claim I do rely on some gross empirical data, which is readily available from standard sources, and which makes sustained calls for more empirical research unwise and unnecessary—at least if its purpose is to guide reform efforts. The basic numbers of youth unemployment are very grim, and show that this situation is widespread with special pressure on

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members of minority groups. The available data does not paint a pretty picture.[1] Indeed, when one looks at the youth unemployment rate today (in this instance for sixteen- and seventeen-year-olds) we find that the numbers are virtually indistinguishable from the period between 1950 and 1955, when there were no protective laws on the books and systematic forms of segregation existed.[2] Starting in 1955 or so, the unemployment picture for both black and white males got worse, and the gap between black and white employment rates rose dramatically, even as the minimum wage compressed wages. What is striking about this early data is that the changes during this period of time, including an increase in minimum wage laws, had a differential effect between the groups, with a worse effect on black males. The simplest explanation is that earlier unemployment rates may have been roughly equal because the wage rates may have been lower for black workers, reflecting their weaker job qualifications at the time. This is a classic case in which institutional changes left both groups worse off.

The question then is what drives these changes, and here the theory tells a picture that is all too clear: regulation. The simplest graph of the effect of the minimum wage law shows that if the wage is constrained, supply will exceed demand at that level. This change means that the number of employment contracts formed will be fewer than would be the case if the restraint were removed, which would cause wages to fall and employment levels to rise. Labor markets are devilishly complex, but one thing that is sure today is that there are many forms of labor restrictions today not in place in the 1950s that help account for increased unemployment rates.

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1. *See, e.g.*, BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, USDL-14-1498, EMPLOYMENT AND UNEMPLOYMENT AMONG YOUTH SUMMARY (Aug. 13, 2014), *available at* http://www.bls.gov/news.release/youth.nr0.htm [http://perma.cc/9U4P-W5JY].

The number of unemployed youth was 3.4 million in July 2014, down from 3.8 million a year earlier. The youth unemployment rate was 14.3 percent in July 2014, 2.0 percentage points less than a year before. Among the major demographic groups, July unemployment rates were lower than the prior year for young men (15.1 percent), young women (13.4 percent), whites (12.2 percent), and blacks (24.8 percent), while youth jobless rates changed little for Asians (10.9 percent), and Hispanics (16.5 percent).

2. For the data, see WALTER E. WILLIAMS, LEGISLATING BLACK UNEMPLOYMENT, NCPA POLICY REPORT NO. 112 (1984), http://www.ncpa.org/pdfs/st112.pdf [http://perma.cc/3XAE-REHK].

Most critically, it is important to be conscious of where the gaps in our empirical knowledge lie—it is with the uncertainty as to the relative harm that is done by different measures, acting alone or in tandem. For example, it is very difficult to understand the adverse impact of a minimum wage law. One complication is that the impact depends on the gap between the market wage and the minimum wage. If the former is above the latter, the effects will be small, because wages can reach equilibrium. But there may still be workers in a robust market who are only employable at wages below the minimum wage, even if they constitute a small fraction of the total. With some increments in minimum wages, other adaptations of the employment contract could offset the burden of the regulation: those workers could be required to work on split shifts, pay for their own meals, and the like in order to dull the effect of the high minimum wages. At this point the adverse effect of the minimum wage law will reflect itself in the reduction of joint employer-employee surplus, not in the unemployment rate. But social losses also matter, even if they are much harder to measure empirically. That said, none of these complications have to be resolved before making the simple but sensible recommendation that the removal of all these restraints, which often operate in tandem, should help move us toward fuller employment.

There is another way to put the point. A great deal of evidence suggests that in general, competitive markets outperform monopoly markets. Therefore, markets that have barriers to entry are those with monopoly-like characteristics, which impede efficiency. The simple theoretical point here is that competitive markets essentially exhaust all the gains from trade. Where there are many people on one side of the market buying or selling widgets, people will search for the ideal trading partner. The fewer the impediments to entry and exit, the more likely it is that people will start to reach ideal kinds of results. You will never get to perfection because transaction costs are always positive, but they can be reduced, and I like to think that the Coase Theorem stands for the proposition that the best way to improve social welfare is to minimize transaction costs.[3]

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3. Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

It is also important in this context to be careful in choosing the definition of a competitive market. Apart perhaps from a few commodity markets, there are no perfectly competitive markets anywhere. Labor markets are no exception to that rule. Workers are not perfect fungible in the way that shares of stock are fungible. Nor are they mobile in the way capital is mobile. As Professor Verkerke stressed in his remarks, ordinary people have other identities that interact with their status as employees. People have spousal issues, family attachments, personal disabilities, and all sorts of unique characteristics that impact their individual choices. But no matter how significant these personal features, they do not undermine the simpler point that for any given worker there are many job opportunities, just as for any given employer they are many different job applicants. The slippages that one observes in labor markets are of theoretical interest but of relatively little practical importance. Competitive labor markets are never, for example, the subject of an antitrust inquiry on the ground that some firm has dominant control in a particular market. The automobile and the commuter bus and train put an end to that. It is therefore important to remember that there is nothing in a minimum wage law, or indeed, in any other form of regulation that makes matters *more* competitive. The restraints on entry make them less competitive. There is no pressing social need to spend large government resources to make employment more difficult.

The same argument applies with respect to other distortions that are already in labor markets, including various programs such as the earned income tax credit, social security, Medicaid, or food stamps. This brief article is not the place to examine these forms of government intervention for their own merits. But it makes no sense in my view to take the position that we should add another set of regulations whose likely effect is only to make matters more difficult than they already are. Second-best arguments that take the form "we now have to do A because we have just done B" should receive short shrift in policy discussions. If A is a mistake, the first-best alternative is to remove it. The effort to create clever offsets is usually counterproductive. The original distortion remains and new ones are added, which then become the engine for still further programs.

The common argument, for example, that it is good to expand welfare programs to offset the loss of jobs attributable to

minimum wages is a species of that dangerous reasoning. The two populations are not easy to identify, and there is every reason to think that each of these programs has its own tax and regulatory difficulties. If these programs are to be justified it should be on a stand-alone basis, not as part of a complex package. All too often economists resort to the theory of second-best to make the technically true claim that so long as there is one distortion in the market, it is impossible to say whether adding a second will make things better or worse. There is of course no theoretical way to refute this point. But the difficulty with it is that it is a showstopper in every case. Does anyone believe that it is fine for New York City to have rent stabilization because there are tariffs on imported beef or steel? The far better approach is to identify the market failure or externality that needs correction and address it directly. If there is a shortage of information about job listings, introduce—or better yet have a private party introduce—a listing service that will reduce the cost of search. There is no need for any regulation on these grounds.

As should be evident from this discussion, evidence about market structure and market imperfections that may prove relevant to a general inquiry on regulation writ-large is hard to deal with. But it is important to note that the lessons that come from outside the labor law area will not prove supportive of labor regulation unless rent and price control are regarded as a models that justify the minimum wage. No matter where we look, it is a good working assumption that any form of government action that pulls us further from a competitive equilibrium should be resisted. From this it does not follow that all forms of regulation should be rejected. In some markets, simple writing requirements could lead to a greater efficiency in markets, be it for labor or real estate, by reducing the costs of dispute resolution. It would, for example, be a gross error to confuse a statute of frauds, whose writing requirement has this objective, with a minimum wage law that does not. It is one thing to reduce the cost of ex post enforcement by taking ex ante precautions. It is quite another to reduce the opportunities for gains through trade by imposing many restrictions on labor markets.

Now it is of course the case that there are some markets, outside the labor area, in which it is not possible to reach a com-

petitive equilibrium. That is generally true in network industries, where each party has to interconnect with its actual and potential competitors. But it does not take much empirical evidence to distinguish an employment market from a telecommunications or transportation market, where these difficulties can arise. In labor markets, there is no reason to be worried about monopoly practices in the absence of government regulation. Even a firm in a network industry has to hire workers in competition with other employers, meaning that it may have some monopoly power in product or service markets, but none in labor markets. So this is an area where the general theory of economics cautions against public intervention on the terms and conditions of employment contracts. The purpose of regulations that are imposed should not be to frustrate contracts, but to reduce the impediments to their formation. Every time the law decides to "protect" certain people, its effort backfires. Thus the minimum wage law that protects people from low wages, protects them from getting any job at all.

The same logic applies to those protections that kick in formally only after workers have taken a job. A common form of that protection is protection from unjust dismissal. The law may well render tenure somewhat more secure than otherwise, but by the same token, it reduces the probability that one will get the job in the first place. Employers are repetitive players in markets. Even if they do not grasp the point instantly, one bad experience provides inoculation against others. The lesson that is quickly learned is that the inability to fire at will increases the cost of hiring workers who are high risk. The ex post protection turns out to be an ex ante disadvantage, which is why for so many years, very much against the grain, I have been in favor of the contract at will, which preserves needed flexibility for the benefit of employer and employee alike.[4]

I think this conclusion ties in neatly with my basic theory. If we look around at labor markets, the most common type of arrangement is of course the contract at will, that allows an employer to fire, and a worker to quit, for good reason, bad reason, or no reason at all. One simple feature about this contract is that

4. *See* Richard A. Epstein, *In Defense of the Contract At Will*, 51 U. CHI. L. REV. 747 (1984).

the threat to quit or fire is always there. Getting a new employee is difficult, as is finding a job, so that both parties have an incentive to preserve the relationship. Often that simple dynamic means that contracts that can be terminated at the blink of an eye can often last for years. Indeed, the incentives to behave well are larger because of the heavy reputational costs that can arise from arbitrary and capricious behavior. These apply on both sides of the deal, but they are likely to be stronger constraints on the employer, especially of a large firm, that is constantly in the labor market. For a firm to get a reputation as a bad place to work is very costly to overcome. And so it is that informal constraints without legal remedies can do an effective job in disciplining behavior—in labor contracts as everywhere else.

To be sure, there is no reason to force all contracts to take this form, but the frequency of the arrangement suggests that it should be the default arrangement. Many of the deviations from this form will preserve the at-will feature for termination, but will often require that the employer pay some fixed severance paid, often tied to some combination of years of service and final salary. The point of these deals is that they allow for clean termination because there is no need to calculate consequential damages or demand that the employee take difficult steps to mitigate damages. It is of course possible to add "for cause" provisions for termination into any employment, but their relative infrequency suggests that parties to voluntary transactions do not want to litigate the break-up, given that the costs are necessarily shared between them.

Now, once state regulation is introduced into labor relations, there are three parties to every employment contract, one of which has all sorts of powers that are never granted to any ordinary private business. Oftentimes it is said, especially with labor contracts, that we should not fear the government. After all most employers and employees are strongly against all forms of race and sex discrimination for the simple reason that it is bad for business whether or not we have an employment discrimination law. In these cases, the argument is made that the law serves the benevolent function of tracking and enforcing social norms. For these purposes, it does not matter which of these social norms I accept or reject, but the following caveat holds in all cases. No matter how desirable the social norm, no matter how strong the consensus behind its application, the last

thing that the laws should do is harden the social norm into a legal command which goes against the grain of the contractual choices of the private parties. The problem is with second order effects. Legal norms are not self-enforcing, nor are they evident. There could easily be factual disputes that the third party cannot understand. It is easy to miss some social norms from the outside. It is possible that norms will evolve more rapidly than the law itself. Hence the threat of legal enforcement will change primary practices even before the law is asserted, for at the very least documentation of behaviors and practices reduces the level of informality at which businesses can run, and the extra costs are divided in uncertain proportions between the party. There are also additional taxpayer-funded public expenditures that are themselves a wedge in contracting behavior. There are reasons why parties set out some terms explicitly and leave others to the be worked out informally. That option is effectively eliminated when government oversight comes in.

All these matters apply to the youth unemployment market like any other, only more so. Here workers are inexperienced. They may be of widely varying quality. It is risky to hire them. It is in the interest of workers with weak credentials that they be able to start at low wages so that they can dispel doubts on the job, which could then lead to promotions as they acquire additional skills and reputational capital. Freezing workers out at the ground level means that they cannot gain access to all the nonpecuniary benefits of the job. The point here applies not only to workers with little education. It applies also to those with more education who are willing to work at unpaid internships.[5] They should be encouraged to do so, because the contacts and skills they acquire can easily lead to paying jobs with the firms that run the internships, or to getting skills that can be used elsewhere. The benefits of laws banning unpaid internships in practice do not go to the workers they are claimed to protect, but, as intended, to their union competitors, who can usually acquire higher wages, and in any event do not take unpaid internship

5. For some of the complexities, *see* Sharon A. Snyder, *Unpaid Workers—Interns Under the Fair Labor Standard Act*, MARYLAND STATE BAR ASSOCIATION SECTION OF LABOR AND EMPLOYMENT LAW NEWSLETTER, Spring 2013, *available at* http://www.ober.com/publications/2228-unpaid-workers—-interns-under-fair-labor-standards-act [http://perma.cc/CD4L-2FG4].

jobs. So there is yet another empirical truth: rules that are sold as protecting the regulated parties are often supported by their direct competitors who are not similarly burdened by the laws.

Well, how does one reform the law? The modern answer is to propose half-measures, which depend on ad hoc exceptions to the rule, such as allowing flex time or a limited youth exemption under the FLSA. But these measures add complexity without getting to the root of the problem. And they will surely do little to stem the constant flow of well-crafted lawsuits under the Fair Labor Standards Act, which should be rejected as a failed social experiment that only chills a labor market that needs to expand, and which should be instantly repealed. Once repeal is done, employers and employees can decide whether they want flex time or overtime. Employers will be able to hire people on part-time or permanent basis, without having constantly to satisfy somebody inside the government whose external norms are not based on anything which you would remotely call empirical evidence. What these rules are based upon is at best a theoretically consistent a priori vision of what they regard to be the just society that they're prepared to impose on everybody else. They are certainly not based on empirical research of any form.

I think that the same analysis applies to employment discrimination laws, which again I have long opposed.[6] Is it really the case a priori that we are absolutely positive that anybody who decides to discriminate on any grounds—race, sex, and so forth—is in fact behaving in an inappropriate manner? I do not think that need be the case at all. It may well be that in certain kinds of jobs, women do better than men. It may be true that older people are better than younger people at certain jobs. It may well be that there are consumer preferences that actually matter especially in the provision of intimate personal services which give rise for discrimination based on sex, race, religion or national origin. Let voluntary sorting take place and it is not clear that men will always be preferred to women, or the reverse. The same is true with age, and even the hot-button topics of race and national origin. What is likely without a labor law is a more efficient matching of workers with jobs and workers with

6. RICHARD A. EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS (1992).

clients. Indeed, workplace dynamics matter, and one of the strongest arguments for the repeal of Title VII and similar laws, including the Age Discrimination in Employment Act, is that repeal will facilitate a variety of special recruitment, affirmative action, and diversity programs that a resourceful firm looking for a market edge can introduce on their own initiative—without having to run the gauntlet of getting approval from the Commissioners of the EEOC or any similar organization.

In speaking against employment discrimination laws, I freely confess that I do not know what the ideal configuration of workers is for any given firm. But that is precisely the reason why the laws are so dangerous. The EEOC does not know that either, but it tries to fix a problem that it does not understand. Viewed in this light, the advantage of freedom of contract is that people with better knowledge on the ground can outperform the EEOC, whose five commissioners have no extensive practical knowledge in most labor areas. It is yet another application of the basic principle that decentralized decision making will work better than government operation because the government suffers from two incurable disadvantages: It has neither the incentive nor the knowledge to make the right tradeoffs in complex situations.[7] It is by no means the case that all employers, or indeed any, will behave in a retrograde fashion without antidiscrimination laws. Why should anyone think that an antidiscrimination law is needed for gay and lesbian workers when most employers are way ahead of the game in introducing specially-tailored programs that would not be required by any antidiscrimination laws? Nor does it matter if some groups for religious or other reasons choose not to enter that market for gay or lesbian workers. What matters is the number of opportunities that any person has, not the number of places where he or she cannot work. Better an expanded labor market that offers countless jobs, some of which are open to subsets of the population, than a labor market with fewer opportunities available to all. People gravitate to the people who prize their skills, not to those who do not.

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7. With the inevitable citation, Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

On this point, I remember years ago a friend of mine who ran a large public corporation told me his views on hiring. Here was his blunt message: "Look, 35 percent of the workforce is white male, and I've got to hire God knows how many people every year. I can't just concentrate on that group. I have to make this place congenial to everybody, and if I don't have people in my workforce who can work with anybody who comes in, they're no good to me." Well, this set of understandings is a way in which you can enforce a non-discrimination principle in a robust and contextual manner in large corporations. It works because the CEO really wants it, and it spreads up and down the ranks. These attitudes last when internally generated. They are suspect when imposed from without by decrees from uninformed government agents whose power is inverse to their knowledge.

What is instructive in this regard is that the government's position has never held with respect to age discrimination. Here the practice before the passage of the ADEA was for most firms to have firm retirement rules for virtually all workers from top to bottom. The decision to end a relationship did not put workers out to sea, because the employment contract dovetailed with the pension programs (including Social Security) that were designed on their behalf. Nor did the employer act like a legislature that banned these workers from taking new jobs at other firms, which is the norm in England where it wreaks havoc with overall labor markets by shutting people out for no good reasons. In the United States, workers who retired from one business could work for another, or even start their own business.

When there is an employment practice as uniform as mandatory retirement, there are only two possible reactions. The first is that the market, that is, the countless employers in the market, all suffer from some collective delusion that leads them to systematically undervalue the contributions of older workers. But that is not remotely plausible. These are not combined judgments by a small group that speaks for all firms. These are independent judgments made by a large class of firms, and they have good reason to change that judgment if it is incorrect. Their local knowledge dominates any knowledge that any government commission could have of the subject. The second explanation is best. They actually know what they are doing.

What then is the explanation for the practice? Here the simplest point is that often times there is a natural cycle to workers. Keeping older workers on makes it more difficult for younger workers to advance in orderly fashion to higher positions. In addition, it is often wise to replace people before they start to deteriorate rather than waiting until the time that performance levels start to dip, at which point there could be extensive loss in productivity and morale, until some cumbrous procedure is put in place to resolve the dispute on some individuated grounds. It is easy to state that workers can only be fired for cause, but that principle is devilishly hard to apply especially when the loss of efficiency could take place at an increasing rate. The advantage of a fixed retirement rule for all—which most companies have for their senior workers under an exemption from the ADEA[8]—is that it does not cast needless aspersions on the workers let go and does not involve the firm in ugly internal fights as to who should stay and who should go. So long as labor markets are left unregulated, there should be a voluntary sorting after a mandated retirement in which good workers get picked up by other firms that can make that kind of individuated judgment about a given worker without having to make invidious comparisons with his or her coworkers. How strong these arguments are is likely to vary from case to case. But what matters for the legal judgment is that these variations are not amenable to an ADEA-type regulatory scheme. Do nothing via government and the problem will take care of itself at the firm level.

In dealing with this issue, Professor Verkerke cites a study indicating that it is wrong to assume that higher retention rates for older workers necessarily results in a loss of entry level positions.[9] I suspect that is true for the simple reason that there is relatively little overlap in the skill sets of two classes of workers so that it is unlikely that one should be regarded as a close substitute for the other. In general it is unwise to draw any inference about the desirability of the ADEA from this one nega-

8. *See* Jonathan Gruber, Kevin Milligan & David A. Wise, *Introduction and Summary* to SOCIAL SECURITY PROGRAMS AND RETIREMENT AROUND THE WORLD: THE RELATIONSHIP TO YOUTH EMPLOYMENT (Jonathan Gruber & David A. Wise eds., 2010).

9. *See* J.H. Verkerke, *Employment Regulation and Youth Employment: A Critical Perspective*, 38 HARV. J.L. & PUB. POL'Y 801, 805–06 (2015).

tive finding. The first reason is that this finding is not likely to apply in all submarkets with equal force. Thus in the academic market, in my view the ADEA has had very bad effects because it does influence the rate of substitution between senior faculty and junior faculty. Here the skill sets are relatively similar and hence the rates of substitution are far higher. When I worked on this issue extensively at the University of Chicago around 1990,[10] it was widely assumed that the salary of an entry-level employee at age thirty to thirty-five was about half of that of a senior employee at age seventy or so. Yet on average, with notable exceptions, the productivity of the older professor was on the decline. The ability to take on graduate students for multiple-year commitments was impaired. Work in new fields was diminished. Influence over new hires could be inordinate. The ability to guide the long-term policy of the department or university was compromised. In private I could not find a single administrator who was in favor of lifting the cap on mandatory retirement. In fact, quite the opposite, they all rushed to introduce buyout programs for senior faculty that could pave the way for the more rapid deployment of younger faculty, which is something that a university would not do if it desperately wanted to hang on to senior faculty as a group. But by the same token I could not find one who was prepared to speak out against that proposal, given the heat that would be generated in the other direction.

The situation is different in other industries. In many cases, employees opt strongly for early retirement, so there is no fear of a displacement effect. In other cases, the law does not apply, as to partners and senior executives. The clear point here is that the motivations that influence job retention decisions for senior workers, and the overall legal environment in which these decisions are made, is vastly different at the end of the employment cycle than it is at the beginning. It is therefore a mistake to assume that if the ADEA did not have much effect on labor rate participation at the top, other forms of employment regulation would also have very little effect at the bottom. That is just not so. Entry level workers have a different set of issues in establish-

10. For some then-contemporary reflections, see Richard A. Epstein & Saunders Mac Lane, *Keep Mandatory Retirement for Tenured Faculty*, REGULATION, Spring 1991, at 85.

ing work habits, proving their reliability, and getting a first job. Those are not the difficulties at the top. So again, these statutes are complex and in general the ADEA is, unfortunately, easy to enforce, which is why in the areas where it cuts against the standard contractual solutions it is very costly to adopt given its dislocations from voluntary norms.

So the lesson should be clear. Empirical studies only matter if they seek to verify some theoretical proposition that relates to the efficiency of various labor markets. The substitution effects are theoretically of little importance in dealing with an assessment of the ADEA and similar statutes. What matters here is the first principle. The heavy burden falls on those who wish to regulate labor markets. With minimum wage and employment discrimination laws that burden has not been met. What we do have unfortunately is an ugly cycle. First, the government puts one set of restrictions in place, and it discovers that unemployment rates get higher or income levels get lower, or labor participation goes down. But once the bad news is absorbed, the regulators never agree to repeal what's already there. They just add another layer on top of that existing layer. As Gail Heriot said, and said correctly, in her remarks: individually these things are bad; together, they have negative synergies.[11] The best response today to labor market regulation comes straight from Moses: "Let my people go."

11. *See* Gail Heriot, *Working Backwards: How Employment Regulation Hurts the Unemployed*, 38 HARV. J.L. & PUB. POL'Y 781 (2015).