An Uneven Playing Field: The Contract of Employment and Labour Market Regulation

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Abstract

Proponents of voluntary exchange in labour markets place great reliance on the contract of employment as an appropriate vehicle for the practical implementation of their exchange model. This paper argues a contrary view and suggests that the contract of employment may not be an appropriate vehicle for the voluntary exchange of labour.

1. Introduction

The winds of change arey sweeping away the industrial relations system rapidly away from the Higgins legacy of a centralised monolithic system of award regulation. The coalition's voluntary agreements policy - perceived by most prior to the last election as pure ideological fantasy - is now moving close to reality in Australia. Those who said it could not happen now look nervously at New Zealand, hoping that the Employment Contracts Act will fail to take root in that country. The same people have also seen the failure

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to halt Troubleshooters and other forms of contract hire arrangements as a sign that fantasy may become reality.

Two key justifications may be promoted for the introduction of individual contracting as the primary mechanism for conducting industrial relations in Australia. Firstly it is a mechanism for directly introducing market forces to bear upon industrial relationships. In other words, it is hoped that the law will facilitate (and indeed create) the conditions under which the laws of economics will prevail. By contrast industrial awards and industrial tribunals modify markets forces in order to achieve wage justice in an economic society in which there is perceived to be inequality of bargaining power. The other principal justification for focusing on the contract of employment (or individual contracting) is to undermine the power of unions and, in particular, their power through concerted collective action to undermine market forces.

This article focuses on the first justification and considers whether the assumptions underlying that justification are valid. The argument, put at its simplest, is that the legal construct known as the contract of employment, is an inappropriate legal mechanism for bringing about a genuinely free market in labour.

2. The Contract of Employment as a Mechanism for Voluntary Market Exchange

The starting point for many modern proponents of individual contracting is a rejection of centralised - collectivist models of industrial regulation, such as Australian (and formerly New Zealand) compulsory arbitration. Penny Brook in her recent book *Freedom At Work: The Case For Reforming Labour Law in New Zealand* (Brook 1990), typifies this approach. According to Brook, the notion that governmental agencies can regulate industrial relations to effect socially just outcomes is fundamentally flawed:

> The ability of central planners to improve on the outcome of voluntary processes is severely hampered by their sheer incapacity to gather and utilise information about individuals varying needs, preferences and circumstances. (Brook 1990, p. viii)

At the core of Brook's argument is the view that individual autonomy and freedom accompanied by voluntary market exchanges will lead to positive sum games for the participants. Even better, there are benefits for all in society. There is a more efficient use of labour resources, greater productivity, and an empowering of individual workers. Wages will more readily reflect their true value, be higher overall, and unemployment will be reduced.

The proponents of voluntary market exchange in the labour market admit that to be successful, the transaction - the mechanism for exchange - must be neutral. Otherwise the symmetry of the exchange and the relationship will be compromised. Furthermore, the autonomy and freedom so necessary for the positive sum game outcome will be vitiated; resulting in the alienation and disincentive characteristic of the centralist - collectivist model.

Proponents of voluntary market exchange in labour markets, such as Brook and Richard Epstein (Epstein 1991), place great reliance on the contract of employment as an appropriate vehicle for the practical implementation of their model. This philosophy underpins the New Zealand Employment Contracts Act.[1] Brook, Epstein and others argue that voluntary exchange is best achieved through private law - exemplified by the English common law system. It is "seen as having inherent advantages over statutory law in the governance of many day to day relationships." (Brook 1990, p. 97) Its "ability to deliver 'efficient', welfare - enhancing decisions is seen as resting on its basic respect for the autonomy of individuals". Moreover its reliance on rules that tell individuals not what to do but how to do things - its emphasis on process not outcomes - makes it a more efficient mechanism for voluntary market exchange. Moreover, "pursuit of social justice in this context is seen as at best meaningless" (Brook 1990, p. 98).

The rhetoric sounds enticing , but the difficulty is that economists like Brook, while waxing lyrical about the English common law, seem largely ignorant of its content, operation and history. And this ignorance leads to a fundamental error in the advocacy of the use of the contract of employment - in New Zealand and Australia - as a mechanism for labour market regulation. For the sake of analysis, the flaws in Brook's approach which I will identify are divided into three broad categories.

2.1 *Just another form of contract?*

First of all, Brook assumes that the contract of employment as it exists in New Zealand (and there is not a great deal of difference between New Zealand and Australia in this respect) is similar in its content and application, to other forms of contract. Brook relies heavily on the work of Epstein in making this assumption and Epstein's work (Epstein 1983a, 1983b and 1991) is littered with assertions that the contract of employment is just like any other contract. He says for instance: "the common law rules on transfer do not treat labour relations as something distinctive or special. When I studied law initially at Oxford, there was no separate branch of the common law governing labour relationships." (1991, p. 4)

I do not know what Epstein read while he was a student at Oxford, but he could not have read any of the English cases on the contract of employment (see Diamond 1946, Fridman 1963 and Freedland 1976), nor could he have read William Holdsworth's classic work *History of English Law* in which he states:

> In truth, until political economists of the earlier half of the nineteenth century converted the legislature to the belief that freedom of contract was the cure for all social ills, no one ever imagined that wages and prices could be settled merely at the will and pleasure of the parties to each particular bargain: or that the contract between employer and workman could be regarded as precisely similar to any other contract.[2] (Holdsworth, 1924, p. 386)

The truth is that in our legal syste, the common law contract of employment is fundamentally different to other forms of contract. It contains far more terms which are implied automatically by operation of law than any other form of contract. These are "court imposed" terms. And these terms are balanced heavily in favour of employers. No other form of contract imports a term (and in employment law these terms are not inappropriately called "duties") that one party *and one type of party only* must obey the orders of the other. To this we could add the duty of good faith, the duty of care and competence and, arguably, a duty of co-operation. These of course are all owed only by employees *to* employers. The principal terms or duties implied by law which bind employers are much more limited and specific duties such as the duty to pay wages in return for work. The common law does not even impose a duty upon an employer to provide work during the duration of a work contract.

This all makes a mockery of Epstein's statement that "in analyzing contractual validity, then, the legal system did not speak about one set of rules for employers and another for employees" (Epstein 1991, p. 4). This fundamental asymmetry should not come as a surprise to anybody who knows anything about the history of the common law contract of employment. The contract of employment grew out of the law of master and servant which itself directly formed part of the law of domestic relations along with marriage and parenthood. The law of master and servant was all about obligation and subordination. It was in may ways alien to contract. So when certain forms of master servant relationship were called contracts they retained a special status in the law founded in the distinctive right of one party to exercise authority over another. Most of the terms were implied by law rather than set by mutual agreement. With the growth of the concept of the free market and with it freedom of contract, in the 19th Century the employment relationship came to be seen as more contractual in essence.

Necessarily, many of the master/servant *obligations* waned, especially those which impeded the freedom of capitalist employers to dipense with labour. The parties could agree upon terms, and the old presumptions of yearly hiring gave way to the idea of a contract of definite duration. The old master and servant doctrines which would allow termination of the relationship of master and servant only on grounds of wilful disobedience, gross moral misconduct or habitual neglect, were dissipated.

But the English common law through the notion of terms implied by operation of law - rather than by "contract" - has retained many of the old obligations which existed in the law of master and servant. The British and Australian judiciary - not to be denied - have greatly expanded and enhanced these "non-contractual" terms or duties. The contract has become in effect a status contract and the courts are extremely reluctant to find that even an express written term, agreed between the parties, will oust one of these court imposed terms. It should also be noted that some of these terms implied by law, in fact evolved out of a failure of contracting - in other words the courts sought to impose a term simply because the parties messed up their contract. An example is *Harmer v. Cornelius* (1858) 5 CB NS 236 where an employer engaged two scene painters to paint a set for a play. The employer engaged the painter's for a fixed term but due to his own default, failed to properly assess whether they were any good at painting. When it turned out that they weren't he wanted to avoid the contract. So he asked the Court to find, and the Court so found, that there was a general duty on the part of all employees that they are "of a skill reasonably competent to the task" they undertake to do. If they were not they could be summarily dismissed. In other cases where the parties failed to agree about the hours of work, the courts were quite ready to hold that "the law will imply that the party hired shall work at all reasonable hours when required" (see *R v St. John Devizes* (1829) 9 B&C 896).[3]

2.2 A corruption of common law?

The second flaw in the arguments of proponents of the use of the contract of employment is that having deified the contract of employment and the common law judges who created it, they then turn around and criticise it in its modern form. They worry about 20th Century common law judges corrupting their sacred common law. The criticism is of the judiciary imposing equitable notions of unconscionability, due process and so on upon the common law rules. Thus Brook (1990, p. 100) says:

There is increasing evidence throughout the Western world of "judge

made law" moving far beyond the prerogatives of traditional common law courts. In particular, there is increasing judicial involvement in assessing the fairness of outcomes and dictating acceptable outcomes - a role not unlike that assumed by collectivist governments, and potentially as damaging. In the context of employment relationships, a significant development is the increasing role of the courts in unjust dismissal cases. More generally there is an increasing assumption by the courts of their right to provide a running commentary on contractual relationships, teasing out satisfying solutions and pronouncing on fairness; bearing the banner of social justice, discovering ever new and alienable rights, and, in the process, weakening or confusing the principles that traditionally made the common law an effective means of protecting individual rights and promoting socially beneficial relationships.

It is indicative of Brook's ignorance of the common law contract of employment that she gives as an example of this weakening of traditional principles by the courts, the "periodic flirtations with the notion of defining employment as a matter of status based purely on rights and duties - not unlike a Master - servant relationship - rather than as an contractual relationship" (p. 100). Her example is, of course, an accurate description of the contract of employment as it was in the 19th Century - and indeed as it is now.

Clearly, it is a fundamental mistake to rely upon the common law to find the solution to our late 20th century ills. To worship the 19th century common law and then to seek to freeze some misconception of it, is to live in a false reality. What is needed is a statutory code which incorporates the best features of the common law so as to facilitate the most desired model of voluntarily market exchange. The need for a code rather than a misty eyed harking back to past mythologies is exemplified by my third and final criticism of proponents of the contract of employment model.

2.3 *Common law symmetry?*

The greatest degree of asymmetry in the traditional contract of employment model is in the area of remedies. The common law denies to a wrongfully dismissed employee damages which would be available for wrongful termination of many other forms of contract. In particular the common law denies compensation for humiliation, loss of dignity, injury to feelings and loss of the prospect of obtaining another job, for employees who have been dismissed unlawfully and oppressively. Their only remedy is for damages for wages in lieu of proper notice. This allows employers to dismiss in

circumstances which are harsh or oppressive with impunity. It is interesting to note that the New Zealand Law Commission (1991) recently recommended that the law in New Zealand be changed to permit the award of such damages. It was recommended that such amendments be incorporated into the Employment Contracts Act. The Law Commission believed that a change in the law was necessary to help restore the symmetry of the contract of employment if it is to become the major mechanism for labour market regulation.

The second difficulty with remedies is the traditional common law rule that the courts will not order specific performance (or reinstatement) of a contract of employment. While the common law continues to put few, if any, brakes on the power of an employer to unilaterally dismiss employees, but retains a rule of law that it will not redress by reinstatement wrongful or unfair use of the power of dismissal by employers - the law can hardly be said to operate equally. The voluntary market exchange - the entering into of a contract of employment - immediately results in an unequal contract. Brook, Epstein and others valiantly try to argue that from an economic point of view an employer cannot afford to arbitrarily, and in an irrational manner, dismiss employees. It will, they say, affect their commercial reputation as well as their reputation with their remaining employees and there will also be the negative costs of finding and training a replacement. But in the end we are forced to accept St. Antoine's (1988,p. 67) criticism of Epstein:

> His analysis admits of no living, breathing human beings, who develop irrational antagonisms or exercise poor judgment, on the one hand or who suffer the psychological as well as the economic devastation of losing a job, on the other.

Contrast this with Epstein's statement (1991, p. 11) that the precarious nature of the at will doctrine provides both sides with a secured obligation and that:

> [B]efore quitting or firing, one has to make a hard decision of whether the benefit foregone is worth the labour or the wages, as the case may be, that can now be retained. But once that decision to settle the arrangement is made, the security on the other side is instantly realised, without the formalities and delay of foreclosure [court] proceedings. The worker instantly recovers her labour, and employer his cash.

It is rare to hear a sacked worker exclaiming the recovery of her labour!

Again it is interesting to note that the New Zealand Employment Contracts Act retains a power for grievance committees to direct the reinstatement of employees who have been unjustifiably dismissed, unless the individually negotiated contract excludes this right.

3. Conclusion

Proponents of the use of the contract of employment as a mechanism for labour market regulation need to look again at their fundamental assumptions and their basis of knowledge. The contract of employment as it exists in Australia is clearly inappropriate to achieve voluntary market exchanges in the manner desired.[4] Freedom of contract when applied to the contract of employment is a misnomer. It is freedom to enter into a status and into a state of subordination; into a state of play in which the rules are biased and the playing field tilted.

Notes

1. This is no coincidence. Brook was a policy analyst with the New Zealand Business Round Table when she wrote her book (Brook 1990) and her research was influential in the formulation of the Employment Contracts Act.
2. See further the criticisms of Professors Getman and Kohler (1983, 1416), who state that "Professor Epstein's article [Epstein 1983a] is representative of a growing but lamentable tendency in the legal literature to comment criticially on areas in which the author has no expertise, using as a measure axioms formulated *in vacuo* and without regard to observed actualities". For further debate on law and economics in the workplace see Gottesman (1991)
3. A good recent illustration of the reluctance of the courts to permit an expressly agreed term to override a court imposed term is *Johnstone v. Bloomsbury Health Authority* [1991] 2 All E R 66.
4. Even apart from the criticisms offered in this article there are other problems. For instance the high transaction costs associated with a pure contract of employment regime, its relative inefficiency at the macro level (Muckenberger and Deakin 1989, 186-94) and of course, the reality of inequality of bargaining power.

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