A SUBJECTIVIST ECONOMIC ANALYSIS OF GOVERNMENT-MANDATED EMPLOYEE BENEFITS

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I. INTRODUCTION

In recent years governments, including that of the United States, have shown a growing tendency to provide benefits to workers through laws that require employers to provide these benefits to their employees rather than through direct provision by government. Indeed, efforts at deregulating markets have completely bypassed labor markets.

The economic rationale for most types of government intervention into product markets involves issues of market failure, typically public goods or externality arguments.[1] But such arguments are rarely put forth in the advocacy of mandated benefits.[2] The arguments for mandated benefits seem to proceed on the assumption that "employers, left to their own devices, will oppress workers . . . ."[3] The ability of employers to oppress is presumably made possible by the relative ignorance of employees (for example, with regard to risks or alternative employment opportunities) or the absence of a mechanism for workers to demonstrate their preferences, particularly with nonunion employees. It is this imperfect information, rather than externality or public goods considerations, that creates the perception of a market failure in need of government intervention. A related argument is that prohibitive transaction costs prevent the attainment of mutually beneficial arrangements, resulting

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1. Public goods and externalities involve third parties affected by an activity of two other contracting parties, or by one party engaged in a non-cooperative activity. *See* Coase, *The Problem of Social Cost*, 3 J.L. ECON. 1 (1960). The mandating of benefits involves a government edict altering the terms agreed to by the two consenting parties to the employment contract.

2. One exception to this generalization is found in Summers, *Some Simple Economics of Mandated Benefits*, 79 AM. ECON. REV. 183 (1989).

3. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, in LABOR LAW AND THE EMPLOYMENT MARKET 117 (R. Epstein & J. Paul ed. 1985).

in incomplete markets. It also seems that the political motivation for mandating benefits is the voting public's perception that such mandates redistribute income from employers to employees.

The purpose of this Article is to explore the imperfect information and incomplete markets rationales for government-mandated benefits. Specifically, it will address the question of whether, and to what extent, the private market for labor fails to generate a Pareto-efficient package of wages and fringe benefits. Additionally, it will address the question of whether mandated benefits succeed in redistributing income from employers to employees. The analysis is based on subjective value theory as it applies to labor markets and proceeds from the general argument to specific cases. It is focused narrowly on intervention into the relationship between the employer and individual employee. Hence legislation affecting collective bargaining is beyond the scope of this Article. The concept of "benefits," however, is not limited to fringe benefits but also includes basic pay and non-monetary working conditions. The authors' contention is that the general rationale for mandating benefits is fundamentally flawed in its failure to recognize the subjective nature of value and its implications for the functioning of unregulated labor markets.

Section II of the Article describes the subjective nature of employees' evaluations of job characteristics and the function of the labor market as the mechanism that balances the desires of employees with those of the employer. Section III presents the subjectivist's approach to the evaluation of institutional policies. Section IV demonstrates graphically the detrimental effect of institutional constraints that are binding on the employment relationship. Section V considers labor market policies already in place in the United States or presently under consideration. Specific policies include minimum wage legislation, unemployment insurance and workers' compensation, the regulation of occupational safety and health, pension regulation, mandatory health insurance, and other mandated employee benefits. A summary and conclusions are presented in Section VI.

II. Subjective Value in the Market for Labor

A. *Subjective Value Theory*

Subjective value theory is one of the key features of the "Austrian School" of economics, whose founders developed in the late Nineteenth Century the marginal analysis that is the central analytical tool of economics today.[4] The key distinction between the Austrian and mainstream, neoclassical approaches is to a large degree a matter of emphasis; the Austrian focus of scientific analysis is on the individual decisionmaker, rather than an aggregated group of actors. The fundamental proposition of subjective value theory is that value resides in the subject of analysis (the human actor) and not in the objects (economic goods) to which that value is applied. The value of some particular object is not separable from the intended purposes of the subject of the analysis, and these purposes vary across individuals and over time. If economic analysis is to be scientific and value-free, then the analyst may not substitute his own judgment or values for those of his analytical subjects with regard to what is desireable or with regard to defining the want-satisfying qualities of objective phenomena. Recognition of the subjective nature of value places limits on the power of economic analysis that are often unrecognized by other economists. First, if the values and motives of individuals are entirely subjective, it is impossible for the economic analyst to pass judgment on what an individual's optimal set of actions is (or should be) in the face of a given set of objective conditions. A second limitation follows from the first: It is impossible to aggregate individuals to evaluate the efficiency of social choice sets on the basis of a single social welfare function. Without such a function, it is impossible to determine in the aggregate the social utility of trading off one objective against another. In practical terms, it is impossible to judge the desirability of trading off the gains of some individuals against the losses of others.

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4. *See* Yeager, *Why Subjectivism?*, 1 R. Austrian Econ. 5 (1987). For an Austrian approach to the economic analysis of law, see Rizzo, *Uncertainty, Subjectivity, and the Economic Analysis of Law*, in Time, Uncertainty, and Disequilibrium 71 (M. Rizzo ed. 1979).

B. *The Functioning of the Market for Labor*

In most important respects, the laws of demand and supply and the concept of equilibration apply as well to the labor market as to commodity markets. Labor markets, however, are far more complex than commodity markets, in large measure because workers cannot be separated from the work effort they supply. Consequently, all aspects of the environment in which labor is employed have an effect on the price of labor. In accepting employment, an employee in effect accepts a "package" that combines the monetary wage, an assortment of fringe benefits, and a collection of job characteristics that are associated with the job. These characteristics include not only expected intensity of effort to be supplied but also such things as income variability, physical risk exposure, and opportunity for advancement (including the provision of on-the-job training). In short, the package includes everything associated with the job that affects the worker's utility.

Each of these characteristics should be perceived as having a market that has a demand and supply aspect. On the supply side, an employer chooses the quantity of each characteristic to combine with the wage rate. To the extent that legal institutions permit, the quantity of any of these job characteristics can be varied by the employer. Desirable characteristics (for example, paid vacations) can be increased, or undesirable characteristics (for example, noise) can be reduced, but only at a cost. Assuming that the law of diminishing returns applies, each incremental reduction in an undesirable characteristic (for example, a one-percent reduction in the probability of an injury) will be more costly than the previous incremental reduction. Cost conditions vary greatly across occupations, industries, and firms. Hence the quantity supplied of any characteristic will vary considerably across different employers.

In offering a package of wage and non-wage characteristics, the employer is operating on a large number of margins. An employer is willing to incur the costs of expanding at one margin if there are offsetting savings realized by contracting at another margin. These tradeoffs can be offered to labor. A substantial literature exists that tends to verify the existence of tradeoffs between wages and non-wage characteristics of jobs. The concept of "compensating differentials" traces back to

Adam Smith,[5] but only in recent years has empirical work been attempted. That work suggests that workers do indeed face a tradeoff between wages and such job characteristics as earnings variability,[6] repetitive or obnoxious working conditions,[7] and the probability of incurring an accident,[8] among others. Moreover, Professors Bellante and Link have shown a significant correlation between an individual's tendency to avoid risk in his personal affairs and the degree of financial risk implicit in that individual's choice of occupation and industry.[9]

The demand for job characteristics is generated by the subjective valuations of workers. Individual workers will of course not value all job characteristics, or for that matter money income, equally. Presumably, diminishing marginal utility applies to all aspects of the job. In an ideal (but imaginary and unattainable) world, workers would face a price (in the form of a wage-rate adjustment) for each job characteristic. Then, each worker could choose the combination of wage rate and job characteristics in such a manner that no change in any of the characteristics could possibly increase the worker's total personal utility. Of course, no single work environment can accommodate many different workers' tastes, and the real world cannot possibly provide enough variability across work environments to provide each worker a job with exactly his utility maximizing package of wage and job characteristics. An approximation of the ideal, utility-maximizing package is obtained for each worker, however, when he chooses among the variety of packages supplied by employers.

The employer, in his role as labor market entrepreneur, co-

5. *See* A. SMITH, THE WEALTH OF NATIONS 111-19 (E. Cannan ed. 1976).

6. *See, e.g.*, Feinberg, *Earnings-Risk as a Compensating Differential*, 48 S. ECON. J. 156 (1981); King, *Occupational Choice, Risk Aversion, and Wealth*, 27 INDUS. LAB. REL. REV. 586 (1974).

7. *See* Lucas, *Hedonic Wage Equations and Psychic Wages in the Returns to Schooling*, 67 AM. ECON. REV. 549 (1977).

8. *See* Thaler & Rosen, *The Value of Saving a Life: Evidence from the Labor Market*, in HOUSEHOLD PRODUCTION AND CONSUMPTION 265 (N. Terlecky ed. 1975).

9. *See* Bellante & Link, *Worker Response to a Menu of Implicit Contracts*, 35 INDUS. LAB. REL. REV. 590 (1982). The measure of taste for risk avoidance used by Professors Bellante and Link is an index constructed by the University of Michigan for its survey of households. The index involves responses to questions about the use of seat belts, smoking and drinking habits, extent of medical and auto insurance coverage, and so forth. The index is described in 2 J. MORGAN, A PANEL STUDY OF INCOME DYNAMICS: TAPES, CODES, AND INDEXES 123 (1972). The same index of risk avoidance has been found to influence choice of public versus private sector employment. *See* Bellante & Link, *Are Public Sector Workers More Risk Averse Then Private Sector Workers*, 34 INDUS. LAB. REL. REV. 408 (1981).

ordinates the different subjective values of workers with his desire to secure labor services. His reward for this service is the saving in labor costs that can be realized by altering the characteristics of the job package he offers to attract labor. The entrepreneur's success depends on his ability to perceive and to act upon each discrepancy that exists between the effects of an incremental change in the firm's non-wage costs of production and the effects on the wage rate that must be paid by the firm to attract a given quantity and quality of work force.

Because workers vary significantly with regard to their tastes, propensities, and circumstances, the package of pay and other characteristics that the firm offers will tend to attract those employees for whom the total package is most attractive. In the context of heterogeneous worker tastes and employer cost curves, a process of sorting and matching takes place. Each worker maximizes utility by gravitating toward the occupation, and in turn the firm, that is most attractive to the worker; each employer minimizes labor costs by offering that package of job characteristics that will attract the desired mix of workers at the least cost. When cost or demand conditions change, or when the institutional setting changes, adjustments will occur. These adjustments may take time, but the long-run consequence is to squeeze the most worker utility out of each dollar of labor cost that the institutional setting will permit.

Of course, a worker can only maximize utility to the extent of the variability obtainable in the set of job choices available to him. A simple axiom of welfare economics extends quite readily to this situation: The greater the range of opportunities in the set of packages available to each worker, the greater will be the utility or welfare of workers. In other words, the greater the variability of job characteristic combinations inherent in the variety of jobs available to the worker, the closer the worker can come to the ideal of global utility maximization.

III. Subjectivist Policy Evaluation

Recognition of the subjective nature of value does not, as it might seem, preclude the scientific evaluation of social institutions or of public policy aimed at establishing or altering those institutions. What is required for such evaluation is merely that the heterogeneous nature of individual values and goals be recognized. Subjective value theory, when combined with several

other key propositions of Austrian Economics, makes possible some rather concrete analyses of social institutions in general, and labor market legislation in particular. One such proposition is that human behavior is purposeful. Thus if we observe a voluntary action on the part of an individual, we can assume that such behavior maximizes the utility of the individual, even though the same action might be inconsistent with the utility maximization of another subject under the same objective circumstances. A second proposition is that when two or more individuals engage in voluntary cooperation or exchange, each does so with the prospect of achieving a gain from the exchange. Such mutual gains from trade are the basis for all cooperative economic activity, even though the goals and purposes of the parties to the cooperative activity are dissimilar. The act of exchange brings the desires of the cooperating parties into a pattern of mutual compatibility. In a large and complex society, the benefit of the market form of organizing individuals' activities is the coordination of millions of independent activities that are based on values and goals peculiar to the individual actors. Hence, *one criterion for judging the efficiency of any social institution concerns whether the particular institution facilitates or retards the process of economic coordination.*

A third relevant proposition is that the real world is characterized by incurably imperfect information, not only about present conditions, but about the future consequences of present actions. One result is that although equilibrating forces are always present in markets, those markets will never be in perfect equilibrium. Indeed it is the disequilibrium that prevails in markets that creates the discrepancies (between input and output values, among output prices in various locations, among input prices for various uses, and so forth) that give rise to opportunities for gains from trade. Human action to obtain such economic gain works to eliminate the discrepancies. Competition is the process that brings forth the discovery of potential gains from trade, and the entrepreneur is the prime catalyst in this discovery process.[10] The entrepreneur's alertness to previously unexploited opportunities is the essence of the process of value production. In a market economy, the entrepreneur pro-

10. *See* I. KIRZNER, COMPETITION AND ENTREPRENEURSHIP (1973). Although it might be said that the description of this process is the whole of Kirzner's work, this point is particularly emphasized in *id.* at 69-75.

vides the coordination of individual plans. Given imperfect information in a continually changing world, individual plans can never be fully coordinated, but the role of the competitive process is to move markets in the direction of perfect coordination. Thus, *a second criterion for evaluation of social institutions is whether such institutions further or hinder the process of discovery.*

The two criteria suggested here, combined with a subjectivist perspective on the functioning of the labor market, provide an effective device for analyzing the particular institutions of mandated employee benefits. Because coordination of the various worker interests and employer costs is facilitated by a variety of employment packages, a key question is, "To what extent is the existing degree of variability that typifies contemporary labor markets enhanced or limited by social and legal institutions?" Furthermore, because discovering utility maximizing and cost minimizing combinations requires information, and utilizing the discoveries requires flexibility, a second key question is, "Do mandated employee benefits interrupt utility enhancing moves by workers and employers from one package to another?"

The more traditional, neo-classical approach to evaluating mandated employee benefits is to measure and compare their costs and benefits. This approach would attempt to derive an objective measure of the implicit prices employers demand for marginal adjustments of job characteristics and the benefits these adjustments provide. Given the complexity of the labor market and the associated measurement problem, however, economists can be more confident in the existence of implicit prices than in their ability to detect and measure them. Aside from the relatively minor problems of detecting and measuring such implicit prices, subjectivists envision a more fundamental limitation to the use of whatever quantitative information can be obtained from labor market studies. It is not the objective, implicit market prices to which workers and firms respond; rather, they respond to the discrepancies between objective market values and the subjective values of workers. If participants in the labor market were in perpetual equilibrium, no distinction between objective and subjective values would exist. But perpetual disequilibrium is more characteristic of the real world, and so discrepancies of some sort always exist and bring forth human action. Occasionally, objective values serve rela-

tively well as proxies for the objective-subjective value discrepancy. Other times they serve less well, but they are always empirical proxies. The unreliability of using only objective values is one reason for the widely varying parameter estimates that typify quantitative labor market studies. Consequently, scientific observers are never able to make valid judgments about the optimality of any package. The observer can at best observe whatever tradeoffs (implicit prices) the labor market provides and the behavior of workers in response to these implicit prices. The same is true for the entrepreneur. Nonetheless, his success in capturing labor market gains from trade depends on his actions over the range of margins of adjustment available to him.

The above observations carry some important implications. The potential for individual and thus social welfare optimization is greatest when the range of options open to workers and the flexibility of employers to adjust is greatest. Changes in institutional constraints can be adjusted along any number of margins. If the range and diversity of options available to workers is reduced, so then are their individual prospects for welfare maximization. In short, the labor market will provide greater welfare if employers do *not* all provide the same health care benefits, the same provisions for parental leave, the same risk of an accident, and so forth. Moreover, because employers are motivated to provide a market setting that, subject to institutional constraints, maximizes workers' utility per dollar of labor cost, the cost of any mandated benefit will ultimately be shifted to employees. When the shifting is complete, social welfare is reduced to the extent that the mandate alters the employment setting.

IV. A Graphical Presentation

The subjectivist notion that individual actions are purposeful means that workers choose occupations and firms with a goal in mind. The accepted goal is that of utility maximization. The opportunity cost of any occupation and firm sets a minimum level of utility that must be realized from the employment package that the firm offers if the worker is to accept employment. This level of utility can be generated by different combinations of the benefits in the employment package. In Figure 1, the various combinations of expenditures on two benefits, X and Y,

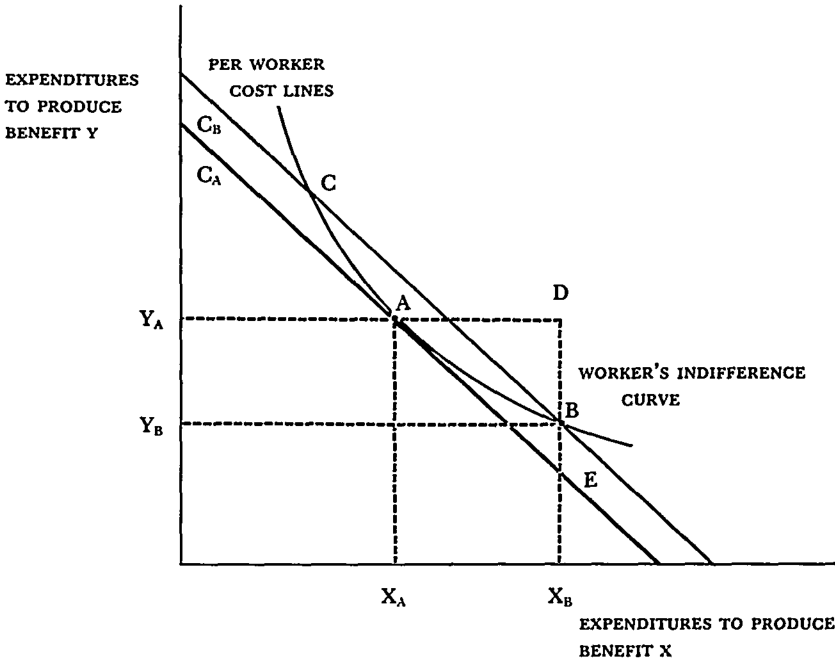

Figure I: Worker Tradeoffs and Employer Adjustments in the Presence of Government-Mandated Benefits

that generate the same utility for one worker, the object of our analysis, are shown by the points on his indifference curve. Thus each of the combinations at points A, B, and C would suffice to secure the employment of this individual.

If there are sufficient individuals like this one, that is, with similar preferences for X and Y, the employer can secure a work force by offering benefits in any combination along this indifference curve. The forty-five degree lines, C_A and C_B, show combinations of expenditures on X and Y that require equal per-worker costs. It is for the employer to discover that combination A (X_A, Y_A) minimizes the cost of securing a work force. If the present standard is represented by point B (perhaps because *most* individuals prefer this combination), the entrepreneur's recognition that enough workers to satisfy his needs consider A as good as B will be rewarded by a lower labor bill.

Now, suppose that government mandates that the minimum level of benefit X is X_B (after all, it is observed that elsewhere in the industry this is the standard). Given time to adjust, the new labor market solution is not at point D, where the greater level of benefit X is provided without the employer adjusting along

other margins. The entrepreneurial employer realizes that he can keep his work force and meet the legal minimum expenditure on benefit X at point B, where his employees are receiving the same level of utility as before the mandate. At the very least he adjusts his provision of benefit Y to Y_B.

But this is not the end of his adjustment. At B the employer's per-worker costs have risen, and he will demand less labor. Alternatively, he will hire the same number of workers and meet the mandated provision of benefit X only if his employees will accept package E, where the per-worker cost is the same as that of package A. The employer will lower his provision of benefit Y below Y_B and reduce his work force as workers leave for other alternatives. The ultimate solution is somewhere between points B and E, where both the workers, who receive less utility from the employment package, and the employer, who has higher per-worker costs, are worse off.

Only if the original solution were at a point like C would mandated increases in benefit X improve the lot of this worker. This would happen only if the employer failed to perform the entrepreneurial function for which he is rewarded, *and* the government could, somehow, better perceive the subjective values of workers from outside the market than could the employer from inside the market where these values are revealed. To the extent that the entrepreneurial function of employers and the sorting and matching that takes place over time serves to produce efficient results like point A, government mandates cannot increase the welfare of workers. As the preferences of heterogeneous workers are likely to be arrayed all along the per-worker cost line C_A, mandating any minimum level of benefit X will cause a diminution of worker and employer utility.

V. Applications

The usefulness of subjective value theory, as a background for a policy analysis of the labor market, is best demonstrated by specific examples. The examples that follow are applications of subjectivism to cases of government-mandated benefits that either are in force or enjoy some significant measure of popular support as current proposals.

A. *Federal Minimum Wage Legislation*

The economic impact of minimum wage legislation is one of the most thoroughly researched topics in economics. Although there are substantial differences in quantitative estimates of magnitude, virtually all economists agree on the following qualitative effects: The higher the real minimum wage, the greater will be the amount of unemployment; at the levels of the relative minima that have been experienced in the United States, only a small portion of the work force has usually been affected, negatively or positively;[11] and such employment losses as have occurred have been highly concentrated among young, unskilled workers, and among these, black teenagers are the most severely displaced.[12] The empirical issues are made complicated and formidable by the need to rely on objective measurement in addressing them. The predictions of employment loss are based on marginal productivity theory,[13] which predicts a downward sloping demand curve for labor. The marginal productivity literature has not explored subjectivist insights that shed further light on the consequences of minimum wage legislation.

The conventional conclusion is that the benefits to workers whose wages are raised by an increase in the minimum wage comes solely at the expense of those workers who lose their jobs. If this conclusion is correct, it presents sufficient cause to deny the Pareto-optimality of increases in the minimum wage. Well-intentioned popular support for the minimum wage must be based on either disbelief that significant disemployment effects result from it, or that the benefits to job retainers in some non-Paretian sense justify the costs to job losers.[14]

The considerations raised in Section II above, however, sug-

11. Coverage of the Fair Labor Standards Act, 29 U.S.C. §§ 201-206 (1982 & Supp. V 1987), has become so nearly universal as to virtually render state minimum wage laws inoperative or moot.

12. *See* Meyer & Wise, *The Effects of the Minimum Wage on the Employment and Earnings of Youth*, 1 J. OF LAB. & ECON. 66 (1983).

13. *See* Brown, Gilroy, & Kohen, *The Effect of the Minimum Wage on Employment and Unemployment*, 20 J. OF ECON. LITERATURE 487 (1982).

14. Much support, of course, is based on self interest. Unions and high wage firms have an incentive to support minimum wage legislation to raise the relative cost of labor to firms employing low-skill, low-wage labor. Moreover, federal legislators from high wage regions face a similar incentive with regard to low nominal wage regions. *See* Silberman & Durden, *Determining Legislative Preferences on the Minimum Wage: An Economic Approach*, 84 J. POL. ECON. 317, 325-327 (1976); Bloch, *Political Support for Minimum Wage Legislation*, 1 J. LAB. RES. 245, 245-46 (1980).

gest that empirical studies understate the cost of the minimum wage. Conventional examinations fail to take into account other margins of adjustment available to employers. Employers will respond to a higher minimum wage by altering other characteristics of the job package, such as fringe benefits and on-the-job training. The altered configuration of these variables may be optimized over time, but this optimization will be subject to the additional constraint of the minimum wage and will be second-best to a less constrained optimum. In many instances, the apparent gainers do not really gain.

One margin that is likely to see considerable adjustment is that of on-the-job training. On-the-job training exists in many forms. Specific-skill training provides the trainee with a trade. During the period when he is learning his trade, his wages are low, reflecting his productivity. Low wages are necessary for him to compete with the more skilled, trained workers available to his employer. As the wages of the least skilled rise by mandate, employers rely more heavily on more skilled workers and offer fewer training opportunities. Given the positive effect of on-the-job training on wage growth over time, job retainers receive a higher current wage at the cost of lower future wages.

A more subtle form of on-the-job training is the teaching of responsibility (or perhaps provision to the worker of the opportunity to demonstrate that he is already responsible). Reflection on the types of individuals who obtain minimum and near-minimum wage jobs indicates that, in a sense, all of these low wage jobs provide a valuable type of training for dropouts and marginal high school graduates. Such jobs provide an opportunity to both learn and demonstrate the discipline and work habits that are required in advanced industrial societies. Such demonstration is necessary for the worker's advancement into the high paying, high skill, blue collar jobs that are eventually available to (and almost entirely filled by) persons of little formal education. To the extent that the loss of this opportunity is felt disproportionately by the socioeconomic groups seen to be disadvantaged, access to middle-class status is made most difficult for those people who are the targets of the well-intentioned supporters of minimum wage legislation. Thus the intended redistribution may be totally frustrated in the long run.

B. *Unemployment Insurance and Workers' Compensation*

The existing systems of unemployment and injury compensation differ substantially in focus, method of finance, and economic impact, but share the objective of insuring workers against risks associated with employment. Both have been thoroughly analyzed elsewhere, but the two systems have consequences that are particularly amenable to analysis by the subjectivist perspective presented above.

Unemployment insurance is established by federal legislation, but it is largely administered and financed by state governments. The historical absence of private markets, presumably the result of high transactions costs, has been offered as a rationalization for government provision of unemployment insurance.[15] In the absence of government-mandated unemployment insurance, the labor market would generate equalizing differences in wages and other aspects of the employment package to accommodate the differing probabilities of unemployment across various occupations and industries. This implicit insurance and its wage-adjusted "premium" would not be uniform across all employments because the cost of providing employment stability varies across firms according to the seasonality and cyclical sensitivity of product demand and to inventory carrying costs. Moreover, workers vary substantially in their willingness to trade employment stability for wages and other job characteristics. Those workers who are particularly averse to the risk of unemployment will be attracted to those occupations in which stability is most easily or cheaply provided. Workers less willing to pay for employment stability will be attracted to occupations and industries that provide less stability. For workers who highly value leisure or other non-market uses of time, a high incidence of unemployment, particularly if its timing is predictable, may be attractive. For example, teachers euphemistically refer to the end of the paid school year as the beginning of summer vacation. Hence it cannot unambiguously be predicted that the "premium" for market-provided unemployment insurance will in all instances be positive. Again, the sorting and matching of employees that

15. *See* J. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 311 (2d ed. 1988). Stiglitz offers a transactions cost argument for the limited coverage of private insurance contracts in the social security context. The argument also applies to unemployment insurance, perhaps with greater force.

would take place and the resulting pattern of compensating pay would reconcile the subjectively varying values of workers with the objectively varying cost conditions of employers.

The imposition of an unemployment insurance scheme alters the pattern of pay across the various employment sectors. The incidence of unemployment occurs unevenly across industries. Because experience rating of levies on employers is limited and in some states non-operative, however, the tax to support unemployment compensation is much more uniform across industries. Uniform insurance rates reduce the size of the premium (assuming it is positive) that must be paid to attract workers into jobs that offer less employment security. A cross-subsidization takes place from low to high unemployment industries. This subsidization lowers the price of goods produced in high unemployment industries relative to the price of goods produced in low unemployment industries. In this manner, unemployment insurance creates an externality—a divergence between private and social cost—that would not exist in its absence.[16]

Like unemployment insurance, workers' compensation programs are state-financed and administered. Some form of mandated employment-related injury compensation exists in each state; but because no federal guidelines are in force, considerable variation prevails across programs. In all states, workers are compensated for job-associated injuries on a "no-fault" basis, and firms are required to purchase the insurance that covers such compensation.[17] Despite the prevalence of public schemes, the problems created by job-related injuries need not be handled by mandated insurance coverage. Private markets for injury insurance function effectively and are expected to charge premiums that are actuarially fair. If employers and employees were free to negotiate over the extent of liability for

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16. The cross-subsidization described here is not the only distortion associated with unemployment insurance. Conventional analyses have provided ample evidence of a distortion of the employer's layoff decision. For empirical evidence of the extent to which unemployment insurance has encouraged instability of employment, and has thus provided more dramatic evidence of the creation of a government-induced externality, see Feldstein, *The Effect of Unemployment Insurance on Temporary Layoff Unemployment*, 68 AM. ECON. REV. 834, 835-44 (1976). For an updating of the evidence on the effect of unemployment insurance on the duration of unemployment, as well as a useful literature review, see Gustman, *Analyzing the Relation of Unemployment Insurance to Unemployment*, in 5 RESEARCH IN LABOR ECONOMICS 69 (R. Ehrenberg ed. 1982).

17. *See generally* Nelson, *Workers' Compensation: Coverage, Benefits, and Costs*, 51 SOC. SECURITY BULL. 4 (1988).

job-related accidents, a process of sorting and matching would take place in which different occupations and different employers would offer varying degrees of safety with compensating differentials in wages.[18] Employees would gravitate to those jobs with the mix of risk and wages that maximize their respective subjective utility. Admittedly, there might be problems in a private system if the insurance pool were small or if there were high costs associated with adjudicating disputes.

Requiring firms to provide workers' compensation will lower wages and other forms of compensation. Wages in some occupations, however, will be more affected than others. Although workers' compensation insurance typically provides for a greater degree of experience rating than do state unemployment compensation payroll taxes, it does not result in premium costs that are exactly proportionate to payout experience. Because workers' compensation partially mitigates the consequences of industrial accidents, the equalizing differentials needed to attract workers to jobs involving greater degrees of accident risk will be less than they would be without workers' compensation. High accident industries and occupations are subsidized by low accident occupations and industries. Consequently, workers' compensation has the effect of lowering product prices in high-accident industries and raising them in low-accident industries. As with unemployment insurance, workers' compensation thus creates an externality in the form of a divergence between private and social cost.

Interestingly, some portion of the costs of mandated insurance benefits is borne by persons outside the labor market. Besides the cost workers bear when the range of risk and wage choices is narrowed, there is the social cost of the externality. There is a reallocation of resources toward those industries that have a high risk of unemployment or injury and away from less risky industries. This effect is created by the change in relative prices that induce consumers to purchase more of the products of one industry and less of the other. In addition, the provision of insurance alters safety and unemployment incentives.[19] Injury rates will rise in accordance with the generosity

18. *See* Thaler & Rosen, *supra* note 8.

19. The effect of workers' compensation on safety incentives is developed in Rea, *Workman's Compensation and Occupational Safety Under Imperfect Information*, 71 AM. ECON. REV. 80 (1981).

of a state's per-accident benefit levels,[20] and unemployment will rise with increases in unemployment benefits.

Workers' compensation is one of the least controversial of the various mandated benefits currently in existence. The organization of the system as it has evolved is, in some respects, a model for solving a perceived social need in such a way as to minimize its undesirable, unintended effects. For instance, the state compels the purchase of insurance but is not its monopoly supplier. Hence, the advantages of private sector competition are available. In addition, the no-fault nature of the insurance, combined with a fixed payment schedule, eliminates many of the transactions costs (primarily related to adjudication) that would otherwise be present.[21] Finally, the absence of federal guidelines has allowed substantial variation in programs across states. This variation permits experimentation that over time reveals desirable and undesirable features, and it permits the gradual evolution of the system.

Whatever may be the arguments regarding mandated insurance, it cannot logically be argued that forces in the labor market are unable to internalize differences in unemployment and accident rates. Perhaps a case might be made, particularly for the less controversial workers' compensation programs, that the result of mandated insurance is more efficient or more equitable than that generated by market forces. Such a case, however, has yet to be forcefully made.

C. *Occupational Safety and Health*

Whereas states have addressed the perceived problem of workplace safety by requiring workers' compensation, the approach of the federal government has been to regulate workplace conditions directly through the Occupational Safety and Health Act of 1970 (OSHA).[22] The commission established by the Act has promulgated more than 4,000 specific standards governing workplace safety.[23] The mandatory provision of safe

20. *See* Chelius, *The Influence of Workers' Compensation on Safety Incentives*, 35 INDUS. & LAB. REL. REV. 235 (1982) (empirical evidence on the increase of injuries with the increase of per-accident benefits).

21. Adjudication of workers' compensation seems to be limited to the issue of whether or not a particular accident or death is incurred "on-the-job."

22. 29 U.S.C. §§ 651-678 (1982 & Supp. V 1987).

23. *See* R. SMITH, THE OCCUPATIONAL SAFETY AND HEALTH ACT: ITS GOALS AND ACHIEVEMENTS 9 (1976).

working conditions is motivated by a perception that employers lack proper incentives to provide safe working conditions and that workers possess imperfect information related to occupational safety and health.

The belief that firms lack incentives to provide safety is highly questionable. The losses incurred by employers in the form of increased workers' compensation premiums and downtime, as well as the adverse impact on workers' morale, provide employers with an incentive to protect their work force. Regularly increasing investments by employers in human capital provide an additional incentive to protect their investments. Fully-informed workers would assure that employers pay for any uninsured job risk in the form of compensating wage differentials. This extra cost would be sufficient incentive for employers to provide the optimal amount of safety precautions. If workers were not aware of the degree of risk inherent in their work, however, it would not be possible to determine whether these incentives were sufficient to provide a socially optimal degree of safety.[24]

The issues of whether workers recognize differential risk and whether such recognition generates appropriate compensating differentials is complex. Professor Viscusi has presented evidence indicating a reasonable degree of accuracy in workers' perceptions about job risk.[25] Moreover, the accuracy of perception appears to hold even among low-risk industries in which workers might be expected to be less perceptive of variability in risk. If workers' estimates of on-the-job risk are reasonably accurate, there is every reason to expect that compensating differentials for this type of risk are accurate as well. Because the risk of occupational disease is by nature more difficult to perceive and, unlike accidents, difficult to associate with a particular employer, less confidence is justified in the labor market's ability to internalize the risk of occupational disease. Thus the case for mandated standards regarding occupational illness is stronger than the case for mandated safety standards.

Evidence of the effectiveness of OSHA on workplace safety

24. This Article employs the conventional definition of the "optimal" amount of safety: The optimal amount is that amount for which the marginal social benefit is equal to the marginal social cost.

25. *See* W. VISCUSI, RISK BY CHOICE: REGULATING HEALTH AND SAFETY IN THE WORKPLACE 60-69 (1983) (comprehensive conventional analysis of the benefits and costs of safety and health regulation).

and health has been mixed. In general, it suggests that OSHA has not measurably reduced accident and illness rates.[26] One might be tempted to explain this in terms of administrative problems and adjustment lags. A better explanation, however, emerges from the Austrian school approach. Recognition of the role of the entrepreneur as the agent of innovation in the discovery process suggests that the Act's long-run effect on workplace safety will be detrimental rather than positive.

The phenomenon of workplace safety, like all other aspects of production, is subject to the process of technological change and improvement. The establishment of uniform national standards in such profuse detail alters the incentives for entrepreneurs. Technological change in the provision of workplace safety may be frustrated by the imposition of rules that tend to freeze the technology of safety and reduce the incentive for entrepreneurial alertness to, and discovery of, new safety possibilities. To illustrate this point, let us assume that the various regulations originally specified in the Act took into account the best technologies available at the time, and that they somehow anticipated correctly the subjective value and objective cost of workplace safety. OSHA regulations would then be efficient, but only in a purely static sense. New safety innovations would require bureaucratic approval. Uniformity induced by OSHA rules would retard the process of discovery. Competition from any new technology would be inhibited. The codification of safety at a static point will tend to prevent the attainment of Pareto optimality in future periods. In this sense the provision of OSHA standards would be *dynamically* inefficient even if they were *statically* efficient. Stated otherwise, any short-run gain in efficiency would, with the passage of time, be overtaken by the loss of potential safety gain through technological improvement. However technologically up-to-date the rules of OSHA may have been at the time of passage, it is highly likely that many became obsolete over time. Even the pace of obsolescence, a direct function of the pace of technological innovation, is slowed by the codification of safety laws.

Of course the rules of OSHA can be and have been revised,

26. *See* McCaffrey, *An Assessment of OSHA's Recent Effects on Injury Rates*, 18 J. HUM. RESOURCES 131, 140-45 (1983); R. SMITH, THE OCCUPATIONAL SAFETY AND HEALTH ACT: ITS GOALS AND ACHIEVEMENTS 67-70 (1976); Viscusi, *The Impact of Occupational Safety and Health Regulation*, 10 BELL J. ECON. 117, 133-36 (1979).

but achieving change now involves additional costs related to bureaucratic approval. The motives for change are less related to incentives for providing safety than to the sometimes perverse incentives entailed in the substitution of bureaucracy for market mechanisms. To introduce safety innovations, the employer must bear the cost of lobbying for change. Moreover, because the change is uniformly imposed on others, its value is public and the innovator is denied his entrepreneurial reward. This changing of the nature of inter-temporal safety improvement from a purely private good to a public good introduces an additional impediment to the dynamic attainment of optimal workplace safety.

D. *Pension Regulation: The Employee Retirement and Income Security Act*

The Employee Retirement and Income Security Act of 1974 (ERISA)[27] introduced a statutory requirement that sets the minimum fraction of a worker's pension benefits that must be vested in each year of the employee's tenure. Originally, ERISA required one-hundred percent vesting of the worker's interest after ten years of employment.[28] The Tax Reform Act of 1986 accelerated the ERISA vesting deadlines.[29] Today, the worker's interest must be fully vested after five years of employment.[30] Because of the high degree of mobility in the United States work force, many workers, covered by plans that required long periods of employment to become vested, never realized the benefits of a retirement plan. The benefits were considered illusory (a reference to market failure) and ERISA was enacted to provide employee benefits by securing their retirement rights.[31]

An attempt to secure benefits for workers through ERISA is as likely to fail as the other mandates discussed throughout this

27. 29 U.S.C. §§ 1001-1461 (1982 & Supp. V 1987).

28. Pub. L. No. 93-406, § 203(a)(2)(A), 88 Stat. 829, 854 (1974).

29. Pub. L. No. 99-514, § 1113(a)(2)(A), 100 Stat. 2085, 2446 (1986) (codified as amended at 29 U.S.C. 1053 (Supp. V 1987)).

30. For comparison purposes, we use the statutory requirement for pension plans that offer *cliff vesting*, that is, plans that change from zero to one-hundred percent vesting at an instant in the employment relationship. For *partial vesting* plans, the statutes permit fractional vesting at an earlier time in exchange for delaying the requirement of one-hundred percent vesting. *See id.*; EHRENBERG & SMITH, MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY 405 (3d ed. 1987).

31. *See* A. GOLDMAN, LABOR LAW AND INDUSTRIAL RELATIONS IN THE UNITED STATES OF AMERICA 256-57 (1984).

Article. The added constraint on the set of possible employment arrangements introduces a new cost into the employment relationship that is shared by both workers and employers. ERISA, to the extent it increases employers' future obligations to their employees, will limit employers' offerings to those employment options with lower work-life income and higher pension benefits. Employers can no longer offer higher present wages and lower vested future benefits as an employment package option. Those employees preferring present wages to future pension benefits will be made worse off. All will find that ERISA has limited the employment choices by making lower present wages and higher pension benefits the industry standard.

Of course, there are more margins to adjust than wages alone. As mentioned above, on-the-job training contributes greatly to an individual's productivity, and it is costly to employers. In some circumstances, a firm might be required to invest heavily in training during the early years of an employee's career and, therefore, would expect to recover this investment through the enhanced productivity of the employee in later years. Because the employee cannot indenture himself to the employer (most personal service contracts are not enforceable), the employer will seek some other means to protect his investment in his employee. Long periods of employment before workers' rights in pension benefits become vested provide workers with an added incentive to remain in their present position. Such an employment agreement has all the elements of a loan agreement. The firm "lends" the worker the time and means to acquire training and the worker repays the loan with enhanced productivity. The invested pension benefits are the loan's "security," a mutually acceptable, private means of enforcing the training-employment agreement. With today's ERISA, a well-trained worker can leave his employer after five years, without losing pension benefits, and claim the value of his training in the form of higher wages with another firm (one that is encouraged to "steal" trained employees rather than invest in them). As a consequence, ERISA is likely to result in fewer job-related training programs. Instead, businesses are more likely to rely on formal avenues of training, like universities and technical schools, which are better suited to general rather than specific training and where the cost of training must

be borne by the worker (and often by the state). Thus, fewer jobs, higher educational requirements, lower wages, a less productive work force, and fewer choices are the likely results of ERISA.

E. *Mandatory Health Insurance*

A bill proposed by Senator Edward Kennedy, entitled, Basic Health Benefits for All Americans Act of 1989,[32] is presently under consideration by Congress. The Kennedy plan requires that every employee working more than seventeen-and-one-half hours per week, and his family, be provided with at least the following health insurance coverage: in- and out-patient hospital and doctor care; diagnostic and screening tests; prenatal and well-baby care; and care for pre-existing conditions of the employee. Employees may not waive participation in the health plan, and their spouses and dependents can be exempted only if they prove they are covered by another plan. The plan must pay for at least eighty percent of the covered expenses above the deductible. In addition, the maximum deductible allowed is $250 for the worker ($500 per family), and total cost to the worker for covered expenses may not exceed $3000 per year. Small business employers are limited to a few (two to five) insurance companies licensed by the government to supply health insurance in the employers' areas.[33]

The subjectivist analysis suggests that mandated health insurance coverage will not improve the lot of workers. If the objective measure of income—the dollar value of wages and fringe benefits—does not change, statutes that increase the fraction of worker compensation paid as health insurance coverage necessarily reduce the subjective value workers derive from their compensation package. Workers and their employers are forced by statute to exchange work effort for a compensation package that the worker values less than an equal or less costly alternative, and labor market entrepreneurs cannot exploit the difference in subjective value by offering the compensation package workers want.

Insurance companies presently offer a variety of coverage options because their clients demand them. Often several

32. S. 768, 101st Cong., 1st Sess. (1989).
33. *See id.* at §§ 312-314, 321-322.

choices are provided by a single employer. Across the employment spectrum the variety is myriad, including the option to forego health insurance in exchange for higher wages. This diversity of options provides value because people want different things. Families with no dependent children do not want to pay for coverage that provides for well-baby care, and individuals that know they are healthy do not want to pay the premium needed to cover the insurance provider's expectation of a pre-existing condition. Many families with two incomes choose to insure the entire family under one spouse's plan because of economies in dealing with one insurance company and one plan. These and many other options are precluded by the Kennedy proposal. In addition, it appears likely that employer reactions to the Kennedy plan will further limit the range of worker options. Employers will likely increase their dependence on part-time employees limited to no more than seventeen work-hours per week. A student would not be able to choose, say, to work twenty hours per week and forego health coverage, even if she is covered by her parents' health plan.

If enough people desire coverage below the Kennedy plan minimums, at the implicit price of coverage (in terms of wage and other marginal adjustments), one can be assured that, over time, a labor market entrepreneur in an economy free of statutory constraints will discover that this "market" for benefits exists. He will offer the desired coverage and, in the process, make himself *and* the employees better off. Legislation that sets minimum limits effectively outlaws this market.

The negative welfare effects of mandated health benefits extend beyond the employer and employee. Consider the effect the Kennedy plan would have on the behavior of insured persons. Insurance companies offer deductibles (the amount that the insured must pay before any payment by the insurance company) and co-insurance (paying less than one-hundred percent of expenses incurred by the insured) to avoid "moral hazard." Moral hazard is a social problem created when insured individuals lack the proper incentives to limit consumption and to take precautions. As the deductible rises or co-insurance levels fall, moral hazard is reduced. With competition, insurance companies share the savings from reducing moral hazard by lowering the price of insurance. Those individuals least inclined to use health care or best suited to bear the risk of a

larger share of their health care costs would prefer co-insurance and large deductibles. The Kennedy plan denies these individuals their preferred choice, and, by over-insuring them, encourages moral hazard and the accompanying waste of health care services.

A recent study suggests that many individuals do not carry insurance because of the high cost, much of it resulting from coverage mandated by state laws.[34] Although not universal, many states mandate coverage for treatment by chiropractors, acupuncturists, and naturopaths (herbal doctors); for the treatment of alcoholism and drug abuse; and for the treatment of mental health problems. There are five states that mandate coverage for *in-vitro* fertilization.[35] According to state estimates, if benefits now mandated could be chosen, the reduced cost would result in significant increases in the number of persons that choose health insurance plans.[36] Ironically, the impetus for the Kennedy plan is the observation that so many workers are without health insurance.

F. *Other Mandated Employee Benefits*

Some proposals for family and medical leave mandate that employers provide leave and other benefits to employees upon the birth of a child or serious family illness.[37] As with all mandated benefits, the cost will lead employers to adjust on the available margins. To the extent employers can discriminate in hiring, the wage of parents and employees of child-bearing age will fall relative to that of other employees. In general, if the group that receives the benefits cannot be singled out the wages of all employees will fall, including those of individuals that do not benefit from parental leave.

A more direct form of mandated benefit to parents that is sometimes suggested is a requirement that employers provide child day care. Alternatively, it is sometimes proposed that employers subsidize off-site child care for the children of employees. The ramifications of employer-provided child day care in either form would be the same as for mandated parental leave.

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34. *See* Goodman & Musgrave, *Freedom of Choice in Health Insurance*, in NATIONAL CENTER FOR POLICY ANALYSIS, POLICY REPORT No. 134 (1988).

35. *Id.* at 11.

36. *Id.* at 20-22.

37. *See, e.g.*, S. 345, 101st Cong., 2d Sess. (1990); H.R. 770, 101st Cong., 2d Sess. (1990).

In an unregulated market, employers will lower their labor costs by providing child care when that is a form of compensation desired by an as yet untapped segment of the work force. As a consequence, they will attract those employees who place a particularly high value on this type of benefit. Conversely, they will be less attractive employers to those who do not desire this benefit. Unless such potential employees find other aspects of that job package sufficiently attractive, they will gravitate toward firms that do not offer child care. Compelling all employers to offer child care would block this tendency toward sorting and matching across the job market. Unless employers can impose the cost on those employees who benefit from it, such provision will merely socialize the cost of child care. Once again, an externality would be created rather than cured by government mandate.

Legislation requiring the application of "comparable worth" to federal employment is occasionally introduced. Perhaps a case can be made for comparable worth in public sector employment, as it is clear that relative wages in the public sector are not market-determined and do not bear any particular relation to wages in the private sector.[38] It is often suggested, however, that application of the comparable worth principle should be legislatively mandated for the private sector. In the argument for comparable worth there is a recognition of one fundamental issue raised earlier in this Article—that any job has many characteristics. The worth of these characteristics is determined in the labor market, based on the subjective values that workers place on these characteristics. It is the response of workers to the market-generated implicit prices that produces the sorting and matching of workers and jobs in the labor market. In combination with the supply side of the markets for differing characteristics, these responses determine the equilibrium values of implicit prices. The subjective values that workers associate with the characteristics, as revealed by their actions, determine the monetary value of the characteristics of jobs.

The comparable worth principle bases the pay for these job characteristics on the results of a "job analysis," in which a spe-

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38. *Cf.* Bellante & Long, *The Political Economy of the Rent-Seeking Society: The Case of Public Employees*, 2 J. LAB. RES. 1 (1981) (processes for determining public and private sector wages lead to differing wage levels for equivalent amounts of human capital).

cialist determines what each of these characteristics is worth. The values determined by the specialist are no less subjective than those of the worker. The only objective information available to the specialist is the market-generated implicit prices. Even if the objective information is accurate, it will be of no use if the purpose of the specialist is to derive values that are independent of a supposedly flawed market process. Under this condition, the specialist can only substitute his own judgment as to what those characteristics *ought* to be worth for the values determined by workers in terms of their revealed willingness to trade off wages for incremental differences in non-wage characteristics.

Generally, the advocacy of comparable worth is motivated by the fact that pay in occupations that tend to be dominated by women has been low, relative to male-dominated occupations. Advocates seek to rectify this pay difference by legislatively mandating a system of pay determination that they believe will result in higher pay in these occupations. There is ample evidence that occupational segregation by gender has limited the range of occupations available to women. This "crowding" of women into a limited number of occupations has artificially raised the supply and lowered the market wage in these positions.[39]

The problem, however, is not with the functioning of the job market. Rather, the problem is with barriers to the free entry of women into occupations of their choice. As the above arguments suggest, those barriers artificially limit the range of options available to women and are a source of welfare reduction. Remedial action, therefore, should be aimed at reducing those barriers. Indeed, a large share of governmental and private activity has been aimed in this direction. Adoption of the comparable worth principle of wage determination would eliminate the market altogether as the mechanism for wage determination and prevent wages from serving any kind of allocation function. The range of opportunities and the possibilities of individual welfare maximization for both genders would be severely limited by the likely adjustments of employers.[40]

39. *See* Bergmann, *The Effect on White Incomes of Discrimination in Employment*, 79 J. POL. ECON. 294 (1971) ("crowding" because of racial discrimination lowers the marginal productivity of minority labor).

40. For a comprehensive discussion of comparable worth that is consistent with the

VI. SUMMARY AND CONCLUSIONS

The subjective nature of value, combined with the multiple-characteristic nature of the implicit or explicit bargain between employer and employee, make it likely that government mandates of basic pay, fringe benefits, and other working conditions will reduce rather than enhance worker welfare. The welfare reduction takes place in several respects. First, a free functioning labor market makes available to workers a wide array of fringe benefits, working conditions, and pay combinations. The tastes, abilities, propensities, and personal circumstances of those workers are also varied. Mandating benefits of any type reduces the variability of the combinations, or "packages," available to workers and thus reduces their potential for welfare maximization. Second, progress in the workplace is an inter-temporal process of discovery. The discovery process finds application not only in workplace safety, but in all pecuniary and non-pecuniary aspects of the work environment. Government mandate of details of the employer-employee relationship reduces both the incentive and possibility for experimentation. Thus, the government mandate is likely to be dynamically inefficient. Third, the multiple-characteristic nature of the total compensation package makes it unlikely that legislation can, in the long run, raise the value of the total compensation package by raising one element in the package. Firms have multiple margins along which to adjust to any mandate.

The ease with which employers can, in time, avoid the costs of government mandates by reducing some other aspect of the total job package merits further analysis. The stated intent of minimum wage legislation is to redistribute income toward low wage workers. Although usually implicit, it would be hard to deny that redistribution is a prime motivation of the political support for other types of mandated benefits. Yet the subjectivist analysis strongly suggests that the mandating of benefits is not an effective, long-run redistributive method.

What, then, is the nature of the political support for government-mandated benefits? One explanation lies in the fact that the process of adjustment along the many margins available can be costly and subject to long time lags. Before the long-run

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subjectivist perspective of this Article, see D. WALKER, VALUE AND OPPORTUNITY: COMPARABLE PAY FOR COMPARABLE WORTH (1988).

dissipation of those rents is accomplished, substantial income transfers of a transitory nature may result. The difficulty of adjustment and thus the length of the adjustment lag is greatest when many aspects of the total job package are subject to an explicit contract. Workers covered by collective bargaining are, consequently, in a stronger position to gain transitory rents and thus have a stronger incentive to seek government mandates. Additionally, by supporting the extension of collectively bargained benefits to uncovered workers by mandate, unions can raise the cost of non-union labor and thus reduce competition for their jobs. The transitory nature of this tendency toward cost equalization suggests a motive for a continuous effort on the part of organized labor to find and support additional forms of mandated benefits.[41] Similarly, firms that have been locked into expensive packages have a motive to seek legislative mandate of those benefits to raise their rivals' costs.[42]

A second explanation of the support for government-mandated benefits is found in the rational ignorance of voters.[43] The concept of rational ignorance is particularly relevant to mandated benefits when the intended beneficiaries are small in number relative to the entire population. Such benefits would occur, for example, through a program of mandated child care. Rational ignorance is a consequence of the collective decision-making process employed at the top of government. The issues are many, complex, and varied. Representatives make the decisions, and with a limited number of choices, there is not likely to be one candidate that exactly matches the views of any particular voter. Information on candidates' positions and, indeed, on one's own position, is costly to obtain and the likelihood that one's vote will be influential in an election at this level is slight. The natural consequence is that voters focus on the issues that are important to themselves and ignore the other dimensions of a candidate's platform. Because rationally ignorant voters choose politicians that cater to their special interests, political campaigns take on a special interest flavor.

41. *See* Gray, *Let Small Business Do What It Does Best—Create Jobs*, 10 J. LAB. RES. 73, 74-75 (1989) (suggesting that organized labor may have a cost-leveling motive behind its support for non-union benefits).

42. *See* Salop & Scheffman, *Raising Rivals Costs*, 73 AM. ECON. REV. 267 (1983); McCormick, *The Strategic Use of Regulation: A Review of the Literature*, in THE POLITICAL ECONOMY OF REGULATION: PRIVATE INTERESTS IN THE REGULATORY PROCESS 13, 20-27 (R. Rogowski & B. Yandle ed. 1984).

43. *See* A. DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 238-59 (1957).

Rational ignorance allows special interest groups that represent workers who want government-mandated benefits to achieve their goals. In an unregulated world, these workers would tend to gravitate to the work environment that offered these benefits. In the political arena, they have an incentive to seek out and support a politician that promises to deliver these benefits to them in their present work environment. Other workers, not particularly desirous of the benefit, are nonetheless rationally ignorant of the consequences and do not oppose the politician. They look instead for politicians that promise to deliver mandated benefits that satisfy their particular wants. By concentrating benefits in the hands of the limited number of vocal supporters, politicians gain voter support. The politician realizes little opposition to proposed mandated benefits because the cost of the benefit is hidden in an employer's unanticipated future response, and these costs are spread over many workers who, for such a small individual cost, remain rationally ignorant.[44] The reality of budget deficits and institutional constraints on spending (most notably the Gramm-Rudman-Hollings Act[45]) limit the government's ability to respond to special interest requests with increased subsidies. Thus the natural response is to pass statutes that attempt to redistribute wealth to the special interests in a covert manner.

If policy is to be rational, it should be scrutinized with regard to its effects on allocative efficiency, regardless of the motivations for its political support. The mandating of benefits significantly impedes the efficient functioning of the labor market. Policy positions that rationalize the mandating of benefits on the basis of market failures and externalities are not persuasive. We have seen that government mandates often create externalities. Similarly, by substituting bureaucratic rulemaking for entrepreneurial discovery, government mandates create rather than alleviate a public goods problem.

The argument that labor markets occasionally fail to provide a good, even though the costs of providing it are less than the amount that buyers would willingly pay, is used as a rationale for unemployment insurance. In reality, this incomplete-mar-

44. *See* R. HOLCOMBE, AN ECONOMIC ANALYSIS OF DEMOCRACY 143-61 (1985).

45. Balanced Budget and Emergency Deficit Control (Gramm-Rudman-Hollings) Act of 1985, Pub. L. No. 99-177, 99 Stat. 1038 (codified at 2 U.S.C. §§ 901-908 (1988)).

kets argument cannot correctly be used to support a government-mandated provision of insurance. The absence of a private market makes it impossible to know in advance that the costs of establishing compulsory insurance would be less than what uncompelled buyers would willingly pay for it.[46] More importantly, this and other arguments for compulsory explicit insurance against labor market risks fail to recognize that the implicit insurance markets contained in compensating wage differentials may be more efficient than explicit markets. Wage differentials may be a more efficient form of insurance because on-the-job transactions and monitoring costs are less than those associated with third-party insurance. In any event, the absence of explicit insurance markets does not provide evidence that the market is incomplete or non-existent.

Finally, the idea that workers lack adequate information about such things as health and injury risk has been used to rationalize legislation that intervenes to protect the worker. Because no one has perfect information, this line of reasoning has intuitive appeal, but evidence that workers systematically underestimate risk is entirely lacking.

The obvious general policy conclusion that follows from the above argument is that the current trend toward increased imposition of government-mandated benefits should be resisted rather than encouraged. Although this conclusion is a negative one, the argument also begets specific policy recommendations that call for positive action. Existing tax law severely limits the use of cafeteria plans. Reform that would make it easier for firms to offer a wider variety of benefit options to workers, including a worker option of taking a cash equivalent to a particular benefit, would clearly enhance worker welfare. Indeed, any reform or employment law that increases the opportunities for workers and firms to arrive at workplace arrangements characterized by diversity rather than uniformity is to be encouraged. In this manner the widely varying needs, desires, and circumstances of workers and firms can be accommodated by the labor market.

If there is economic justification for government imposition of workplace uniformity, it must be based on arguments stronger than those considered here. The diversity of pay,

46. As pointed out in J. STIGLITZ, *supra* note 15, at 89, much government provided "insurance" is a disguised form of partial income redistribution.

fringe benefits, and working conditions observed across the labor market is an indication of market success rather than failure.