Behavioural Economics and Labour Law

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Abstract: Can behavioural economics help to make better labour law? This article traces the relationship between empirical work and legal thought, and focuses on new studies in behavioural economics and their potential implications for labour policy. Work by behavioural economists, and its implications, is discussed in four main fields of labour law policy: the effect of fair pay on the motivation to work; the effect of security in pay, and potentially job security, on productivity; the relevance of participation rights and job satisfaction in the workplace; and the differences between opting in and opting out of workplace schemes such as occupational pensions. Studies on these questions provide evidence that labour rights which correct inequality of bargaining power, protect security in pay and conditions and promote workplace participation redress significant market failures. If the thinking is careful and slow, behavioural economics seems indispensable to make better labour law.

[*] London School of Economics and King's College, London. Please email l.e.mcgaughey@lse.ac.uk with comments. My thanks to Orly Lobel, Alain Cohn, Dan Ariely, Valerio De Stefano, Simon Deakin, Amy Ludlow and Alysia Blackham for exchanges and discussion. Normative endorsement should not necessarily be implied from their positively excellent assistance. I am most grateful to my students over the last six years on the Commercial Law course at the LSE, who come from departments such as economics, accounting, management and philosophy for an introduction to law. This fascinating module was originally called 'Commercial and Industrial Law' and was probably the first to include teaching of labour law in the world, from 1895. Through its history, its interdisciplinary character attracted some very interesting people who produced very influential ideas, including one famous LSE student who is discussed below.

1. INTRODUCTION

Since the financial crisis that began in 2007, behavioural economics has become mainstream. Its method is to test how people react to particular changes to their environment. Conclusions are then drawn about general human tendencies in specific situations. The method had been around for some time in psychology,[1] but now an organised body of literature has developed. Generally it shows that human reason and choices are complex, are not always self-interested, and do not always maximise welfare. It can hardly be a coincidence that behavioural economics has attracted so much attention now. Up to the financial crisis, economic models of rational choice formed the main intellectual defence for deregulatory policy. Lack of consumer protection for mortgagors of American homes; credit ratings agencies who were paid to rate income streams from sub-prime mortgage debt by the people who were selling it; derivatives of sub-prime debt being traded by investment bankers without basic duties of disclosure. It was all defended with the view that people have the capacity to act freely and rationally in the market.[2] 'If you seek economic growth, if you seek opportunity, if you seek social justice and human dignity,' said George W. Bush in 2008, 'the free market system is the way to go'.[3]

But more and more, this *laissez faire* attitude to productive economic policy did not seem like the way to go. As the financial system went bankrupt, as crisis in finance spread to crises across governments, it made those economic theories less persuasive than before. This was profoundly influential for the generation who saw the effects of the crisis first hand, those whose formative education and early careers spanned the years of collapse. Many problems in the law, and problems in labour law, did not contribute directly to the insolvency of Northern Rock, Bear

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[1] E.g. S Milgram, 'Behavioral Study of Obedience' (1963) 67(4) *Journal of Abnormal and Social Psychology* 371-8, where Milgram found that 26 out of 40 test subjects (65%) were willing to electrocute people (who were actually actors) at increasingly high voltages in a laboratory if the actors failed to 'learn' word pairs, because a 'teacher' was ordering them to do it. The conclusion was that people overwhelmingly obey orders to do things which are morally wrong when put in a context of an authority relation (even though they are always 'free' to leave).

[2] One example of a theorist representing such views is the joint recipient of the 2009 Bank of Sweden Prize in Economic Sciences in Memorial of Alfred Nobel, OE Williamson, *The Economic Institutions of Capitalism* (1985). Williamson continually emphasised, to his credit, that people often acted with 'bounded rationality' (meaning that we have cognitive limits in solving complex problems) and he is therefore distinct from the hard line efficient market hypothesists. However, as discussed below Williamson does not recognise bargaining power as a market failure, and does not appear to acknowledge further potential constraints on rational choice in his theoretical models.

[3] D Eggen, 'Bush Warns of Aggressive Economic Regulation. On Wall St., He Defends Bailout' (14 November 2008) Washington Post. As discussed below this use of the term 'free market' is a misrepresentation of most deregulatory policies because one party usually ends up being much more 'free' than other. There is little doubt that markets are, generally speaking, efficient mechanisms for allocating resources and promoting productivity where people have relatively equal bargaining power, are sufficiently informed and capable of making good choices. This is what a truly 'free market' means, but the term is often used for something very different.

Stearns or Lehman Brothers.[4] As much as one might wish to never waste a good crisis, the connections were more remote. But one can say that labour policy made people more vulnerable when the crisis hit: income was more unequal and jobs were less secure.[5] It could also rightly be said that *any* institution which had been shaped *to any extent* according to economic models of rational choice was open to question. Behavioural economics has questioned these models, but what positive contributions can it make to labour law?

This article examines some of the most important experiments in behavioural economics that relate to the workplace and discusses their potential implications. First, from 2011 a group of *German nightclub card studies* on changing people's relative pay indicate that relative fairness in income affects people's motivation to work. Unfair pay demotivates, and this suggests that when inequality of bargaining power produces an unfair distribution of resources, it potentially damages productive efficiency. It means unequal bargaining power, which most labour laws act to mitigate, is a market failure. Second, from 2009 the *Madurai game studies* showed that when the stakes are very high, people tend to perform worse than they otherwise would in almost all tasks. This implies that when people's income is very insecure, as is often true with many 'performance related' pay structures, the effects are counterproductive. It also raises a question about whether increasing job insecurity (known as 'at-will employment' in the US, or 'flexicurity' in the EU) is counterproductive. Third, in one of the oldest forerunners of the behavioural economics method, the *Hawthorne experiments* from 1924, it was observed that people's productivity increased as they participated in decisions about their workplace. Also, a group of *Lego Bionicle studies* show that if people's work is acknowledged they are more motivated and productive. This indicates that labour policies that promote workplace participation, and foster a culture of mutual recognition, probably boost productivity.

The fourth area of work in behavioural economics, and possibly the best known, includes the *401(k) studies* from 2001 which showed that saving rates for occupational pensions can be dramatically improved when people are automatically enrolled, subject to a right to opt-out. The concept of 'switching the default' is hardly new in the law, because it is what all implied contract terms do. However, carrying the idea into many new fields of policy is proving to be a very valuable step. Part 2 ends by discussing the suggestion that with behavioural economics, a new philosophy of 'libertarian paternalism' can be developed. This is said to require that people can opt-out of almost all labour rights if they 'choose'. However, it seems this view has very little to do with behavioural economics and is more to do with a special political viewpoint that is ultimately unpersuasive in relation to any labour policy. It seems the need for a minimum floor of labour

[4] On the causes of the financial crisis, and its connection (or lack thereof) to labour or corporate law, see JC Coffee, 'What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis' (2009) 9(1) *Journal of Corporation Law Studies* 1 and B Cheffins, 'Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500' (2009) 65(1) *Business Lawyer* 1.

[5] E.g. RB Reich, *Aftershock: The Next Economy and America's Future* (2010).

rights will remain, and that behavioural economics instead highlights that need more than ever.

Part 3 concludes by asking, should behavioural economics be used to develop the law and labour policy? The answer given is a qualified 'yes'. Like with all empirical work, it is prudent to avoid using the latest test to justify a quick 'system 1' decision to overturn well established norms. Slow and careful thinking, however, will mean that behavioural economics can help make better labour law.

2. BEHAVIOURAL ECONOMICS AND LABOUR LAW

Before looking at behavioural experiments in detail, it makes sense to briefly outline the relationship that economics and labour law have had up to today. As one kind of social science, probably the main reason that economics could be useful to legal thought is if it helps predict the consequences of particular rules.[6] With good predictions, normative implications may be drawn about what is the right thing to do. One way to verify or falsify an economic theory is by conducting quantitative studies, which correlate data to see whether close relationships exist. Much of this was made possible by the organised collection of statistics by government, for instance after the Census Act 1800 in the UK,[7] or the Bureau of Labor Act 1884 in the US.[8] Potential relationships between the minimum wage and employment,[9] job security and innovation,[10] or long run macroeconomic performance and labour rights,[11] can be tracked. Quantitative studies and regression analysis cannot prove causation, but they can certainly be an important check on erroneous theories.[12] A second method is qualitative analysis, where

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[6] See generally M Friedman, 'The Methodology of Positive Economics' in M Friedman, *Essays in Positive Economics* (University of Chicago Press, 1953) ch 1, 4, 'the only relevant test of the validity of a hypothesis is comparison of its predictions with experience. The hypothesis is rejected if its predictions are contradicted ("frequently" or more often than predictions from an alternative hypothesis) […]'.

[7] One of the most important pieces of work to result from census data was C Booth, *Life and Labour of the People in London* (1889) vol I and (1891) vol II, mapping poverty in London.

[8] See also ILO Labour Statistics Convention (1985) C 160.

[9] E.g. DE Card and AB Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (1995) and S Machin and A Manning, 'Minimum Wages and Economic Outcomes in Europe' (1997) 41 *European Economic Review* 733, with very different results to Friedman (1953) 6.

[10] E.g. VV Acharya, RP Baghai and KV Subramanian, 'Labor Laws and Innovation' (2010) NBER Working Paper No. 16484. See also SK Bhaumik and R Dimova, 'Good and Bad Institutions: Is the Debate Over? Cross-Country Firm-Level Evidence from the Textile Industry' (2014) 38(1) *Cambridge Journal of Economics* 109-126.

[11] E.g. J Armour, S Deakin, P Lele and M Siems, 'How do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection' (2009) 57(3) *American Journal of Comparative Law* 579, with very different results, for example to JC Botero, S Djankov, R La Porta, F Lopez-de-Silanes and A Shleifer, 'The Regulation of Labor' (2004) 119(4) *Quarterly Journal of Economics* 1139.

[12] There is some suspicion of quantitative studies among lawyers, but this does at times seem excessive, e.g. M Lipton and PK Rowe, 'Inconvenient Truth about Corporate Governance: Some Thoughts on Vice-Chancellor Strine's Essay' (2007) 33(1) *Journal of Corporation Law* 63, 'It is inherently foolish to design

surveyors or interviewers would ask people why they thought they were doing what they did,[13] or what were their subjective assessments of how social institutions worked.[14] While quantitative studies tended to find more favour with theorists who were content to model their subjects as rational actors, those doing qualitative studies tended to view people as autonomous beings, capable of a complex but inevitably contextualised process of reasoning. A widely held view is that with different contexts there are multiple rational ways of behaving.[15] The difficulty was that such studies were susceptible to people giving different reasons compared to what might be their true motivations, not out of deception, but because of sub-conscious motives. Both quantitative and qualitative empirical work could approximate reasons for events, and outcomes in connection with labour laws, but this left room for empirical work of another kind.

Studies in experimental psychology represent a *tertium quid* in empirical methods of social science. Rather than correlating statistical data or interviewing, psychological experiments test how people react to particular changes to their environment. As this method's relevance for social science was appreciated, it created a new 'behavioural economics' and it has begun to have a profound theoretical influence. At the outset, it should be emphasised that behavioural economics appears to have fewer implications for large corporate parties contracting for the sale of goods in a commercial setting.[16] Here the standard economic textbook models of equilibrium and rational choice will often remain instructive and useful.[17] But in a way that appears to be paralleled in the law,[18]

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a corporate law structure based on the "findings" of academics, since their studies are contradictory and their positions change over time-as one would expect, since academics need an ever-changing mix of new "product" to aggrandize their professional status.'

[13] See generally, PM Cawthorne, 'Identity, Values and Method: Taking Interview Research Seriously in Political Economy' (2001) 1(1) *Qualitative Research* 65.

[14] E.g. T Schuller and J Hyman, 'Trust Law and Trustees: Employee Representation in Pension Schemes' (1983) 12 *Industrial Law Journal* 84, T Schuller and J Hyman, 'Pensions: The Voluntary Growth of Participation' (1983) 14(1) *Industrial Relations Journal* 70, and E Batstone, A Ferner and M Terry, *Unions on the Board: An Experiment in Industrial Democracy* (1983) ch 5.

[15] M Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness' (1985) 91(3) *American Journal of Sociology* 481. It does seem that economists themselves are not immune from contextualised thought processes. See RH Frank, T Gilovich and DT Regan, 'Does Studying Economics Inhibit Cooperation?' (1993) 7(2) *Journal of Economic Perspectives* 159.

[16] E.g. D Kahneman, *Thinking, Fast and Slow* (2011) 284 and 294, 'There is no loss aversion on either side of routine commercial exchanges.' Similarly, human motivation, below, plainly has less relevance to any kind of commercial contractual bargaining.

[17] It is noteworthy that the first graphs of supply and demand intersecting at an equilibrium were expressly said not to work, and not applied for labour markets, see F Jenkin, *The Graphic Representation of the Laws of Supply and Demand and Other Essays on Political Economy* (1887, 1996 edn Routledge) Jenkin's Part 1 used examples like the sale of wheat in graphing supply and demand, while Part 2, on 'Application of the Laws of Demand and Supply to the Special Problem of Wages' contained no similar graphs because Jenkin did not think that the same principles were applicable.

[18] In the law, a general presumption of 'freedom of contract' has since the 19th century slowly been giving way to multiple regulation in different contexts, particularly agreements about employment, tenancy, consumer and making small investments. Compare the statements in *Printing and Numerical Registering Co v Sampson* (1875) 19 Eq 462, per Lord Jessel MR, 'men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice' and *George Mitchell (Chesterhall) Ltd v Finney Lock Seeds Ltd* [1982] EWCA Civ 5, per Lord Denning MR, 'But the freedom was all on the side of the big

economics is developing different principles in markets involving non-commercial parties, such as markets involving consumers, residential tenants, or for employment.

Behavioural economics has undoubtedly spurred a large amount of new interest in economics generally, including among lawyers.[19] Part of the reason appears due to a realisation that law and economics, as the interdisciplinary field, did not need to be identical with the view of economic theory that its chief proponents represented. In 1984, in 'Some Economics of Labor Law', Richard Posner memorably wrote that,

> because labor law is (as we shall see) founded on a policy that is the opposite of the policies of competition and economic efficiency that most economists support, the field is unlikely to attract as a subject for teaching and scholarship, the lawyer who is deeply committed to economic analysis; it is likely to repel him. [20]

It would obviously be true that if the understanding of 'most economists' was that competition and economic efficiency required rejection of labour law, then discourse between labour lawyers and economists would be difficult. It would make economic theory very isolated and divorce it from modern society.[21]

But the understanding of efficiency that this school of law and economics represented was based on *all* people acting generally rationally, with only a few acknowledged, and tightly defined boundaries.[22] For instance, a list accepted by Posner included 'the availability heuristic, overoptimism, the sunk-cost fallacy, loss aversion, and framing effects'.[23] Moreover, there were very few acknowledged, and

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concern which had the use of the printing press. No freedom for the little man who took the ticket or order form or invoice.'

[19] For examples of behavioural economics at work areas other than labour law, see O Bar-Gill and E Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review* 1.

[20] RA Posner, 'Some Economics of Labor Law' (1984) 51(4) *University of Chicago Law Review* 988, 990.

[21] cf A Haferkamp, D Fetchenhauer, F Belschak and D Enste, 'Efficiency versus Fairness: The Evaluation of Labor Market Policies by Economists and Laypeople' (2009) 30 *Journal of Economic Psychology* 527, finding a disparity between economists' and non-economists' view of labour rights, and RH Frank, T Gilovich and DT Regan, 'Does Studying Economics Inhibit Cooperation?' (1993) 7(2) *Journal of Economic Perspectives* 159, finding that older economics students in Cornell were more likely to 'defect' than 'cooperate' in a prisoners' dilemma game at the end of their degree than at the start, while non-economics students were more likely to cooperate. This was attributed, at 170, to 'repeated and intensive exposure to a model whose unequivocal prediction is that people will defect whenever self-interest dictates.'

[22] E.g. OE Williamson, *The Economic Institutions of Capitalism* (1985) 40-41, defining bounded rationality as limits on cognitive capacity to solve complex problems. This, however, appears to be a much more restricted view of the matter than that favoured by H Simon, 'A Behavioral Model of Rational Choice' (1955) 69 *Quarterly Journal of Economics* 99.

[23] E.g. RA Posner, 'Rational Choice, Behavioral Economics and the Law' (1998) 50 *Stanford Law Review* 1551, 1553. Respectively these mean that (1) people bring recent 'available' experiences or information to mind first when making decisions (2) being more optimistic about prospects of personal success than may be warranted (3) the tendency for people to invest more in something they have invested in already on a sometimes irrational hope things might improve (e.g. "I've already been queuing for half an hour, so

tightly defined, categories of case that circumscribed people's capacity for action. In this respect, a typical list would include duress, fraud, infancy or insanity, or negative external effects on third parties.[24] The essential point is not what any particular scholar put on their personal list, but what was left off it. The fewer anomalies included on the acknowledged list, the fewer market failures. This would narrow the scope that this type of law and economics gave for justifying changes away from a general freedom of contract paradigm. Yet, it is increasingly apparent (if it was not always) that the stricter models of rational choice were not an inevitable, or even a majority interpretation of economic thought.[25]

The principal innovation of behavioural economics is to prove through testing that what is often supposed to be a rational choice model leads to mistaken predictions about efficient allocation and production of resources. In doing so, it creates an increasingly accurate positive theory of economics. With better understanding of choices people make, better predictions may be made.[26] The standard methodology of positive economics holds that 'the only relevant test of the validity of a hypothesis is comparison of its predictions with experience'.[27] So, accurate knowledge of behavioural responses, when built into positive understanding of how markets work (or fail), will make normative conclusions more informed. If one economic model predicts that there will be productively efficient outcomes, but another predicts there will be productively inefficient outcomes, we should prefer the model which makes predictions that square with experience. Behavioural economics brings this experience. It may turn out that some markets are shaped by rules that result in sub-optimal production. These will be classed as market failures,[28] and the normative implication will follow that legal rules should be changed to redress the failure.

Making predictions about what people will do, in order to identify market failures, is not a complete theoretical framework. A complete theoretical

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if I just stay a little longer […]) (4) that we are averse to losses more than we should be, and (5) that people are prone to respond differently to a problem depending on what information it is presented with.

[24] E.g. FH Easterbrook and DR Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416, 1434. Note that the authors accept a minimum wage policy only on the ground (potentially) that it would be serving a redistributive function as part of 'poverty law'.

[25] This set of views is consolidated in the bestselling volume by RA Posner, *Economic Analysis of Law* (2011).

[26] Posner (1998) 50 *Stanford Law Review* 1551, 1559-1560, appears to dismiss this possibility: 'it is profoundly unclear what "behavioural man" would do in any given situation […]. Describing, specifying and classifying the empirical failures of a theory is a valid and important scholarly activity. But it is not an alternative theory […].' The appropriate response would seem to be that rational choice models usually require an elaborate series of reasons to deduce what 'rational man' would hypothetically do in various situations. Examples of such elaborate explorations include RA Coase, 'The Problem of Social Cost' (1961) 3 *JLE* 1 and OE Williamson, *The Economic Institutions of Capitalism* (1985). Each prediction in such contexts is therefore open to adjustment according to more robust theories.

[27] M Friedman, 'The Methodology of Positive Economics' in M Friedman, *Essays in Positive Economics* (University of Chicago Press 1953) 8-9.

[28] For more on the concept in modern thought, see FM Bator, 'The Anatomy of Market Failure' (1958) 72(3) *Quarterly Journal of Economics* 351. For a prevalent mid-19th century view, and catalogue, see JS Mill, *Principles of Political Economy* (7th edn 1909) Book V, ch IX, §7 ff. For the catalogue that was originally formulated, see A Smith, *The Wealth of Nations* (1776) Book V, ch 1.

framework requires a normative theory with a defensible goal. In a democracy, a defensible goal is necessarily oriented toward the general good of society, and not some select group. It must be for the benefit of the many and not the few.[29] Economic theory typically takes its goal as greater economic growth, and efficient use of resources, and reminds us that this is a valuable thing because waste is immoral.[30] The reason why economic growth, and productive efficiency to that end, matters is because with more resources people in society (individually or collectively) acquire more property. But property only matters because it is one method for people to express and develop their personalities.[31] This is valuable because it furthers the aim of what has variously been spoken of as seeking, together with others, a better content of our 'character',[32] to bring forward everyone's 'capacity',[33] the 'utmost possible development of faculty in the individual human being',[34] or to ensure 'the opportunity to develop individuality becomes fully actualized'.[35] This kind of social justice can be measured only imperfectly, yet it is increasingly well done by the United Nations' inequality-adjusted Human Development Index.[36] Because economic productivity is a part of

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[29] Thucydides, *History of the Peloponnesian War* (ca 411 BC) Book 2, para 37, where Pericles said, 'Our government does not copy our neighbors, but is an example to them. It is true that we are called a democracy, for the administration is in the hands of the many and not of the few.'

[30] See R Posner, *Economic Analysis of Law* (2011) 37, 'A second meaning of justice, perhaps the most common, is – efficiency […]. Even the principle of unjust enrichment can be derived from the concept of efficiency […] And with a little reflection, it will come as no surprise that in a world of scarce resources waste should be regarded as immoral.' Arguably Posner has made the error (though possibly this was deliberate) of confusing a concept here (justice) with one of its conceptions (efficiency) and has moreover attempted to reinvent the idea of efficiency (the least wasteful method to achieve a goal) as a substantive end, when in fact it can be no more than a means to an end.

[31] See GWF Hegel, *Elements of the Philosophy of Right* (1820) §41.

[32] B Spinoza, *On the Improvement of the Understanding* (1677) §§13-14, 'man conceives a human character much more stable than his own, and sees that there is no reason why he should not himself acquire such a character […] This, then, is the end for which I strive, to attain to such a character myself, and to endeavor that many should attain to it with me. In other words, it is part of my happiness to lend a helping hand […]'.

[33] T Paine, *The Rights of Man* (1792) Part II, ch 3, 'There is existing in man, a mass of sense lying in a dormant state, and which, unless something excites it to action, will descend with him, in that condition, to the grave. As it is to the advantage of society that the whole of its faculties should be employed, the construction of government ought to be such as to bring forward, by a quiet and regular operation, all that extent of capacity which never fails to appear in revolutions.'

[34] S Webb and B Webb, *Industrial Democracy* (9th edn 1926) Part IV, ch 4, 847-849, 'We ourselves understand by the words "Liberty" or "Freedom," not any quantum of natural or inalienable rights, but such conditions of existence in the community as do, in practice, result in the utmost possible development of faculty in the individual human being […]. When the conditions of employment are deliberately regulated so as to secure adequate food, education, and leisure to every capable citizen, the great mass of the population will, for the first time, have any real chance of expanding in friendship and family affection, and of satisfying the instinct for knowledge or beauty. It is an even more unique attribute of democracy that it is always taking the mind of the individual off his own narrow interests and immediate concerns, and forcing him to give his thought and leisure, not to satisfying his own desires, but to considering the needs and desires of his fellows.'

[35] AA Berle, 'Property, Production and Revolution' (1965) 65(1) *Columbia Law Review* 1, 17.

[36] This human development index measures gross national income, with a deduction for inequality, life expectancy and years in education. See United Nations Development Programme, *Human Development Report 2010, 20th Anniversary Edition. The Real Wealth of Nations: Pathways to Human Development* (2010). As an accurate measure of 'human development' the HDI is itself still developing. For example, social

this larger social aim, economic considerations may have to concede to social ones, though the social must never concede to the economic.

Where does behavioural economics fit in? If it can help to make accurate predictions about how people work in markets, it can identify when markets fail or succeed to promote productive efficiency: a route to economic growth, human development and social justice. Some literature in behavioural economics and law has focused on general findings, like the 'endowment effect', 'fairness dynamic', 'optimism bias' and so on. Whether in or outside the workplace, from these findings jumps have been made to conclusions about what to do.[37] By contrast, what follows below is a discussion of specific behavioural experiments which relate to the workplace, and the direct implications they have for policies relating to the phenomenon that was being tested. Where the experimental evidence runs out, further directions for future research are alluded to. The four topics are (1) the relation between fairness in pay and conditions at work to productivity, (2) the relation between security of pay, and potentially job security, to productivity, (3) the relation between workplace participation and productivity, and (4) opting in or opting out of various workplace rights.

(1) Fairness and Productivity

One of the most important contributions that behavioural economics has made to social science relates to our understanding of human motivation at work. The motivation to work matters because it naturally affects the productive efficiency of people and the organisations they work in. The normative relevance this has is that if a first institutional arrangement tends to demotivate people, and leads to less productive outcomes compared to a second, the first may be classified as a market failure.

Probably the most important experiment in this respect was conducted by Alain Cohn, Ernst Fehr, Benedikt Hermann and Frédéric Schneider. This was an experiment 'in the field' as opposed to a laboratory. The criticism has been made that laboratory conditions can deviate from real life and so be capable of explaining less about the real world.[38] In fact, results in laboratories may both over- and under-illustrate the various contextual pressures that exist in the real world. Either way, experiments in the field can generally be taken to be even more conclusive. The test participants were temporary workers who got jobs for two

expenditure on security cameras, prisons, or nuclear weapons all still count as contributing gross national income, and the years spent in education have no manner for measuring the quality of thinking those years produce.

[37] E.g. CR Sunstein, 'Human Behavior and the Law of Work' (2001) 87(2) *Virginia Law Review* 205, and C Jolls, 'Fairness, Minimum Wage Law and Employee Benefits' (2002) 77 *NYU Law Review* 47. Both are discussed below at part 2(5).

[38] E.g. Posner (1998) 50 *Stanford Law Review* 1551, 1570.

weekends in two German towns.[39] These workers did not know they were part of an experiment, and worked in pairs, handing out cards to pedestrians on the High Street for entry into nightclubs and bars. They had to either sell the cards for €5 or would give out the cards for free in return for the customer's information. There were a total of 96 workers in 48 pairs, and they were subjected to three different treatments. A first group worked at a wage of €12 an hour. A second group were hired at €12 an hour, but then were told shortly into their first shift that both workers in the pair would be receiving a wage cut to €9 per hour. The third group, most importantly, were also hired at €12 an hour but were then told the following: 'Worker 1 continues to earn €12 per hour while worker 2 receives €9 instead of €12 per hour. This was the manager's decision.' Obviously, Worker 2 could do very little, except leave at this point. It was that or unemployment, and so they had very little bargaining power against 'the manager's decision'. The terms of the employment contract allowed for variation.[40] The productivity of the workers was measured both in terms of the number of cards distributed, and in the accuracy of the customer information that was recorded.

Among the second group, where wages were cut to €9 an hour, there was a 15 per cent drop in productivity for both workers in the pair, compared to workers in the first group who stayed on €12 an hour. In the third group, where only one participant's wage was cut, there was an overall drop of 34 per cent in productivity between the participants in the team. This was entirely due to the one team member whose wage was cut to €9. The average worker who remained with pay of €12 continued to work as normal. So, the effect of cutting one worker's wage was a greater productivity loss than if both workers' wages were cut. The conclusion of the *German nightclub card study* authors is that, not only absolute levels of pay matter for performance, but also relative pay matters. In short, people's motivation to work is affected by their perception of fairness of their pay relative to other people in their group.

This study has important implications for one of the central issues in labour law, because it shows the connection between motivation to work and fairness in pay: a direct consequence of the capacity that employees have to bargain with employers. Mainstream economic thought had, from Adam Smith onwards, recognised the relevance of inequality of bargaining power.[41] This means the

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[39] A Cohn, E Fehr, B Herrmann and F Schneider, 'Social Comparison in the Workplace: Evidence from a Field Experiment' (2011) IZA Discussion Paper No 5550; (2014) *Journal of the European Economic Association*, Forthcoming.

[40] Although the express terms of the contract allowed for the variation, the change in the experiment probably amounted to a breach of an implied term in employment contracts. In Germany, this is called 'Treu and Glauben' (see BGB §242) and is referred to as either 'good faith' or 'mutual trust and confidence' in the Commonwealth and the United States. In the UK, see *Transco plc v O'Brien* [2002] EWCA Civ 379.

[41] A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) Book I, ch 8, 'It is not, however, difficult to foresee which of the two parties must, upon all ordinary occasions, have the advantage in the dispute, and force the other into a compliance with their terms. The masters, being fewer in number, can combine much more easily; and the law, besides, authorises, or at least does not

weaker negotiating position people have when they hold relatively fewer resources, and so have fewer alternatives. Practically speaking, this is true in most cases when a person bargains with a corporation. However, in a radical departure from orthodox understanding, some strands of law and economics argued that inequality of bargaining power was either non-existent or irrelevant,[42] or that its relevance is only to affect distribution of income. It was said to have no impact on efficiency.[43] As Richard Epstein put it in 1984, bargaining power influences 'which side will appropriate most of the surplus in any negotiations' between the employer and employee.[44] When sharing the joint surplus, a workforce with more collective voice could take a larger share of the product than an individualised workforce would,[45] and otherwise the larger share is automatically appropriated by the employer.[46] But if 'efficiency is driving organizational outcomes,' wrote Oliver Williamson, 'modes that are efficient under one distribution of income will normally remain efficient under another'.[47] Distribution of income and wealth did not, it was said, affect whether contracts were concluded.[48] Rational actors will still

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prohibit their combinations, while it prohibits those of the workmen. We have no acts of parliament against combining to lower the price of work; but many against combining to raise it. In all such disputes the masters can hold out much longer. A landlord, a farmer, a master manufacturer, a merchant, though they did not employ a single workman, could generally live a year or two upon the stocks which they have already acquired. Many workmen could not subsist a week, few could subsist a month, and scarce any a year without employment. In the long run the workman may be as necessary to his master as his master is to him; but the necessity is not so immediate.'

[42] RA Posner, 'Reflections on Consumerism' (1973) 20 *University of Chicago Law School Record* 19, 24-25, 'The argument of "exploitation" based on "unequal bargaining power", however, lacks, so far as I can see, any economic basis.' OE Williamson, *The Economic Institutions of Capitalism* (1985) 237-258.

[43] RH Coase, 'The Problem of Social Cost' (1960) 3 *JLE* 1, 5, discussed below, probably triggered this line of thought by remarking, in the course of discussing a settlement in a tort dispute that 'an agreement would not affect the allocation of resources but would merely alter the distribution of income and wealth […].'

[44] RA Epstein, 'In Defense of the Contract at Will' (1984) 51(4) *University of Chicago Law Review* 947, 973-976.

[45] SJ Schwab, 'The Law and Economics Approach to Workplace Regulation' in BE Kaufman (ed) *Government Regulation of the Employment Relationship* (IRRA 1997) 'The law-and-economics position does not suggest that a properly limited concept of unequal bargaining power is meaningless. Indeed, relative bargaining power determines how the parties to a bargain will share the surplus from trade […]'. See also WS Jevons, *Theory of Political Economy* (3rd edn 1888) ch 4, §74, 'Any price between £900 and £1100 will leave a profit on each side, and both parties will lose if they do not come to terms. I conceive that such a transaction must be settled upon other than strictly economical grounds. The result of the bargain will greatly depend upon the comparative amount of knowledge of each other's positions and needs which either bargainer may possess or manage to obtain in the course of the transaction.' The view that 'both parties will lose' pays little attention to who may lose more.

[46] It is an implied term of employment contracts that the employer appropriates the benefits of labour. See, for example, *Stevenson, Jordan & Harrison v MacDonald & Evans* [1952] 1 TLR 101, copyright over lectures belonged to the employee because they were composed outside the course of employment, under the Copyright Act 1911 s 5(1). The same goes for all benefits of work, whether recognised as property or not.

[47] OE Williamson, *The Economic Institutions of Capitalism* (1985) 258.

[48] Epstein (1984) 51(4) *University of Chicago Law Review* 947, 976, 'The whole question of inequality of bargaining power arises in the bounded context of how much of a *supra*competitive wage the worker will obtain. At the very worst, the worker will get the amount that is offered in some alternate employment where he has built up no specific capital.' If one chooses to characterise the issue this way, note that Epstein neglects to mention the question also necessarily relates to how much of a supracompetitive income the employer receives in return for its contribution to the production process. Similarly, Schwab (1997) states 'The efficient result will occur regardless of bargaining power, unless transaction costs

pay enough to ensure that economically efficient activity takes place. So inequality of bargaining power was not in the limited categories of market failure.[49] Of course, it is true that every modern society views inequality of bargaining power a problem that labour law must correct. Law and economics theory contended, however, that things like the protection of collective bargaining,[50] the right to a minimum wage,[51] or upper-limits on working time,[52] must really be concerned with redistribution of wealth on non-economic grounds, and are probably driven by special interests whose motives diverge from the social good. There is no market failure to correct.

Is it true that labour law, when its focus is mitigating inequality of bargaining power, is concerned merely with distribution and not with economic efficiency? There are, of course, multiple reasons why specific labour rights can have positive efficiency consequences, and these have been extensively discussed before.[53] These discussions have concerned labour law's reduction of collective action problems, information asymmetries, transaction costs, improving aggregate demand, and mitigating monopsony.[54] Yet it also seems the *German night club card study* indicates why the central concern with inequality of bargaining power has important and positive consequences for productive efficiency in itself. If workers

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prevent the parties from making the deal […] strategic behavior, holdouts, or asymmetric information […] But unequal bargaining power is not a form of transaction costs that will prevent a joint-welfare-enhancing contract from being consummated.'

[49] See also FH Easterbrook and DR Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416, 1435, 'Questions of distribution among investors are unimportant because that just causes the price they pay for their stakes to change […] even the ignorant have an army of helpers. The stock market is one. Employees work at terms negotiated by unions (and nonunion employees can observe the terms offered at other firms, which supply much information).'

[50] E.g., in the United States, on collective bargaining, National Labor Relations Act 1935 §1, 'The inequality of bargaining power between employees who do not possess full freedom of association or actual liberty of contract, and employers who are organized in the corporate or other forms of ownership association substantially burdens and affects the flow of commerce, and tends to aggravate recurrent business depressions, by depressing wage rates and the purchasing power of wage earners in industry and by preventing the stabilization of competitive wage rates and working conditions within and between industries.'

[51] E.g., in the United Kingdom, on a claim for the minimum wage, *Autoclenz Ltd v Belcher* [2011] UKSC 41, [35], per Lord Clarke, 'the relative bargaining power of the parties must be taken into account in deciding whether the terms of any written agreement in truth represent what was agreed […] This may be described as a purposive approach to the problem. If so, I am content with that description.'

[52] E.g., in the European Union, on a claim for a maximum working week, *Pfeiffer v Deutsches Rotes Kreuz, Kreisverband Waldshut eV* (2005) C-397/01-403/01, 'the worker must be regarded as the weaker party to the employment contract and it is therefore necessary to prevent the employer being in a position to disregard the intentions of the other party to the contract or to impose on that party a restriction of his rights without him having expressly given his consent in that regard […]'.

[53] E.g. S Deakin and F Wilkinson, 'Labour law and economic theory: A reappraisal' in H Collins, P Davies and RW Rideout (eds.): *Legal regulation of the employment relation* (Kluwer 2000).

[54] On this, see A Manning, *Monopsony in motion: Imperfect competition in labor markets* (Princeton 2003). Manning's theory models how a monopsonistic labour market produces sub-optimal results, and contends that labour markets are always monopsonistic. Unpacking why labour markets fit into this model of monopsony, however, is a tricky issue that must be left for another time. It would seem that, as Manning suggests in chapter 1, it is a specific example of the general phenomenon of inequality of bargaining power.

as a group perceive themselves to be unfairly paid compared to their co-workers then the likely outcome is a drop in productive efficiency. Unfair wages in this context represent a market failure. Whenever inequality of bargaining power produces unfair distribution of rights in the workplace this represents a market failure, because it undermines the motivation to work. An additional benefit is that laws which promote equity in workplace income, particularly the minimum wage and collective participation to achieve a living wage, tend to stimulate effective aggregate demand.[55] With more production, there are more exchanges of goods and services taking place. None of this should come as a dramatic surprise for economic thought, because it is experimental confirmation of much of what John Maynard Keynes in 1935,[56] Alfred Marshall in 1890,[57] or Adam Smith in 1776,[58] had already realised.

It is important to see exactly how this differs from the assumptions made in prominent strands of law and economics. The motivation to work is affected by assignment of legal rights (like pay) whether or not we are in a hypothetical world without transaction costs.[59] Ronald Coase had made the contention in 'The Problem of Social Cost' that if there were no transaction costs, and so long as it was known who owned rights, economically efficient outcomes would always be reached through people trading their rights in a market. This was a radical break with mainstream economics at the time, which had indeed seen distribution and efficiency as interlinked. But as Coase put it, 'the ultimate result (which maximises the value of production) is independent of the legal position [i.e. distribution of legal rights] if the pricing system is assumed to work without cost'.[60] For illustration, Coase made specific reference to a number of cases, including *Sturges v Bridgman*,[61] where a doctor succeeded in claiming an injunction to prevent his neighbour, a confectioner from operating his machinery. Coase contended that whatever way the court decided, the use of the property could be traded to the person who wanted it the most without any detriment to economic efficiency if

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[55] MS Eccles, *Beckoning Frontiers: Public and Personal Recollections* (1951) 76-77.
[56] JM Keynes, *The General Theory of Employment, Interest and Money* (1935) ch 24.
[57] A Marshall, *Principles of Economics* (3rd edn 1895) Book VI, ch 4, 649, 'the effects of the laborer's disadvantage in bargaining are therefore cumulative in two ways. It lowers his wages; and, as we have seen, this lowers his efficiency as a worker, and thereby lowers the normal value of his labor. And in addition it diminishes his efficiency as a bargainer, and thus increases the chance that he will sell his labor for less than its normal value.'
[58] Smith (1776) Book I, ch 8, §43, 'The liberal reward of labour, as it encourages the propagation, so it increases the industry of the common people. The wages of labour are the encouragement of industry, which, like every other human quality, improves in proportion to the encouragement it receives.' And at §47, 'Nothing can be more absurd, however, than to imagine that men in general should work less when they work for themselves, than when they work for other people.'
[59] RH Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.
[60] (1960) 3 *Journal of Law and Economics* 1, 8, 'It is necessary to know whether the damaging business is liable or not for damage caused since without the establishment of this initial delimitation of rights there can be no market transactions to transfer and recombine them. But the ultimate result (which maximises the value of production) is independent of the legal position if the pricing system is assumed to work without cost.'
[61] (1879) LR 11 Ch D 852.

transaction costs did not exist.[62] Coase did not acknowledge bargaining power as any kind of impediment, which is a little curious given that the person who developed the transaction cost concept, John R Commons, knew about it all too well.[63]

Coase sometimes seems to have had 'allocative efficiency' foremost in mind when he wrote about efficient results, though he was also plainly concerned with productive efficiency.[64] In fact, a *Mugs and money study* was conducted in 1990 by Daniel Kahneman, Jack Knetsch and Richard Thaler to show that people would not trade rights to the point where the rights were most valued because (even in a world without transaction costs) we tend to overvalue, and hold onto, the things that we are 'endowed' with (or possess initially).[65] The 'endowment effect' meant that, to take just one example, in a study with 44 students at Cornell, who were randomly given mugs and money tokens, and then asked to trade, many more people chose to hold onto what they had, simply because they already had it. This already suggested that *allocative* efficiency cannot automatically be presumed in a transaction cost free world. Rights are not always traded to their most valued use.

But more than this, the night-club card case suggests why *productive* efficiency cannot be presumed either, whenever distribution of legal rights could affect the motivation to work. Suppose that the confectioner in *Sturges v Bridgman*, after losing an appeal against the injunction, bargained with the doctor to continue operating his machinery because it generated more profits overall. Suppose the doctor required that to continue operating the machinery, the confectioner would have to pay 99 per cent of all profits beyond a subsistence income, and suppose the confectioner had no better alternative. This would probably affect the confectioner's motivation to work, particularly as he saw his output being appropriated. Being aggrieved and demotivated would probably not even be irrational.[66] Could the doctor calculate what the precise deduction would be to

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[62] (1960) 3 Journal of Law and Economics 1, 15, 'In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed and so on.'

[63] JR Commons, 'Institutional Economics' (1931) 21 *American Economic Review* 648, on the original concept of transaction costs, and note JR Commons and JB Andrews, *Principles of Labor Legislation* (Harper 1916) ch 1, 9, 'where bargaining power on the one side is power to withhold access to physical property and the necessaries of life, and on the other side is only power to withhold labor by doing without those necessaries, then equality of rights may signify inequality of bargaining power. The gradual recognition of inequalities of waiting power has required changes to be made in the legal means of protecting equality, and these changes underlie the history of labor legislation.'

[64] (1960) 3 *Journal of Law and Economics* 1, 5, '[…] an agreement would not affect the allocation of resources but would merely alter the distribution of income and wealth as between the cattle-raiser and the farmer.'

[65] D Kahneman, J Knetsch and R Thaler, 'Experimental Tests of the Endowment Effect and the Coase Theorem' (1990) 98(6) *Journal of Political Economy* 1325.

[66] There is an analogy here to the 'ultimatum game' experiments. These are revealingly discussed by Posner (1998) 50 *Stanford Law Review* 1551, 1564, '"Why won't he take the penny?" For the same reason that I would not kiss Professor Sunstein's feet for $1,000. The offer of the penny would signal to the respondent the proposer's belief that the respondent holds a low supposal of his own worth, that he is

maximise the confectioner's effort? The answer appears to be 'no' in any situation where the confectioner reasonably thought that a penny of the doctor's enrichment would be unjust.[67] It might be true to say that the confectioner *should* ignore the unfairness, cut his losses, and work productively anyway, just as the workers whose pay was reduced to €9 might have done. Perhaps unfair distributions of legal rights *should* not affect productive efficiency. But to say that economic production is maximised *whatever* the initial distribution of legal rights (even in a world without transaction costs) is inaccurate. Fairness in distribution necessarily affects productive efficiency because it affects motivation. Thinking only about transaction costs simply leads to inaccurate predictions.

It is true, however, that a lack of motivation from unfair treatment, which can result from unequal bargaining power, might be mitigated in a number of ways. An employer could, for example, introduce a close system of productivity monitoring, coupled with sanctions for under-performance. The employer could spend money on organisational brand promotion to ensure that its workforce comes to identify more closely with their work, and to hold up morale. However, such strategies all come with costs, typically known in management science literature as 'agency costs'. Agency costs are often referred to as the costs of monitoring or bonding, and aim to align the interests of the 'agent' with those of the 'principal'.[68] When inequality of bargaining power produces unfair pay, and lower motivation, this inevitably affects productivity. But an employer will often have a private incentive not to correct the fairness in distribution of the company product, even though it produces a social cost. Instead, further social costs will be incurred as the employer over-invests in monitoring or bonding devices which attempt to mimic (but probably never match) the socially efficient solution.

It may be pointed out that the *German nightclub card study* concerned workers who, given their context, would have regarded themselves as being in similar situations. Would the outcomes differ if workers had grounds to believe they received an unfair share of the gains compared to people in dissimilar situations, such as management, or the shareholders of an organisation? There is not an

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grateful for scraps, that he accepts being ill-used, that he has no pride, no sense of honor. This weak-spirited creature is just the type who in a prepolitical, vengeance-based society would have been stamped on by his aggressive neighbors and, thus deprived of resources, have left few offspring.'

[67] To give just one numbered example, suppose the doctor can make up to £1000 pa in income, the confectioner up to £2000 pa, there are no alternatives, and each needs a minimum of £100 pa to survive. Suppose (1) the confectioner is not given an injunction, and the doctor cannot continue his practice. There will be £2000 pa in production. Or, suppose (2) the doctor wins the injunction. The doctor knows he can stop working now and make a large profit, if only he can find the right balance. Effectively the doctor is in a position to make the confectioner his employee. He could offer the confectioner any amount, except that the doctor will take some fraction. But whatever that fraction is (1% or 99%), the confectioner could rationally react by depriving them both of a gain. The total product is therefore likely to be less than £2000.

[68] The best known discussion is M Jensen and W Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305. While an employee is often seen as an employer's agent, it should be noted that an employer which appropriates the benefits of labour is also an agent on this understanding of the term.

experiment on this yet, but it would be surprising if there were no effect at all. It would seem that just as people can make comparisons between themselves and people who are in a similar position, they can also compare themselves with people in other positions (e.g. the company CEO) with some sense of proportionality.

There is one more main question raised by this experiment. Unfair wages diminish the productivity of the person who feels relatively undervalued, but could there be any effect on people who are substantially overvalued? Much of the modern agency cost literature, since Michael Jensen and William Meckling's work in 1976, has become concerned with the fact of agency costs existing, for instance when a director is not sufficiently accountable to shareholders and uses the opportunity to unjustly enrich himself or herself.[69] Yet in law and economics terms this might also be described as an issue 'merely' affecting distribution and not efficiency. Originally, however, the matter was indeed posed as a question of the damaging efficiency consequences, namely by AA Berle and Gardiner Means in *The Modern Corporation and Private Property*. Berle and Means pointed out that if they were unaccountable, company directors could 'serve their own pockets better by profiting at the expense of the company than by making profits for it'.[70] So overvaluation, unjust enrichment at the expense of others, was an economic efficiency issue, not simply a distributive issue, because it would lead to less productive effort by the person who was unjustly enriched.

The same line of reasoning would appear to fit with all cases where individuals or firms are capable of using their unequal bargaining power to extract excessive gains. This does concern work, but goes beyond labour law. This could include any contracting partner, including in consumer contracts,[71] residential tenancy agreements,[72] and contracts to buy shares or other financial products. An

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[69] The view that company directors had a tendency to do this goes back at least to A Smith, *The Wealth of Nations* (1776) Book V, ch 1, 'The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.' (Profusion, of course, is what is now called unjust enrichment in modern legal terminology.)

[70] AA Berle and GC Means, *The Modern Corporation and Private Property* (1932) 114, 'If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group. In the operation of the corporation the controlling group even if they own a large block of stock, can serve their own pockets better by profiting at the expense of the company than by making profits for it.'

[71] E.g. EU Unfair Terms in Consumer Contracts Directive 93/13/EC, recital 16, 'in making an assessment of good faith, particular regard shall be had to the strength of the bargaining positions of the parties […]'.

[72] E.g. *Attorney General of Canada v Nav Canada* (2008) FC 71, [19] Hugessen J of the Canadian Federal Court, 'Bearing in mind the usual disparity of bargaining power and financial resources between such tenants and their landlords, the Act is evidently intended to restore the balance of power through the public employment of a rental officer to try and mediate and, if necessary, to adjudicate disputes between them.'

empirical study regarding this hypothesis remains an interesting direction for future research. Yet the view of Berle and Means, not to mention the legislation which exists worldwide in those areas, would seem to be a natural extension of the idea that fairness of income positively affects productivity.

(2) SECURITY AND PRODUCTIVITY

A second issue, about which behavioural economics has interesting implications, concerns not just the distribution of rights at work, but the security of rights: particularly security of pay, and potentially job security. In the *Madurai game studies* designed by Dan Ariely, Uri Gneezy, George Loewenstein and Nina Mazar, a group of people were asked to play six different games and depending on their performance, they would get different rewards.[73] The experiment was conducted by a group of Masters students at Narayanan College, in Madurai, which is in Tamil Nadu, India. In total, 87 residents of the town took part. Each person played the six games, and at the start of each a dice was rolled to determine at random whether person would receive a 'low', 'medium' or 'high' reward for their performance. The high reward was set at 400 rupees per game, and so 2400 rupees was the maximum possible winnings, equivalent to around 5 months of the average per capita consumer expenditure of the locality.[74] The games required creative thinking, memory and motor skills of one kind or another, for instance, guiding a metal ball through a tiltable labyrinth which has holes in it that the ball should avoid.[75] They found that for all of the games, the participants who were told they could receive the high reward performed the worst.[76]

In a variation of the experiment, the same games were set up where participants were first given the maximum amount of money they could win, and were told it would be taken away again in proportion to how far their score fell below the highest possible. The idea here was to see if people performed differently if they felt they already had something which they could then lose. 'Loss aversion' is a well established phenomenon which means that changes which appear to make things worse loom larger in people's minds than changes which appear to be gains.[77] On average people prefer avoiding losses to making gains of the same magnitude by a factor of 2 to 1.[78] Unfortunately, as Dan Ariely later reported, the experiment could not be completed. The first test participant was given the money, performed poorly and then left the test room politely. The second participant, however, 'was so nervous that he shook the whole time and

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[73] D Ariely, U Gneezy, G Loewenstein and N Mazar, 'Large Stakes and Big Mistakes' (2009) 76 *Review of Economic Studies* 451.
[74] Ariely et al (2009) 76 *Review of Economic Studies* 451, 454.
[75] The six games were called 'Packing Quarters', 'Simon', 'Recall Last Three Digits', 'Labyrinth', 'Dart Ball', and 'Roll-Up'.
[76] Ariely et al (2009) 76 *Review of Economic Studies* 451, 458, and the graphs therein.
[77] D Kahneman, JL Knetsch and RH Thaler, 'Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias' (1991) 5(1) *Journal of Economic Perspectives* 193, 199.
[78] A Tversky and D Kahneman, 'Loss Aversion and Riskless Choice: A Reference Dependent Model' (1991) 106(4) *Quarterly Journal of Economics* 1039.

couldn't concentrate'. He then ran away with all of the money.[79] It was thus felt to be inappropriate to continue.

Why did the prospect of a large money payment negatively affect people's performance in the tests? 'Increased motivation,' wrote the authors,

> tends to narrow individuals' focus of attention on a variety of dimensions […] including the breadth of the solution set people consider. This can be detrimental for tasks that involve insight or creativity, since both require a kind of open-minded thinking that enables one to draw unusual connections between elements.

In fact, the authors had expected that on the games which required only memory skills, the higher payment would induce better performance, but even this prediction was proven to be unsound.[80] In a subsequent experiment with 24 MIT students, they found there was a statistically significant difference in performance between participants who did a task where they hit either the 'N' or the 'V' key on a keyboard, and those who did a task having to find numbers in a matrix that added up to ten.[81] This led to the conclusion that if work involves absolutely no thought, no creativity, no 'cognitive resources and effort', but instead 'requires only physical effort', then higher stakes can motivate better performance.

There are several important and immediate implications from this line of work, and several very interesting questions raised by it. First, the test was designed with the problem of bonus pay in mind. It had previously been thought, and prominently advocated in a large amount of law and economics literature, that it would be desirable to give company directors, senior managers, and perhaps all employees significant variable components in their pay. An old preconception was that if the incentives of people at work were aligned with shareholders, which took the residual profits in a firm, then people would become more productive.[82] From the late 1970s, the theory was promoted for company directors,[83] and then for employees generally according to their relative position within the firm.[84] This led to an increasing amount of pay coming in the form of share options, and discretionary bonuses that were notionally performance related. In the UK, the

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[79] D Ariely, *The Upside of Irrationality* (2011) ch 1, 33.
[80] Ariely et al (2009) 76 *Review of Economic Studies* 451, 458-9.
[81] Ariely et al (2009) 76 *Review of Economic Studies* 451, 460-46
[82] For a general discussion of some of the origins of this view, see E McGaughey, 'British codetermination and the Churchillian Circle' (2014) UCL Labour Rights Institute On-Line Working Papers – LRI WP 2/2014.
[83] Jensen and Meckling (1976) 3(4) Journal of Financial Economics 305, 328. See also, MC Jensen and KJ Murphy, 'Performance Pay and Top-Management Incentives (1990) 98(2) *Journal of Political Economy* 225.
[84] E Lazeer and S Rosen, 'Rank-Order Tournaments as Optimum Labor Contracts' (1981) 89(5) *Journal of Political Economy* 841.

theory was followed in government reports,[85] and the practice was written into the UK Corporate Governance Code.[86]

Importantly, people working in systemically important financial services could frequently expect the majority of their income to be 'performance' linked, and thus unsecure. But in practice people would develop a psychological expectation that they would receive their bonus. For example, in *Keen v Commerzbank AG* a proprietary trading employee argued that it would be unlawful for his employer to irrationally exercise its discretion to not award a bonus in 2005. Mr Keen had a salary of £120,000, but in the last two years had received €2.8m and €2.95m in bonuses. He argued that it was a reasonable expectation that he should not be deprived of his bonus, although this was precisely what his contract stated could be done.[87] The Court of Appeal rejected his claim, though other claimants in different situations have been successful.[88] The legal issue of whether the implied terms of a contract must follow the reasonable expectations of the parties, as they surely must,[89] is less important for this purpose than the actual psychological expectations of the parties. Structures which encourage very unsecure payment potentially encourage more conflicts (as *Keen* shows), worse performance, and greater risk taking. If people perceive something to be theirs already, then it may encourage cheating as people try to hold onto what they have got.

The theory that bonuses and performance related pay could be economically beneficial has not just been restricted to corporate boards and financial services. A tipping culture has become an increasingly important part of food catering work, many service industries have introduced discretionary or performance related elements to their work, and there has been a concerted attempt to promote employee share schemes. This is not to say that things like tipping, or employees buying stocks are *necessarily* bad, but laws which subsidise overindulgence in these practices are. That has happened with tipping, whenever pay from tips can be used to subsidise the employer's payment of the minimum wage,[90] and it has happened through tax advantages for employee share schemes.[91] All these measures make people's income less secure, particularly share schemes which fail the first rule that any prudent investor must follow: diversify. In doing so they lead to consequences opposed to what is desired. Going by the *Madurai game studies*, unless someone is

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[85] E.g. Higgs Review, *Review of the role and effectiveness of non executive directors* (2003) 56-8.
[86] UK Corporate Governance Code 2010 D.1.1 and Sch A.
[87] [2006] EWCA Civ 1536.
[88] Contrast *Clark v Nomura International plc* [2000] IRLR 766 and *Dresdner Kleinwort Ltd v Attrill* [2013] EWCA Civ 394.
[89] In the UK, see *Equitable Life Assurance Society v Hyman* [2000] UKHL 39.
[90] In the UK, this was true until an amendment in the National Minimum Wage Regulations 1999 (Amendment) Regulations 2009 (SI 2009/1902) reg 5. Before this see *Revenue and Customs Commissioners v Annabel's (Berkeley Square) Ltd* [2009] EWCA Civ 361. A challenge to the European Court of Human Rights, on the basis that employers' taking tips to pay the minimum wage, was found to be within a member state's margin of appreciation in *Nerva v United Kingdom* (2003) 36 EHRR 4. In the US, tips still form a large part of people's pay in most service industries because the Fair Labor Standards Act 1938 allowed for deviations, particularly since the Small Business Job Protection Act 1996.
[91] E.g., in the US, from the Employee Retirement Income Security Act 1974 §407(d)(6) and Internal Revenue Code §4975(e)(7).

doing a job which requires no cognitive effort, the impact of such practices (if any) will probably be negative. Even if someone's job does involve purely mechanical actions, merely treating a person like a motor in need of oil is morally suspect.

The outcomes (or non-outcomes) of the *Madurai game studies* when loss aversion was brought into the equation points toward an interesting question about job security. Would there be similar results if future tests looked at not simply high stakes in pay, but high stakes in keeping one's job? There should be little doubt that, when the decision is made by one's peers or an impartial judge, dismissal is a necessary final sanction for poor job performance and is necessary to respond to changes in economic demand. But if people work under a constant threat of dismissal, how does this affect their performance and productivity? One of the beliefs that supports labour market 'flexicurity' in Europe, or at-will employment in the United States, seems to be that if a trumped up authority figure can bark 'you're fired' when they like, staff will be encouraged to work properly. The reality may well be that the irrational threat of losing one's job has the same impact that any high stake has for productive output. In addition to important issues of justice and fairness,[92] it may damage rather than improve productivity.

(3) PARTICIPATION, SATISFACTION AND PRODUCTIVITY

A third major finding of behavioural studies sheds light on the importance of participation in workplace management and productivity. Shedding light on participation was not, however, the intended consequence of the original *Hawthorne experiments*, which were probably the first of their kind in the workplace. In 1924, an Australian researcher at Harvard Business School called Elton Mayo formulated an experiment with the employees at the Hawthorne Works of the Western Electric Company. Mayo's work competed with the studies (real or apparent[93]) carried out by Frederick W. Taylor in 1899, that later developed into the 'scientific management' movement.[94] Taylor had reported that he had been able to improve the productivity of workers who moved piles of pig iron to different places for the Bethlehem Steel Company by studying and then changing working patterns and break times, coupled with various monetary incentives.[95]

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[92] For a discussion of competing values, see H Collins, *Justice in Dismissal* (1992) ch 1, 13-23.

[93] CD Wrege and AG Perroni, 'Taylor's Pig-Tale: A Historical Analysis of Frederick W. Taylor's Pig-Iron Experiments' (1974) 17(1) *Academy of Management Journal* 6.

[94] The term 'scientific management' was in fact popularised by Louis Brandeis in his advocacy before the Interstate Commerce Commission in 1910, against the railways raising their fares against the consumer interest. The managements had blamed the need for fare rises on workers' wages rising, to which Brandeis replied that no rises were necessary, and if they could if they want inject a dose of 'scientific management' to improve productivity. This did not mean, of course, that Brandeis approved of the approach later developed by Taylor. His views on workplace participation were made clear in his calls for an industrial democracy in the hearings before the Commission on Industrial Relations, *Final Report and Testimony* (1916) vol 8, 7659-7660, LD Brandeis, *The Fundamental Cause of Industrial Unrest* (1916) 7672.

[95] FW Taylor, *The Principles of Scientific Management* (1911) ch 2. This short book is quite astonishing to the modern eye. For example, this exchange is recorded, apparently meaning to be humorous: 'Schmidt was

Taylor's approach was different because he viewed each worker he observed and manipulated as something like an 'intelligent gorilla', and so quite comparable with an animate but barely conscious object.[96] Mayo's studies, by contrast, intently recorded reactions, opinions and thoughts of the people in his experiments, although the goal of securing greater productivity was similar to Taylor's.

In the Hawthorne experiments, Mayo wished to substantiate a hypothesis that lighting intensity would affect workers' productivity. He borrowed five factory workers from Western Electric and brought them to an observation laboratory.[97] They would work as normal putting together telephone relays as Mayo's two research colleagues varied the lighting. Unfortunately, as the switches were changed there were no effects. It was then determined to examine the effects of varying rest breaks, lunches, and daily or weekly working times. The observers were instructed to observe, but not to interfere with the work, and simply make the workers feel comfortable so they could get on with the job. Presumably, Mayo wanted to try and avoid 'contaminating' the test environment. So the observers asked the workers when breaks would suit them, and things like what meals they would prefer. Otherwise they stayed out of the way. Again, productivity went up when breaks were introduced, when meals were given, and also when an hour was taken off the day. But even more curious, productivity continued to improve when these benefits were *removed*. Mayo generated a large amount of data and findings, which he later wrote up,[98] but he did not exactly get what he wanted.

The proper interpretation of the Hawthorne experiments became an important point of debate, and it has remained one of the most important experiments in psychology and the workplace. What came to be known as the 'Hawthorne effect' is still widely discussed today. This term appears to have first been coined by Herbert Simon, to mean at a great level of generality that 'the very act of observing people in organizations and making them the subject of study and experimentation may well change their attitudes and behavior'.[99] Quite what

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called out from among the gang of pig-iron handlers and talked to somewhat in this way: "Schmidt, are you a high-priced man? [...] I want to find out is whether you are a high-priced man or one of these cheap fellows here. What I want to find out is whether you want to earn $1.85 a day or whether you are satisfied with $1.15, just the same as all those cheap fellows are getting."
"Did I vant $1.85 a day? Vas dot a high-priced man? Vell, yes, I vas a high-priced man."
"Oh, you're aggravating me. Of course you want $1.85 a day every one wants it! You know perfectly well that that has very little to do with your being a high-priced man. For goodness' sake answer my questions, and don't waste any more of my time. Now come over here. You see that pile of pig iron?"
"Yes."
"You see that car?"
"Yes."
"Well, if you are a high-priced man, you will load that pig iron on that car to-morrow for $1.85. Now do wake up and answer my question. Tell me whether you are a high-priced man or not.'"

[96] Taylor (1911) ch 2, 'This work is so crude and elementary in its nature that the writer firmly believes that it would be possible to train an intelligent gorilla so as to become a more efficient pig-iron handler than any man can be.'

[97] For some general background, listen to C Hammond, *Mind Changers: The Hawthorne Effect* (11am, 3 August 2009) BBC Radio 4.

[98] E Mayo, *The Human Problems of an Industrial Civilization* (1933).

[99] HA Simon, 'Recent Advances in Organization Theory' in SK Bailey, *Research Frontiers in Politics and Government* (1955) ch 2, 28.

changes might result was left open, but the more important view was to follow. 'We now have,' said Simon,

> a considerable body of evidence to support the participation hypothesis—the hypothesis that significant changes in human behavior can be brought about rapidly only if the persons who are expected to change participate in deciding what the change shall be and how it shall be made.[100]

On this theme, in 1968, sociologist Philip Blumberg looked back at the archives Mayo left, and highlighted the one absolutely solid finding.[101] Workers in the test lab consistently outperformed those who stayed in the factory in productivity. Even stranger, the workers seemed happier at work, and began to socialise with each other more after their shifts. Among the interviews were several statements about how they were glad to escape the authoritarian managers back at the factory.[102] But Mayo's main objective was to show how workers can be made productive, so the employer can appropriate the gains.[103] Blumberg concluded this is why Mayo missed the same conclusion that Simon was drawing: that what was making the Hawthorne workers more productive was their new ability to participate in workplace decisions. Even when benefits were taken away, the act of joining people in the process of decision (because it was genuine) meant that the staff had a reason to want to work more effectively. Productivity only dropped as the experiments continued toward 1932, and involvement in workplace decisions dropped away.[104] Participation in the workplace improved productivity.

Law and economics literature has since sought to ignore or sideline the view that meaningful workplace participation (and not simply information and consultation) could lead to productive gains. For instance, Oliver Williamson sought to address Blumberg's claims, albeit indirectly,[105] by pointing to alternative papers. These papers showed, said Williamson, that there was 'serious doubt that efforts to effect participation can be justified on profitability grounds.' Moreover 'evidence relating job satisfaction to productivity,' said Williamson, 'discloses little or no association between the two'.[106] The difficulty is that the literature Williamson cited included Herbert Simon, who as we have just seen, did think there was evidence that participation improved productivity. The other literature he cited had referred to further sources, but when one follows the footnotes

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[100] Simon (1955) ch 2, 29.
[101] P Blumberg, *Industrial Democracy: The Sociology of Participation* (1968) chs 2 and 3.
[102] Blumberg (1968) ch 2, 25.
[103] See also E Mayo, *Teamwork and Labor Turnover in the Aircraft Industry of Southern California* (1944).
[104] Blumberg (1968) ch 3, 37-39.
[105] Williamson (1985) 269-270, cites S Bowles and H Gintis, *Schooling in Capitalist America: Educational Reform and the Contradictions of Economic Life* (1976) 79-80, for a quote from Blumberg saying that 'There is scarcely a study in the entire literature which fails to demonstrate that satisfaction is enhanced [...] or productivity increases from a genuine increase in workers' decision-making power [...]. The participative worker is an involved worker.'
[106] Williamson (1985) 270.

through, they refer to further sources. Williamson's views appear to be based more on a game of Chinese whispers than empirical validation.[107] If Williamson had attempted to address the findings of Blumberg, he might have been reached a different conclusion. If he had looked to chapter 5 of Blumberg's book, he would have seen a large catalogue of experiments up to 1968.[108] If he had aimed to refute the findings, it would have been necessary to conduct a study demonstrating participation in the workplace has no positive effect on productivity. But he did not.

A related point that Williamson raised is whether or not job satisfaction can improve productivity. Of course, job satisfaction is different to whether one participates in the workplace, but the Hawthorne experiments do indicate there is a connection. A recent test, included in a paper on the *Lego Bionicle studies*, by Dan Ariely, Emir Kamenica and Drazen Pralec also appears to prove it.[109] In the authors' first test, a group of students at the Massachusetts Institute of Technology were asked to find at least ten occurrences of two 's' together on sheets of paper with random letters printed on them. They would be paid 55 cents for the first sheet, and 5 cents less for each subsequent sheet. They could all stop working whenever they felt like it, so that the participant had to determine whether the diminishing return warranted the continued work. The participants' work was, however, handled in three different ways. In the first group, when the ten 'ss' were found, the participant was instructed to write their name on the paper, and the experiment observer would file the sheet in a folder. In the second group, the participant was not told to write down a name, and the observer simply put the sheet on the top of a big stack of papers. In the third group, the observer promptly put the sheet of paper through a shredding machine. Thus there were three conditions of being acknowledged, ignored, or seeing one's work immediately shredded. The result was that more participants kept working longer when their work was acknowledged. The acknowledged participants completed an average of 9.03 sheets, the ignored participants 6.77 sheets, and the participants

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[107] The literature Williamson cites is JG March and HA Simon, *Organizations* (Wiley 1958) 48, 50; V Vroom, *Work and Motivation* (Wiley 1964) 181-6; D Katz and R Kahn, *The Social Psychology of Organizations* (Wiley 1966) 373, and WE Gallagher and HJ Einhorn, 'Motivation Theory and Job Design' (1976) 49 *Journal of Business* 367, 371. Inexplicably, Williamson does not, however, refer to the work of the very person whose argument he has ostensibly refuted, P Blumberg, *Industrial Democracy: The Sociology of Participation* (1968). March and Simon do not actually discuss *any* experiments on the pages Williamson cites. Instead March and Simon refer to two further sources, MS Viteles, *Motivation and Morale in Industry* (1953) and AH Brayfield and WH Crockett, 'Employee Attitudes and Employee Performance' (1955) 52 *Psychological Bulletin* 396-424. There is nothing in here either, except further references to other literature, where the reader, one supposes may or may not find something. Gallagher and Einhorn refer back to Vroom's study, summarising: 'A review of 20 studies made by Vroom (between 1945 and 1963) showed that correlations between job satisfaction and performance criteria ranged from .86 to .31, with a median correlation of .14.2.' Gallagher and Einhorn speak of 'job-enrichment' programmes, defined at 360 as the workforce assuming 'some of the prior planning and evaluation/measurement aspects of his job', already a concept too limited. There does not appear to be a direct reference to evidence that can effectively be evaluated.

[108] Blumberg (1968) ch 5.

[109] D Ariely, E Kamenica and D Prelec, 'Man's Search for Meaning: The Case of Legos' (2008) 67 *Journal of Economic Behavior & Organization* 671-677.

whose work was shredded completed 6.34 sheets on average.[110] Interestingly, this meant people who were ignored were almost as unproductive as people whose work was shredded.

In Ariely, Kamenica and Pralec's second experiment, a group of test subjects (male students at Harvard University) were asked to assemble Lego figures called 'Bionicles'. The participants were paid $2 for the first one and then 11 cents less for the next one, and so on, until the participant was paid 2 cents for the twentieth Bionicle. At some point, each participant would find it ceased to be worth their time to continue building. The participants were, however, divided into two groups. The first group of 19 participants would build their Bionicles and the observer in the room would put the Bionicles to one side. But when the second group of 20 participants built their Bionicles, the observer would begin to dismantle the work that had just been done. The participant would have to rebuild Bionicles that had just been built and then dismantled. Every participant was paid on the same scale. When the Bionicles were not dismantled, the average number built was 10.6, and when they were dismantled, the average number built was 7.2. The result was that if people felt their work amounted to nothing, they would be demotivated and ultimately less productive.

The shredding and Lego experiments essentially show the same thing, which is important in itself. It seems certain that similar findings would simply be made again and again. It follows that Williamson's view that job satisfaction was unrelated to productivity was mistaken. These experiments prove it to be a psychological fact. People whose work is ignored, disparaged, discredited, shredded feel less motivated to keep working because they see that continued effort produces more harm than reward. There are many ways in which people at work could be acknowledged. Company managements can simply ensure that they foster a culture of recognition, and ensure that people in the organisation are not left behind. But arguably, one of the best guarantees that workers will be acknowledged is that their views are also acknowledged through a right to participate at the workplace. This implies participation through work councils, representation on the company board and collective bargaining by trade unions. In limited companies particularly, it seems that every year shareholders retain an undue influence over company boards, this will compound future losses in economic opportunity.

(4) Opting Out and Workplace Pensions

Probably the most well known, publicised and potentially successful policy change to have used insights from behavioural economics in recent years has concerned

[110] On the pay scale used, this also led to the result that if participants were either ignored or their work shredded, their average pay per sheet was higher (26.14 or 28.29 cents per sheet) than the participants whose work was acknowledged (14.85 cents).

changing default rules on pension enrolment. In the UK, the Labour government introduced the Pensions Act 2008 which required under section 3 that employers enrol all their 'jobholders' (employees and workers[111]) who are over the age of 22 into a basic defined contribution occupational pension. Jobholders can opt-out if they choose to file the appropriate forms with their employers.[112] The Conservative led coalition government did not cut the plan after the 2010 election and, though delayed for two years, from 2014 auto-enrolment began to be phased in. The inspiration for the policy came from two principles of human choice that had been acknowledged by economic theory for some time, but which behavioural economics had confirmed and then publicised.

First, people have a tendency to think more in the immediate rather than in the long term. Long ago, in *Principles of Political Economy* in 1848, John Stuart Mill had contended that while *laissez faire* was the best general principle, several large exceptions ought to be recognised.[113] The second of these exceptions was 'when an individual attempts to decide irrevocably now, what will be best for his interest at some future and distant time' because we tend to make better decisions when 'judgment is grounded on actual, and especially on present, personal experience'.[114] Mill was immediately concerned with contracts for a long term, or for perpetuity, and took the view that such contracts should not be enforced. However, the principle is applicable to pension savings, where younger people would not predict their future need and save, because the decision to not have saved would be irrevocable in later life.[115]

Second, people have a tendency to prefer the *status quo* to change. This was a familiar concept in the history of economic thought, at least until the stricter rational choice models were formulated.[116] A study confirming the 'status quo bias' in economic literature was conducted by William Samuelson and Richard Zeckhauser in 1988. The authors asked people in a survey to imagine they had just inherited some money from a great uncle, and where they would like to invest it between companies of medium risk, high risk, in treasury bills or municipal

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[111] There had been some contradictory case law on the concept, but since *Autoclenz Ltd v Belcher* [2011] UKSC 41, [35] the position is clear that 'the relative bargaining power of the parties must be taken into account in deciding whether the terms of any written agreement in truth represent what was agreed and the true agreement will often have to be gleaned from all the circumstances of the case, of which the written agreement is only a part. This may be described as a purposive approach to the problem.'

[112] Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010 (SI 2010/772) regs 9-11 and Schedule.

[113] Mill's interesting catalogue for when people are not the best judge of their own affairs includes (1) lack of capacity, (2) decisions that span the long term, (3) principal-agent problems, (4) collective action problems, (5) actions done for the benefit of other people. His reasoning may well surprise people who have become acquainted with the 20th century development of some of these concepts. See JS Mill, *Principles of Political Economy* (7th edn 1909) Book V, ch IX, §7 ff.

[114] Mill (1909) Book V, ch IX, §10.

[115] Mill probably had not turned a great deal of attention to the subject of old age quite simply because retirement at that point simply did not exist for the vast majority of people. See further L Hannah, *Inventing Retirement: The Development of Occupational Pensions in Britain* (CUP 1986).

[116] For a useful summary, see D Kahneman, JL Knetsch and RH Thaler, 'Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias' (1991) 5(1) *Journal of Economic Perspectives* 193, 198.

bonds.[117] Others were told they had inherited stocks in a medium risk company, and whether they would like to change. Although told there were no tax or brokerage charges, people ended up sticking with the *status quo* option. People often like to stick with what they are doing, even if that is nothing.

In 2001, Brigitte Madrian and Dennis Shea tested similar logic in a study of 401(k) pension plans. These plans, named after the United States' Internal Revenue Code §401(k), are 'defined contribution' or 'money purchase' saving schemes with no secure benefit,[118] on which tax is deferred till retirement. They are effectively individual saving accounts, and there is no federal obligation on an employer to contribute to or administer a 401(k). Nor is this pension vehicle a good deal from the employee's perspective compared, for example, to the TIAA-CREF framework or most collectively bargained multi-employer Taft-Hartley plans,[119] for a number of reasons.[120] Still, some saving is better than no saving, and Madrian and Shea were keen to see how participation could be improved. They studied the policy of a health insurance company, one of the 500 largest US companies in 1999, to automatically enrol its new staff in 401(k)s from 1 April 1998.[121] Before, employees could always choose to opt into the scheme. New employees opted in at a 49 per cent rate, though this went up with job tenure. The rate rose to 77 per cent for employees who had been in the firm for 5 to 10 years, and 83 per cent for employees with over 20 years of tenure. By contrast, with auto-enrolment and an opt-out right, an 86 per cent participation rate was achieved from the start.[122] This meant 34 per cent of staff members would not have lost years of saving before they realised the advantages and opted into the pension.

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[117] W Samuelson and R Zeckhauser, 'Status Quo Bias in Decision Making' (1988) 1 *Journal of Risk and Uncertainty* 7, 12.

[118] It is worth noting that 'defined benefit' plans also have 'defined' contributions, though they may vary as well. Another difficulty with the 'defined contribution' term is it obscures that the benefits are wholly undefined because the sums invested are not insured. This obscure terminology became widely adopted after the US Employee Retirement Income Security Act 1974 was enacted, and may have come from the practice in TIAA-CREF, see WC Greenough and FP King, 'Economic Status of the Profession-Retirement Plans' (1968) 54(4) *American Association of University Professors Bulletin* 413, 418-420.

[119] Ironically named after the provision of the Taft-Hartley Act, or the Labor Management Relations Act 1947 §302(c)(5)(B) (29 USC §186) which sought to restrict trade unions' ability to govern the investments of their members. By contrast, Commonwealth and European countries have sought to guarantee a voice for employees, not employers, in the management of pension schemes. In the UK, see the Pensions Act 2004 ss 241-243.

[120] First, and perversely, the more fortunate the saver is in living longer, the more likely the money in a 401(k) will run out. Second, investments are potentially far more risky with the same loopholes that became clear in the Enron catastrophe. Employees were encouraged to invest an average of 62.5 per cent of their retirement savings into Enron shares, which was mostly lost. See PJ Purcell, 'The Enron Bankruptcy and Employer Stock in Retirement Plans' (11 March 2002) CRS Report for Congress, and JH Langbein, SJ Stabile and BA Wolk, *Pension and Employee Benefit Law* (4th edn Foundation 2006) 640-641. Third, the employee often has no effective voice in the way the money is used in corporate governance once invested in companies. See JS Taub, 'Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights' (2009) 34(3) *The Journal of Corporation Law* 843.

[121] BC Madrian and DF Shea, 'The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior' (2001) 116(4) *Quarterly Journal of Economics* 1149, 1151.

[122] Madrian and Shea (2001) 116(4) *Quarterly Journal of Economics* 1149, 1158

From a rational economic choice perspective, Madrian and Shea's findings should not have transpired because a rational person would presumably calculate the positive utility of tax deferred retirement savings immediately rather than having it slowly dawn on them years into a job.[123] The same results were found in a later similar study by Richard Thaler and Shlomo Benartzi,[124] and in the US this contributed to §902 of the Pension Protection Act 2006. This expressly provided that employers could automatically enrol their employees in 401(k) plans, and banned states from banning automatic enrolment. It also allowed employers to automatically qualify for tax exemption on pension savings even if the proportion of pension money went disproportionately to high paid executives and management.[125]

Admittedly, this legal change was a little strange given that employers could auto-enrol staff if they chose (as had *always* been common under many collectively bargained pension plans), and that states were not exactly queuing up to stop it. By itself, telling employers they could voluntarily automatically enrol staff in pensions, with another little tax break for those on high pay, would not make a huge dent in retirement saving figures overall.[126] Nevertheless, a discussion had been encouraged, and in the UK the Pensions Commission in 2004 and the Department for Work and Pensions in 2006 incorporated the ideas into proposals for a right of jobholders to a basic pension.[127] This differed from the voluntaristic tone of the 2006 Act in the US, because under the Pensions Act 2008 the jobholder had the right to the employer's administration of the plan. The employer's role was made substantially easier by a public option fund manager set up at the same time, the National Employment Savings Trust (NEST). The UK system does not require employers to match contributions, and the jobholder can opt-out altogether. However, the contrast between the two auto-enrolment laws was stark: one allowed employers to opt to give their employees a choice, the other required employers put the choice in the employee's hands.

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[123] Madrian and Shea (2001) 116(4) *Quarterly Journal of Economics* 1149, 1176-1177.

[124] R Thaler and S Benartzi, 'Save More Tomorrow: Using Behavioral Economics to Increase Employee Savings' (2004) 112(1) *Journal of Political Economy* 164.

[125] This was in place since Revenue Act 1942 §165(a). See LL Rice, 'Employee Trusts under the Revenue Act of 1942' (1942) 20 *Taxes* 721.

[126] For current figures, see OECD, *Pensions at a Glance 2013: OECD and G20 Indicators* (2013) ch 8, 189. This shows the US as having a rate of 47.1% private pension coverage, which compares favourably to the UK level of 43.3%. Once auto-enrolment takes effect in the UK, however, this will change dramatically. Note that Germany's rate stands at 71.3%, and on top of this Germany has an income linked state pension.

[127] Department for Work and Pensions, *Security in Retirement: Towards a New Pension System* (May 2006) Cm 6841, ch 1, 63, fn 36. Pensions Commission, *Pensions: Challenges and Choices. The First Report of the Pensions Commission* (2004) 207-211. One should note, however, the overstatement in the view on page 207 that a 'free market voluntarist approach to pension savings would work if individuals made rational choices based on good understanding of attractive incentives to save'. This neglects the unequal bargaining power of an employee against the employer to get sufficient wages to save for a decent and dignified retirement, no matter how rational they are.

(5) OPTING OUT AND PATERNALISM

It seems reasonable to predict that auto-enrolment will be successful in the UK, but that less will happen in the US where there is no requirement on employers to begin auto-enrolling staff in a pension. Choice for employers and avoiding 'paternalism' was, however, important for some of auto-enrolment's most prominent proponents, and this goes to the heart of what behavioural economics might become in the future. Richard Thaler and Cass Sunstein wrote in their popular book *Nudge: Improving Decisions about Health, Wealth, and Happiness* that behavioural economics makes possible a middle way between conservative and liberal political philosophy. Default rules may be set according to what society deems desirable, but individuals may be allowed to 'opt out' if they choose. This 'libertarian paternalism' was supposedly not like old style coercive laws, found from the New Deal onwards, if there is an opt-out possibility.[128]

One of the strongest points that Thaler and Sunstein make is that when all people (employers and employees alike) are free to choose, the legal system often induces welfare-reducing choices, particularly when it presents 'do nothing' as the status quo.[129] But Thaler and Sunstein go further, because they advocate more general avoidance of compulsory rules, which they call 'one size fits all' regulation. In other writings the authors do favour a mandatory floor of labour rights to some extent,[130] but this standard appears low. For instance, compulsory National Insurance, and taxation for Social Security is seen as coercive, and they would allow people to 'opt-out'.[131] The concept of 'nudge' or 'choice architecture' is about what to do once it is decided that there is no market failure to warrant changes of mandatory rules, and this seems to be most of the time. They envisage a three tier regulatory system: a first and very small tier of mandatory rules, a second where default rules apply, and a third where there is no particular regulation at all.

What does justify a minimum set of mandatory rules? For Sunstein, the answer appears centred on negative external effects on third parties.[132] This stops short of recognising how evidence from behavioural economics gives a strong indication for why inequality of bargaining power was a market failure,[133] and so

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[128] R Thaler and C Sunstein, *Nudge: Improving Decisions about Health, Wealth and Happiness* (2008) 6. For scepticism of the libertarian paternalist characterisation see O Amir and O Lobel, 'Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy' (2008) 108(8) *Columbia Law Review* 2098, 2117 ff.

[129] Thaler and Sunstein (2008) 19-22.

[130] CR Sunstein, 'Human Behavior and the Law of Work' (2001) 87(2) *Virginia Law Review* 205, 207-208.

[131] E.g. Thaler and Sunstein (2008) ch 9, 'Privatizing Social Security: Smorgasbord Style', albeit a preference is not explicit.

[132] It is unclear whether considerations of fairness, justice or human dignity are for Sunstein independently valuable reasons for regulation. The assumption appears to be that they could be, though there is a necessary trade off between fairness and efficiency.

[133] Sunstein (2001) 87(2) *Virginia Law Review* 205, 237, equates inequality of bargaining power with a desire for redistribution in the same was as many people working at the University of Chicago had. 'But

an occasion for improved labour rights in the same way that Adam Smith or John Stuart Mill would have thought. It led to some surprising conclusions. In a thought provoking article, Sunstein wrote that most labour laws should be subject to an opt-out, except potentially some core health and safety laws.[134] If workers 'wanted' to, why not let them give up of the right to a fair dismissal (to the extent it exists)?[135] If workers 'chose', why not let them waive the right to not be discriminated against on grounds of age?[136] Why not permit contracting out of the right to paid holidays, or parental leave? Even more, why not let workers opt out of the right to join a union, or the right to have no labour organisation dominated by an employer? And, as Christine Jolls has suggested, why not introduce an opt-out from the minimum wage?[137]

The answer to all of these ideas would seem to be that an opt-out would amount to the abolition of the right, and a minimum floor of rights which rectify inequality of bargaining power promote economic productivity: a route to human development. Erasing inequality of bargaining power between employers, often organised as corporations, and workers, who enter the workplace as isolated individuals, has always been the role of labour law. It will continue to be so long as organisations and individuals meet each other through the channel of contract. From an American perspective, permitting an opt out from the right to join a trade union (to sign a 'yellow dog' contract), or allowing company unions is one of the most troubling proposals because that was the *Lochner* era position, in the run up to the Wall Street Crash.[138] This proposal also seems very different to the lesson that experience with automatic pension enrolment, subject to an opt-out, teaches. An accurate analogy between trade unions and pensions would indicate that it is desirable to encourage trade unions to sign collective agreements with employers to automatically enrol new workers in the trade union. If an opt out were always allowed, this would sidestep the prohibitions on the closed shop introduced by US states under the Taft-Hartley Act 1947 §14(b),[139] and which

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the redistributive argument nonetheless stands on fragile ground-not because the existing distribution of entitlements and resources is good, but because blocking the exchange, through a nonwaivable right to job security, is not the best way to produce the desired redistribution.' The reply is simply that compulsory minimum terms do not 'block exchange', but rather promote productive efficiency so that there is more to exchange. When done appropriately this promotes effective aggregate demand, and with it economic growth.

[134] Sunstein (2001) 87(2) *Virginia Law Review* 205, 248-249.

[135] cf JR Ward, 'The endowment effect and the empirical case for changing the default employment contract from termination "at will" to "for cause" discharge' (2004) 28 *Law and Psychology Review* 205. It is worth noting that in the UK and the Commonwealth, it appears quite possible that the default already has changed. See *Johnson v Unisys Ltd* [2001] UKHL 13 and *Reda v Flag Ltd* [2002] UKPC 38. It is doubtful that this could be contracted out of where the parties have very unequal bargaining power.

[136] cf LH Krieger and ST Fiske, 'Behavioral Realism in Employment Discrimination Law: Implicit Bias and Disparate Treatment' (2006) 94 *California Law Review* 997.

[137] C Jolls, 'Fairness, Minimum Wage Law and Employee Benefits' (2002) 77 *NYU Law Review* 47.

[138] See *Adair v United States*, 208 US 161 (1908) and *Coppage v Kansas*, 236 US 1 (1915) and note the dissenting judgments of Holmes J.

[139] See A Cox, DC Bok, RA Gorman and MW Finkin, *Labor Law: Cases and Materials* (14th edn 2006) 1193 ff. Twelve states introduced what proponents called 'right to work' laws and opponents called 'right to work for less' laws between 1944 and 1947, and the ability of states to do this was protected by the Taft-Hartley Act 1947 §14(b).

came into the case law of the European Convention on Human Rights, article 11.[140] Changing this default rule would have the benefit of giving many more people a voice at their workplace.

The right to join a trade union and take collective action, of course, has importance beyond efficiency or fairness, and touches the foundations of political democracy. It has been argued that the National Labor Relations Act 1935 §8(a)(2), which was designed to ban company unions, prevents the establishment of work councils that are freely elected by the workforce. This, however, is simply a mistaken description of the relevant law,[141] because *any* institution in an American enterprise can be elected by the workforce (including seats on the board of directors[142]) so long as it is not an employer dominated substitute for collective bargaining.[143] All too often it seems that the desire to repeal or amend the New Deal labor rights is not motivated by a desire to increase genuine employee participation, but to privatise trade unions, and to ensure democracy at work is 'managed'. Every undemocratic regime must necessarily co-opt organised labour or suppres freedom of association,[144] and the moment those rights are dissipated marks the decline of democratic politics.

Sunstein's conclusions about opting out from labour law seem less to do with behavioural economics, rather than a particular conception of freedom and coercion. On this view, a compulsory right for one party in a contract, and a duty on another, is coercive because it restricts people's choices. In *The Second Bill of Rights,* Sunstein discussed a particular phrase from President Franklin D. Roosevelt's 1944 State of the Union address, which advocated legislation for social and economic rights.[145] In doing so, Roosevelt reminded his audience that

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[140] E.g. *Young, James and Webster v United Kingdom* (1981) 4 EHRR 38.

[141] See *Electromation, Inc*, 309 NLRB 990 (1992) enforced in 35 F3d 1148 (7th Cir 1994) discussed in A Cox, DC Bok, RA Gorman and MW Finkin, *Labor Law: Cases and Materials* (14th edn 2006) 201-218.

[142] E.g. Massachusetts Laws, General Laws, Part I Administration of the Government, Title XII Corporations, ch 156 Business Corporations, §23, and RB McKersie, 'Union-Nominated Directors: A New Voice in Corporate Governance' (1 April 1999) MIT Working Paper. Employees could secure representatives on corporate boards through a collective agreement, or it could be achieved through state law.

[143] An interesting historical precedent of legislation for work councils, available in English, was co-authored by American occupational forces in post-war Germany. See Control Council Law No 22 (10 April 1946) Works Councils, in *Official Gazette of the Control Council for Germany* (1945-1946) available on wikisource.org. An American work council following such a constitution could never be considered employer dominated.

[144] E.g. E McGaughey, 'The Codetermination Bargains: German Corporate Governance and Labour' (2014) Forthcoming.

[145] Franklin D. Roosevelt, *State of the Union Address* (11 January 1944) 'Among these are: The right to a useful and remunerative job in the industries or shops or farms or mines of the nation; The right to earn enough to provide adequate food and clothing and recreation; The right of every farmer to raise and sell his products at a return which will give him and his family a decent living; The right of every businessman, large and small, to trade in an atmosphere of freedom from unfair competition and domination by monopolies at home or abroad; The right of every family to a decent home; The right to adequate medical care and the opportunity to achieve and enjoy good health; The right to adequate protection from the economic fears of old age, sickness, accident, and unemployment; The right to a good education.'

'necessitous men are not free men'. 'What does this mean?' asked Sunstein. Sunstein did not appear to agree that a minimum standard in a contract might expand freedom, because in his view (even if one party has no real choice) it is necessarily restrictive.[146] But the issue becomes clearer when one looks to the original source, a case called *Vernon v Bethell* from 1762. It held that a lender cannot convert a mortgage into a conveyance of the property, so if the borrower can pay, he or she must always retain the 'equity' to redeem the property. In effect it was a primitive, but compulsory, consumer financial protection law. Lord Henley LC said more fully,

> there is great reason and justice in this rule, for necessitous men are not, truly speaking, free men, but, to answer a present exigency, will submit to any terms that the crafty may impose upon them.[147]

It is one thing, in other words, to prevent people doing something on the ground that it is protecting them from themselves. Here society might appropriately draw looser limits, and allow people to make more mistakes. But it is an entirely different thing to prevent someone making a contract with terms that are very unfair, when one party (the 'crafty') stands to profit from it, and when the other party has no bargaining power, needs a job, a home or the necessaries of life. It is right for the law to forestall unjust enrichment, and this is justified, among other things, on grounds of efficiency.[148] Again, the contention that compulsory terms prevent more contracts being made is mistaken, because fairer terms promote productivity, this leads to growth, and so more bargains take place. But more fundamentally, trade is a social act.[149] Contracts rest on a system of enforcement funded by society, and so it is legitimate for society to choose which contracts it wishes to enforce, and to require fairness in their terms. The real coercion would be to require society pay for the enforcement of deals among private parties that were unfair.

The argument for being able to opt out of nearly all compulsory rules in labour law is unpersuasive. Roosevelt may have gone even further and regarded it as dangerous: 'the stuff of which dictatorships are made', that 'yielded to the spirit

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[146] CR Sunstein, *The Second Bill of Rights: FDR's Unfinished Revolution--And Why We Need It More Than Ever* (2004) 90-91.

[147] *Vernon v Bethell* (1762) 28 ER 838, per Lord Henley LC. Sunstein mentions this in a footnote, but arguably does not take into account its full implications.

[148] cf Posner (2011) 31.

[149] JS Mill, *On Liberty* (1859) Chapter V, para 4. Reading more articles, especially, CR Sunstein, 'The Storrs Lectures: Behavioral Economics and Paternalism' (2013) 122 *Yale LJ* 1826, it seems this point, which is central to Mill's work, may have been missed. However this is often true for people who refer to Mill, e.g. RA Epstein, *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (1998) ch 3, 79, 'The Millian ethos assumes that people know their own minds and interests better than anyone else does, and thus should be allowed – indeed, encouraged – to follow their own inclinations unless they do harm to other persons.' This is an exaggerated summary. Mill would have rejected the sort of proposals made by both authors. See JS Mill, *Principles of Political Economy* (1909) Book V, ch 9.

of Fascism'.[150] But this leaves the question, why should any labour rights that society thinks are beneficial be default instead of compulsory? Why, for example, should the right to be auto-enrolled in a pension give a chance for an opt-out at all? There are a number of other labour law rights where the same could be asked. Most notable is the opt-out in some EU member states from the 48 hour working week.[151] Also, since 2013, the UK introduced (against the advice of *both* the Confederation of British Industry and the Trades Union Congress but at the insistence of the Treasurer George Osborne) an opt-out of the right to a fair dismissal, and other rights that are not regulated by EU law, in return for shares in one's company.[152] The same goes in other areas of law: the UK Corporate Governance Code requires, for example, compliance with the rule that the company chief executives and chairpersons should be different people, and that a minimum number of directors are independent, unless the company explains why it chooses not to follow.[153] All UK company rules are bound by the Model Articles, a template constitution, unless the company choses its own particular and different rules.[154] Sometimes default rules are continually changed, which indicates a compulsory regulatory approach could be needed. For example, from 1856, the model company constitution provided that a company's members (usually shareholders) set the pay of company directors.[155] But particularly from the 1980s companies continually changed their constitutions so that directors set their own pay.[156] Because of the large super-inflationary pay rises that company executives have been giving themselves, regulation worldwide has slowly been turning the practice back.[157] In fact, in commerce all contract terms implied by the courts,[158]

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[150] Franklin D. Roosevelt, *State of the Union Address* (11 January 1944).
[151] Working Time Directive 2003/88/EC.
[152] J Prassl, 'Employee Shareholder 'Status': Dismantling the Contract of Employment' (2013) 42(4) *ILJ* 307, noting at 337 that there had at the time been under 10 inquiries of interest by business.
[153] UK Corporate Governance Code (2012) 4-5.
[154] Companies Act 2006 s 20.
[155] See the Companies Act 1862, Table A, art 64.
[156] The general practice was eventually reflected after the Companies Act 2006, where remarkably the new Model Articles were written to read, under art 23(1), 'Directors are entitled to such remuneration as the directors determine [...]'.
[157] To take a few examples, in the UK, a new Companies Act 2006 s 439A was introduced so that company members have a binding vote on directors' pay policy, although not yet the specific figure. In Australia, see Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011, which triggers board elections if over 25% of shareholders oppose director pay. In Switzerland, see the Eidgenössische Volksinitiative «gegen die Abzockerei» of 2013, which required director remuneration committees to be elected by shareholders, that banks could no longer vote, and that pension funds had to exercise their votes. In the US, the Wall Street Reform and Consumer Protection Act §951, which allows for companies to have a non-binding say on pay.
[158] *Malik and Mahmud v Bank of Credit and Commerce International SA* [1997] UKHL 23, per Lord Steyn, 'Such implied terms operate as default rules. The parties are free to exclude or modify them.' In employment contracts, however, as opposed to commercial contracts, this freedom must be genuine, so that arguably if one party is in a much weaker bargaining position, the implied term cannot be opted out of. Such a term would be properly regarded in the UK as a sham, see *Autoclenz Ltd v Belcher* [2011] UKSC 41, at [35].

the whole law of tort,[159] and unjust enrichment, function as default rules, which private actors are formally free to opt out of. What justifies having some rules which private parties can ignore if they choose? Why set defaults?

The easiest answer is that default rules can save on transaction costs, by anticipating what most parties could and should reasonably expect in standardised types of bargains. If people are bias toward the *status quo*, default rules in the right place correct a significant market failure because it saves on transaction costs. But also, a default acknowledges that private parties may legitimately want something else. In modern UK history, there was a continual struggle over whether people could opt out, or had to opt in to the political fund of their trade union. An opt-out was always allowed, because presumably political endorsement was so important that people should always control how their money was spent (a luxury not, it seems, enjoyed by shareholders of many corporations).[160] By contrast it is very doubtful that all the default rules listed above should be default only, and not compulsory, particularly where they create minimum standards. A minimum standard does not mean 'one size fits all', because by nature there are many 'sizes' beyond the minimum. However, in other cases (perhaps the right to an occupational pension beyond the minimum state pension? Probably the separation of the CEO and company chair?) an opt out is legitimate because universal rules do not always do justice in varied contexts.[161]

What other areas of labour law might benefit from thinking more about default rules? If one compares employment to companies, there is a notable absence of a well written template contract of employment, or indeed a model union constitution. Courts imply many terms in employment contracts and also union rule books, and so a codified template contract could promote understanding and best practice. As with companies legislation, the parties would be free to agree to their own rules so long as the minimum rights were complied with. A 'nudge' would be a complement for compulsory minimum standards, but not a substitute because 'occasionally a good shove advances individual and social welfare considerably more'.[162] The remarkable breadth of examples Thaler and Sunstein have found for innovative ideas is to be commended, as is the discussion their work has begun. But it cannot simultaneously be a pretext for abolishing basic labour or human rights: this would be much more about a political belief

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[159] *Henderson v Merrett Syndicates Ltd* [1994] UKHL 5, per Lord Goff, 'the law of tort is the general law, out of which the parties can, if they wish, contract'.

[160] See *Osborne v Amalgamated Society of Railway Servants* [1911] 1 Ch 540 (trade union political fund held *ultra vires*), Trade Union Act 1913 (legalised political fund again, and members could opt out), Trade Disputes and Trade Unions Act 1927 (required members to opt in), Trade Disputes and Trade Unions Act 1946 (let trade unions have an opt out system again), and finally the Trade Union Act 1984, now in the Trade Union and Labour Relations (Consolidation) Act 1992 ss 71-91 (retaining the opt out system, but placing a series of procedural hurdles for the trade union to retain a political fund).

[161] A point usefully made by Aristotle, *Nicomachen Ethics* (circa 350 BC) Book V, part 10, 'this is the nature of the equitable, a correction of law where it is defective owing to its universality [...]'.

[162] G Loewenstein, DA Asch, JY Friedman, LA Melichar and KG Volpp, 'Can Behavioural Economics Make Us Healthier?' (23 May 2012) BMJ 2.

than sound economic understanding. The trouble is Sunstein and Thaler do see themselves as following through the implications of behavioural economics. If very different conclusions can be drawn from empirical work in behavioural economics, to what extent should it influence decisions about the law?

3. PRINCIPLES AND CONCLUSIONS

Part 2 has shown at least four ways that behavioural economics has important implications for labour law. It has also sought to emphasise its consistency with long running ideas in economic thought about the nature of employment, and principles that have been familiar to labour law for some time. Empirical work, academic theories, politicians and proposals all come and go. They are forgotten and they re-emerge in other forms, but some principles endure. Societies as much as individuals have a tendency to think fast and act fast on new ideas, particularly when a fresh faced government comes in, eager to stamp its mark on the statute or history books. For instance, in 2010, the Conservative led coalition government in the UK set up the 'Behavioural Insights Team' with instructions to find ways to save the government money as it implemented its 'age of austerity', 'red tape challenge' and 'bonfire of the quangos'.[163] Britain was said to be in 'it' together.[164] In the words of the first Annual Report, it was also to 'find 'intelligent ways to encourage, support and enable people to make better choices for themselves'.[165] Much of the work by this 'nudge unit' has been interesting and useful, and given his involvement it has been an achievement for Richard Thaler particularly. There has not been much that is officially related to employment so far, although it must be said that the opt-out of many employment rights with 'employee shareholder' status bears a curious similarity to the ideas that Thaler and Sunstein have advanced before. This aside, one of the reasons it has caused excitement is the apparent commitment to evidence led policymaking. Was empirical evidence from behavioural experimentation coming to the centre of new style of 21st century government?

There seem to be good reasons to think that empirical evidence is not necessarily being used to drive policy. To think that a group of people invited to the Cabinet Office would become influential whatever their findings and

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[163] A 'quango' is an acronym for quasi-autonomous non-government organisation. One of the quangos, for example, that got put on the 'bonfire' was the Agricultural Wages Board, which set a minimum wage scale for agricultural workers according to their experience.

[164] E.g. G Osborne, *Speech: Conference 2012* (8 October 2012) 'Zero percent capital gains tax for these new employee-owners. Get shares and become owners of the company you work for. Owners, workers, and the taxman, all in it together. Workers of the world unite. I'm a low tax, small government Conservative.' For a discussion of the history of this concept, see E McGaughey, 'British Codetermination and the Churchillian Circle' (2014) UCL Labour Rights Institute On-Line Working Papers – LRI WP 2/2014.

[165] Behavioural Insights Team, *Annual update 2010-2011* (2011).

suggestions is naive. Whatever findings are made can be manipulated to fit with the objectives of the government, and confirm arguments that had been pre-formulated. So on the government side, empirical work may have little influence. But on the scholarly side the obvious problem is that academic independence and credibility becomes questionable as much as it does when researchers take corporate funding, commissions and consultancy work. If it were true that empirical testing would alter policy, it is also not clear that this would always be appropriate. Again, empirical evidence would seem to be indispensable for informing intelligent public discussion which, depending on the goals in view, should be ultimately translated into public policy. But very different conclusions could be drawn from the same experimental results, largely because people bring their usual heuristics to the findings, without thinking things through slowly.

Government, of course, is not a scientific endeavour, but rather it involves interests. Empirical evidence does not persuade people by itself, but is one element in a persuasive process of social communication. It needs to be fitted in with principles and objectives. Empirical work at its best can establish which consequences can follow from particular actions. But consequentialist reasoning only gets so far. It is no good knowing what all the consequences from every conceivable action would be unless there is an idea of purpose, of what should be achieved. Some goals are more important than others and sometimes, just sometimes, principles in pursuit of one purpose must be followed no matter what the effect is on other issues, to 'let justice be done whatever be the consequence'.[166]

It would be no discredit to the important work done by those in the nudge unit to observe that the main reason it was formed was that members of the Conservative party found some of the political views of Thaler and Sunstein appealing. This was an extension of the opt-out policies (like opting out from the European Social Chapter[167]) that had been formulated in the early 1990s, long before behavioural economics became well known. There is, arguably, a better view of what constitutes social good, and this can be informed by empirical work. But the process of thinking about what will achieve it is, and should be, a slow and careful one. Reflection on principles, and obtaining a reflexive equilibrium between principle and evidence, should always remain at the centre of policy.

All this said, behavioural economics has produced experimental evidence, which is robust and can always be repeated. The standard models of rational choice appear to remain useful in modelling commercial markets, so it is likely that a radical rewrite of the core micro-economics curricula will not happen any time soon. However, there are decisive implications for non-commercial markets, and particularly labour policy. First, through the *German nightclub card studies* it was explored how the motivation to work is affected by fairness in pay and conditions

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[166] *Somerset v Stewart* (1772) 98 ER 499, 509, per Lord Mansfield. This case affirmed slavery was unlawful at common law.

[167] C Barnard, 'The United Kingdom, the 'Social Chapter' and the Amsterdam Treaty' (1997) 26(3) *Industrial Law Journal* 275.

at work, and so how productive efficiency is affected. This meant that the traditional objective of labour law, to rectify inequality of bargaining power, has always been an objective that promotes efficiency as much as it aims for goals of fairness. Second, security in receiving pay and potentially job security serves an important efficiency function because, as the *Madurai game studies* showed, when we see very high stakes, we tend to be distracted from doing good work. Third, the *Hawthorne experiments* showed that when employees participate in workplace decisions, this promotes productivity. This implies that classic labour law institutions such as work councils, employee representation on company boards, and collective bargaining backed with the right to take collective action, all redress a significant market failure of under-participation at work.

Fourth, the *401(k) studies* showed that because we tend to prefer the *status quo*, automatic enrolment in occupational pensions will produce significant rises in saving. The success of these policies, however, rests on employees having a basic right to a pension administered by their employers. This involves compulsory (and not just default) rules. In all situations, the reason that companies might not voluntarily introduce fair wage scales, adequate pay and job security, workplace representation or decent occupational pensions is not because these measures would not realise efficiency gains. They would. The reason is that the private costs to managements or shareholders could often be perceived to outweigh the share of the social gains they would receive. But these conflicts of interest, the interest of the few against the many, should not be able to hold back social and democratic improvement. Behavioural economics shows more than ever why labour law is needed.

4. APPENDIX: 'CASE LIST' OF BEHAVIOURAL EXPERIMENTS

Hawthorne experiments (1924) PI Blumberg, *Industrial democracy: the sociology of participation* (1968) chs 2 and 3

Imagined investment studies (1988) 1 Journal of Risk and Uncertainty 7

Mugs and money studies (1990) 98(6) Journal of Political Economy 1325

Economic prisoner dilemma studies (1993) 7(2) Journal of Economic Perspectives 159
401(k) studies (2001) 116(4) Quarterly Journal of Economics 1149

Lego Bionicle studies (2008) 67 Journal of Economic Behavior & Organization 671

Madurai game studies (2009) 76 Review of Economic Studies 451

German nightclub card studies (2011) IZA Discussion Paper No 5550