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CROSS-EMPLOYEE REDISTRIBUTION EFFECTS OF MANDATED EMPLOYEE BENEFITS

Sharon Rabin-Margalioth*

I. OVERVIEW

Mandated employee benefits (“mandates”) offer an attractive alternative to policy makers. The popularity of these benefits is obviously not a function of actual wealth redistribution from employers to employees, as none exists, but is due to their political feasibility. Some mandated employee benefits finance social programs such as health insurance, unemployment insurance and disability insurance. Alternative financing mechanisms would be hard to advance politically because they would require additional explicit taxes. The benefits of the mandates are highly visible and it is clear to workers that they receive the benefit.¹ However, the benefits have the virtue of hidden costs because they do not appear as government expenditures and because few employees lose their jobs after their implementation.

Are these schemes equitable from the intra-employee standpoint? The redistributive consequences of mandated benefits among groups of workers, vis-a-vis themselves, has received scant attention.² The objective of this paper is to discuss the intra-employee redistribution effects of mandated employee benefit policies. The thrust of the argument is that mandates involuntarily imposes dual labor market practices on labor market participants. These practices further entail

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1. Alan B. Krueger, *Observations on Employment-Based Government Mandates, with Particular Reference to Health Insurance*, in LABOR MARKETS, EMPLOYMENT POLICY, AND JOB CREATION 297 (Lewis C. Solmon & Alec R. Levenson eds., 1994) (discussing why employee mandated benefits programs fair well with policymakers); Lawrence H. Summers, *Some Simple Economics of Mandated Benefits*, 79 AM. ECON. REV. 177 (1989) (explaining why in the political apparatus mandates are a second best alternative for both conservatives and liberals).

2. See *infra* note 61.

regressive redistribution outcomes, in which external labor market employees are partially subsidizing the provision of the mandated benefits to internal market employees.

This paper draws heavily on the distinction between fixed versus variable labor costs and the dual labor market theory. The claim is that many employee benefits mandates, whether legislated or judicially enforced, are of a fixed-cost nature. This means that the cost of providing the benefit does not vary with the wage rate, but rather with the number of employees. Mandates impose no additional costs once an employee is covered, regardless of how many hours she is putting in, or her hourly wage. Fixed cost mandates are sensitive to the size of the workforce rather than employee wages. Such mandates may induce firms to employ fewer workers and work them more hours, and increase the demand for higher compensated employees, for whom the provision of the benefit is cheaper relative to the wage rates. On the other hand, a countervailing incentive arises when mandates exempt certain categories of workers;³ mandates may cause an upward shift in demand for employees in the uncovered sector.

An increased demand for extended work schedules in the covered sector and highly compensated workers coupled with an increase in demand for employees in the exempt sector, are two forces which aid in the preservation of a segmented labor market. The internal labor market job holders enjoy fairly stable jobs, high wages and generous benefit packages, while others are forced into external labor market jobs, with lower wages and less benefits.

The dual labor market theory is by no means a new one. The existence of internal primary labor markets operating side by side

3. All mandates entail exemptions. Some exemptions relate to the size of the establishment: *See, e.g.*, Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e(b) (2000) (exempting small businesses employing less than fifteen employees); Family and Medical Leave Act (FMLA) of 1993, 29 U.S.C. § 2611(2)(B) (1994) (exempting employers with less than fifty employees); Worker Adjustment and Retraining Notification Act (WARN), 29 U.S.C. § 2101(a)(1) (1994) (exempting employers with less than 100 employees). Other exemptions depend on the type of employment arrangements: *See, e.g.*, Fair Labor Standard Act (FLSA), 29 U.S.C. § 203(d) (1994) (exempting certain occupations and industries from coverage); FMLA, 29 U.S.C. § 2611(2)(A) (1994) (exempting employees working less than twelve months and less than 1,250 hours in a twelve month period). An exemption can also be defined in compliance terms. From an economical perspective, if a mandate is not enforced in certain industries or geographical regions, this is equivalent to a legislative exemption because employers are not complying with the requirements of the mandate and will not incur the extra labor costs.

with external secondary labor markets is well documented.⁴ The role of mandated benefits, however, in contributing to this phenomenon has not been highlighted. In the account that follows, dual market structures are imposed involuntarily on the parties, via regulation. This is in contrast to the traditional assumption that organizations turn to internal labor market settings voluntarily to overcome specific deficiencies pertaining to investment in training, asymmetric information, risk aversion and transaction costs.⁵

To the extent that mandated benefits promote the formation or growth of dual labor markets, compensating wage differential theory suggests that there are no intra-employee distributional distortions.⁶ Under this view, employees in the uncovered sector would simply be compensated with higher wages on account of their not enjoying the advantages of the mandates, thus leaving total compensation fairly equal.⁷ This means that a sorting process is taking place. Workers who value the mandated benefit less drop out of the covered sector and hold exempt jobs, which do not provide the benefit but pay such employees higher wages. Unfortunately, empirical data suggests the opposite.⁸ Not only do uncovered employees lack the protection of the mandates, these employees are not compensated with higher wages.⁹

Concerns often have been raised over the regressive redistribution effects of internal labor markets. For example, individuals holding internal labor market jobs tend to earn more and receive more favorable benefit packages than their secondary market counterparts.¹⁰

4. For an excellent survey of the economic incentives to promote internal markets, see generally Michael L. Wachter & Randall D. Wright, *The Economics of Internal Labor Markets*, 29 INDUS. REL. 240 (1990).

5. *Id.* at 244-52.

6. Compensating wage differential theory claims that given identical employees and jobs, employee compensation should be equal. Therefore, if there are two identical workers in identical jobs and one is provided health insurance, the worker without health insurance will receive higher wages. See Melissa Famulari & Marilyn E. Manser, *Employer-Provided Benefits: Employer Cost Versus Employee Value*, 112 MONTHLY LAB. REV. 24, 27 (1989).

7. *Id.* Measuring wage differences is the goal of hedonic price measurements. The wage differential between covered and uncovered employees represents the value of the benefit to the covered employee. See Sherwin Rosen, *Hedonic Prices and Implicit Markets: Product Differentiation in Pure Competition*, 82 J. POL. ECON. 34 (1974).

8. See studies discussed *infra* notes 151-159.

9. See discussion *infra* Part IV.D.

10. PETER B. DOERINGER & MICHAEL J. PIORE, INTERNAL LABOR MARKETS AND MANPOWER ANALYSIS 165 (1971). This is one of the early works that addresses the efficiency aspects of dual labor practices and stresses heavily that a segmented labor market is not equitable. Workers in secondary markets tend to have poorer working conditions, less protection against arbitrary treatment by the employer, higher turnover rates and fewer benefits and opportunities for advancement. *Id.* The unionized versus non-unionized comparison of compensation packages yields

Prior research assumed that the adoption of internal labor market employment practices were the result of voluntary actions, such as the product of market forces, and not an outcome of regulation.¹¹ However, if mandated benefits are shifting employment relationships into dual market settings, then the regulatory process itself is aiding in the disparate allocation of jobs within the two labor markets. It therefore can no longer be claimed that regressive redistribution is the mere side effect of the firm's efficient decision of how to construct the employment relationship.

This article will, in Section II, briefly explain employee-mandated benefits. Section III describes why employment mandates, contrary to common intuition, do not redistribute wealth from employers to employees. Section IV analyzes the intra-employee distributional effects of mandates. Finally, section V offers some preliminary conclusions.

II. WHAT ARE MANDATED BENEFITS?

Broadly defined, mandated employee benefits are any form of mandatory non-wage compensation required by regulation. These include benefits such as employer-provided health insurance,¹² unpaid medical leave,¹³ workers' compensation,¹⁴ unemployment insurance,¹⁵ safety and health standards,¹⁶ uniform standards for employee pension and benefit plans,¹⁷ antidiscrimination mandates,¹⁸

similar conclusions. See RICHARD B. FREEMAN & JAMES L. MEDOFF, WHAT DO UNIONS DO? 59, 77 (1984) (analyzing the wage and benefit gap between the two sectors). Unionized establishments representing the internal market settings are characterized by voluntary benefit schemes, job security protection clauses and internal promotion ladders. Total compensation is more generous in the unionized sector than in the non-unionized sector. *Id.*

11. See Wachter & Wright, *supra* note 4, at 240-42.

12. See, e.g., HAW. REV. STAT. § 393-11 (1985). Hawaii is the only state that mandates employer provided health insurance.

13. See Family and Medical Leave Act (FMLA) of 1993, 29 U.S.C. §§ 2601-2654 (1994). The FMLA entitles employees to take up to twelve weeks of unpaid job-protected leave for specified family and medical reasons, such as the birth or adoption of a child or illness in the family. *Id.* § 2612(a)(1).

14. Workers' compensation insurance provides cash payments and medical benefits to workers who incur a work-related injury or illness. These mandates are state-based.

15. See Social Security Act, 42 U.S.C. §§ 401-504 (1994) (providing for federal old age, survivors and disability insurance benefits and grants to states for unemployment compensation).

16. See Occupational Safety and Health Act (OSHA) of 1990, 29 U.S.C. §§ 651-678 (1994) (requiring employers to furnish each employee with employment and a workplace free from recognized hazards that can cause death or serious physical harm).

17. See Employee Retirement and Income Security Act (ERISA) of 1974, 29 U.S.C. §§ 1001-1461 (1994) (establishing uniform standards for employee pension and welfare benefit plans,

protection against unjust dismissal¹⁹ and advanced notification in the case of plant closing.²⁰ Regulation can either be the product of legislation or judicially introduced; a dominant example of the latter is the common law exceptions to the employment at-will doctrine.²¹

All mandated benefits operate in the same manner. They require the employer to provide covered employees with certain benefits. These benefits are typically non-waivable in that the parties (employer and employee) generally cannot contract around them. Moreover, they must be provided, regardless of the employees' actual preferences. Mandated benefits increase the employer's labor costs, and there is at least the possibility that some or all of these higher costs will be passed onto employees through lower wages.

Minimum wage does not fit within the definition of a mandated benefit.²² As a wage mandate, minimum wage translates into additional labor costs. However, minimum wage is treated separately because labor cost increases associated with wage mandates cannot be passed to incumbent employees through lower wages.²³

The significance of mandated employee benefits has been increasing.²⁴ According to the Bureau of Labor Statistics' (BLS) Employer Costs for Employee Compensation (ECEC), by March 1999, non-wage compensation represented 27.5% of total compensation of U.S. workers.²⁵ Overall there was an increase of 55.3% from 1989 to

including minimum participation accrual and vesting requirements, fiduciary responsibilities and reporting and disclosure duties).

18. The following are the major federal antidiscrimination mandates: Title VII, 42 U.S.C. §§ 2000e to 2000e-17 (2000); Age Discrimination in Employment Act (ADEA), 29 U.S.C. §§ 621-634 (1994); Americans with Disabilities Act (ADA), 42 U.S.C. §§ 12101-12213 (1994).

19. Montana is the only state to legislate an employment just cause dismissal protection mandate. MONT. CODE ANN. § 39-2-904 (2000) (mandating a cause of action for any employee who completed the employer's probationary period and was discharged either in violation of the employer's written policies or without good cause).

20. See Worker Adjustment and Retraining Notification Act (WARN), 29 U.S.C. §§ 2101-2109 (1994) (requiring employers to give sixty days notice of plant closings to their employees and state and local officials).

21. See discussion of judicial mandates *infra* Part IV.C.2.

22. Minimum wage is mandated by the Fair Labor Standards Act (FLSA), 29 U.S.C. §§ 201-219 (1994).

23. See *infra* Part IV.E.

24. See David Weil, *Implementing Employment Regulation: Insights on the Determinants of Regulatory Performance*, in GOVERNMENT REGULATION OF THE EMPLOYMENT RELATIONSHIP 429, 433-35 (Bruce E. Kaufman ed., 1997) for a complete list of federal mandates. See Krueger, *supra* note 1, for a discussion of why mandated employee benefits are endorsed by politicians to advance social programs.

25. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, BULLETIN 2526, EMPLOYER COSTS FOR EMPLOYEE COMPENSATION, 1986-1999, at 2 (Mar. 2000) [hereinafter EMPLOYER

September 2001.²⁶ This is only a rough measure of the role of mandated benefits. On the one hand, the ECEC survey covers many voluntary benefits²⁷ and therefore overstates the effect of mandated benefits on total compensation.²⁸ On the other hand, the ECEC disregards the costs of other mandates, such as antidiscrimination protection, unpaid leave, job security and health and safety standards, thereby understating employers' costs of complying with mandated benefits policies. Nonetheless, these numbers give a rough sense of the magnitude of the costs of providing employee benefits, mandated or not.

III. DISTRIBUTIONAL EFFECTS OF MANDATED BENEFITS: THE EMPLOYER-EMPLOYEE MATRIX

In the past, the literature on the distributive impact of mandated employee benefits policies has concentrated on the issue of whether mandates can successfully transfer wealth from employers to their employees.²⁹ Ample theoretical and empirical analysis supports the claim that such wealth transfers are normally unattainable.³⁰

The theoretical argument follows the price theory model and suggests that employers will shift the cost of the mandates to their employees, typically in the form of lower wages or a decreased rate of

COSTS FOR EMPLOYEE COMPENSATION). The survey includes civilian workers (private industry and state and local government employees). *Id.* Total compensation averaged \$20.29 per hour worked. *Id.* Wages and salaries averaged \$14.72 per hour worked and accounted for 72.5% of total compensation. *Id.* Cost of benefits averaged \$5.58 per hour worked. *Id.*

26. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, EMPLOYMENT COST INDEX (Oct. 2001) [hereinafter EMPLOYMENT COST INDEX].

27. The ECEC covers the following benefits: paid leave (vacation, holiday, sick and other) representing 6.6% of total compensation; supplementary pay (premium pay for overtime holiday pay and weekends, shift differential and nonproduction bonuses) representing 2.5% of total compensation; insurance (life, health, and short and long term disability) representing 6.4% of total compensation; retirement and savings (defined contributions and defined benefits plans) representing 3.7% of total compensation; and legally required benefits (social security, federal unemployment insurance, state unemployment insurance and workers compensation) representing 8.1% of total compensation. EMPLOYER COSTS FOR EMPLOYEE COMPENSATION *supra* note 25, at 2 tbl.1.

28. Yet legally mandated benefits, i.e., social security, federal unemployment insurance, state unemployment insurance and workers' compensation still accounted for 29.6% of the total benefit compensation surveyed. *Id.*

29. See generally Summers, *supra* note 1; Dwight R. Lee, *Why Workers Should Want Mandated Benefits to Lower Their Wages*, 34 ECON. INQUIRY 401 (1996); Susan N. Houseman, *The Effects of Employer Mandates, in GENERATING JOBS: HOW TO INCREASE DEMAND FOR LESS-SKILLED WORKERS* 154 (Richard B. Freeman & Peter Gottschalk eds., 1998).

30. Summers, *supra* note 1, at 181; Lee, *supra* note 29, at 406; Houseman, *supra* note 29, at 154.

future wage boosts.³¹ If decreasing wage rates are impossible due to restraints on wage, such as minimum wage laws or labor market wage rigidities, employers will simply hire fewer employees.³² The expected effect of the mandated benefits will be lower employment levels.³³ According to the price theory model, significant cost shifting to employees indicates that employees are attaching a high value to the benefits provided and are willing to accept a wage cut in exchange.³⁴ A high degree of cost shifting is assumed to indicate that the mandates are efficient.³⁵ Graph 1 illustrates the changes that occur when a mandated benefits program is introduced:

Graph 1: The Impact of Mandated Benefits on the Labor Market

31. See, e.g., Houseman, *supra* note 29, at 184.

32. These basic points are emphasized using simple supply and demand graphs. See Summers, *supra* note 1, at 180; Lee, *supra* note 29, at 402-05; Houseman, *supra* note 29, at 160.

33. See Lee, *supra* note 29, at 402; Houseman, *supra* note 29, at 160.

34. Lee, *supra* note 29, at 403-04.

35. This is the main point of Lee's paper. See generally Lee, *supra* note 28. Mandates initiate a shift both in the demand and supply curves. The leftward shift in the demand curve represents the cost to employers of providing the benefit. The rightward shift in the supply curve represents the value attached to the mandate by the employees. The new intersection determines wages and employment levels. As employees place higher value on the benefit relative to the cost to employers, they will be willing to accept higher wage cuts. Sizeable wage cuts indicate that employees are gaining from the benefit. *Id.* at 403-04. The same idea is advanced in relation to consumer mandates in Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 372 (1990) ("Paradoxical as it may seem, the rules whose costs are most heavily passed on are also the rules that will benefit consumers the most.").

S and D represent the supply and demand curves prior to the implementation of the mandated benefit.³⁶ W and E represent the corresponding wage and employment rate at that stage. When the mandate is introduced, the demand curve D" shifts leftward, the distance (cd) representing the cost of providing the mandate to employers; the supply curve S" shifts rightward, the distance (ab) representing the value placed on the benefit by the marginal employees.³⁷ In the specific graph drawn, all employees place the same value on the benefit.³⁸ This value is greater than the employers' cost of providing the mandate ($ab > cd$), therefore wages fall from W to W", but employment levels rise from E to E", as more individuals are willing to supply their labor at the going wage.³⁹ Both the employees' aggregate surplus rose ($W''bg > Wcf$), and the employers' aggregate surplus ($W''hb > Wic$) rise.⁴⁰ In this case, the mandate is indeed efficient but this is only one of many possible outcomes. In other instances, the magnitude of the shift in the demand curve (representing the employers' cost of providing the benefit) may be greater than the magnitude of the shift of the supply curve (representing the value placed on the benefit by employees), or $cd > ab$.⁴¹ This indicates that employees are valuing the benefit at less than its cost.⁴² In these cases, employment levels would fall ($E > E''$), as well as wages ($W > W''$).

Graphical presentation effectively captures the fact that following the implementation of a mandate, the relative magnitude of the shift in the supply and demand curves determines the rate at which employment and wage rates would change. However, there is another important factor—the relative elasticity of the supply and demand for labor. Relative elasticity⁴³ also determines the wage and employment effects of

36. The supply and demand curves are drawn as straight lines for clarity. Nothing would change in the analysis if they were drawn as curves.

37. Marginal employees are those employees who are on the margin of participating in the labor market or withholding their labor at the going wage. Their valuation of the benefit will determine the wage decrease associated with the mandate.

38. Lee, *supra* note 28, at 403 n.4. S" parallels S.

39. *Id.* at 404.

40. *Id.*

41. *Id.* at 402-06.

42. *Id.*

43. Labor supply and demand elasticities are defined as the percentage change in the employment supplied by employees or demanded by employers, respectively, induced by a 1% increase in the wage rate. An elasticity value of one for labor supply represents unity. It indicates that a one percent increase in wages results in a 1% increase in labor supplied (employment). Any value less than one represents an inelastic labor supply, that is, an increase in a 1% in the wage rate results in less than 1% increase in the employment supplied by employees. A value greater than one indicates the labor supply is elastic, as a 1% increase in wages induces more than a one percent increase in labor supply. This applies to labor demand elasticity as well, only the value is a negative

mandated benefits.⁴⁴ The change in the wage rate, i.e., the percentage of the mandate's cost that is passed to employees in the form of lower wages, can be expressed as follows:⁴⁵

$$\frac{-(\eta d - \alpha \eta s)}{(\eta d - \eta s)}$$

Where ηd is the elasticity of labor demand, ηs is the elasticity of labor supply, and α is the fraction of the mandated benefit cost to the employer which is valued by the employee.⁴⁶ Valuation by employees represents the price employees would be willing to pay for the benefit if the benefit was not mandated and they had to "purchase" the benefit in the free market. If α equals 1, employees are valuing the benefit at exactly its cost and would be willing to purchase the benefit at exactly its cost from their employer. In these cases, employees will absorb the entire cost through lower wages.⁴⁷ Wage cuts will offset costs and employment levels will remain intact.⁴⁸ If employees value the benefit at more than its cost ($\alpha > 1$), wages will fall by more than the cost to the employer and employment levels will increase.⁴⁹ Such a result indicates that the mandate is extremely efficient, and that market failure has stymied voluntary provision of the benefit.⁵⁰

If the value of the benefit to employees is less than the cost to the employer ($\alpha < 1$), the equation indicates that wages will fall less than the cost of providing the benefit, and thus employment levels should fall

number. Since the labor demand curve slopes downward, an increase in the wage rate will cause the demand for labor to decrease.

44. Lee and Craswell unfortunately do not address the impact of labor supply and demand cross elasticities. Lee, *supra* note 29; Craswell, *supra* note 35.

45. Jonathan Gruber & Alan B. Krueger, *The Incidence of Mandated Employer-Provided Insurance: Lessons from Workers' Compensation Insurance*, in 5 TAX POLICY AND THE ECONOMY 111, 115 (David Bradford ed., 1991) (introducing the equation).

46. $\alpha = \frac{ab}{cd}$

ab and *cd* are the values from graph 1 representing employees' value of the benefit and employers' cost of providing the benefit, respectively.

47. Gruber & Krueger, *supra* note 45, at 116.

48. *Id.* at 115.

49. See Graph 1 *supra* p. 317.

50. The efficiency argument for mandated benefits must rely on the presence of market failures. See Summers, *supra* note 1, at 178-81 (listing several possible market failures that arguably stymie the voluntary provision of employee benefits, namely information barriers and adverse selection problems, externality issues, and the fact that some benefits are public goods and would be underproduced without regulation); Olivia S. Mitchell, *The Effects of Mandating Benefits Packages*, 11 RES. LAB. ECON. 297, 300-03 (1990) (detailing the various efficiency justifications for regulatory intervention).

as well. In the extreme case where employees place no value at all on the benefit ($\alpha = 0$), no shift in the supply of labor will take place, and the incidence of the mandated benefit is exactly analogous to that of a payroll tax, from which the employees do not benefit at all.⁵¹

In addition to the value attached by employees to the benefit, employment and wage outcomes are dependent on the magnitude of labor supply and labor demand elasticities.⁵² If the demand for labor is relatively more elastic than the supply for labor,⁵³ meaning that employers will reduce their demand for labor at a higher rate than employees are willing to supply it in response to a wage increase, then even if α is significantly less than 1, cost shifting will occur. In other words, the more inelastic (steeper) the labor supply curve, the larger the scale of cost shifting, regardless of employee valuation of the benefit. This will lead policymakers to believe the mandate is efficient, as no employment rate changes can be detected.⁵⁴

Some relevant numerical examples may be useful. Krueger, for example, offers a 0.1 value for labor supply elasticity and -0.25 value for labor demand elasticity.⁵⁵ These values indicate that labor demand is more elastic than labor supply, as its absolute value is greater. In this case, 71% of the benefit costs will be shifted to employees in the form of lower wages.⁵⁶ This shift rate is relevant to the cases in which employees place no value on the benefit ($\alpha = 0$). If employees value the benefit at 50% of the cost ($\alpha = 0.5$), wage shifting will account for 85.7% of the employer's cost⁵⁷ and employment consequences will hardly be noticed.⁵⁸ If we take a less conservative estimate of labor demand

51. Gruber & Krueger, *supra* note 45, at 116; Summers, *supra* note 1, at 180-81.

52. Gruber & Krueger, *supra* note 45, at 116-17.

53. What is at issue is the relative magnitude of the elasticities values, ignoring the sign. Therefore, if the absolute value of labor demand elasticity is greater than the absolute value of the labor supply elasticity, labor demand is relatively more elastic than the labor supply. This stands even if both values are inelastic (absolute values are less than 1). For example, this would occur when labor demand elasticity equals -0.25 and labor supply elasticity equals 0.1.

54. See generally Lee, *supra* note 28; Craswell, *supra* note 35. Both articles suggest using a cost shifting magnitude as a rule of thumb to evaluate the efficiency of legal mandates.

55. Krueger, *supra* note 1.

56. This estimation is produced by utilizing the above equation, pertaining to changes in the wage rate caused by a mandated benefit: $\frac{-0.25 - 0}{-0.25 - .1} = -.714$

57. $\frac{-0.25 - (.5 \times .1)}{-0.25 - .1} = -.857$

58. The effect of mandated benefits on employment rates can be formulated as follows:

$$\frac{dL}{L} = \frac{W0 - W2 - C}{W0} \times \eta_d$$

elasticity, for example -0.75 ,⁵⁹ cost shifting will account for 88.2% of employer's cost, regardless of employee value ($\alpha = 0$).

Empirical data supports the claim that the costs incurred by employers, in providing mandated employee benefits, are shifted to employees in the form of lower wages, while employment levels are left relatively unaffected.⁶⁰ These studies do not clearly differentiate which factor is responsible for this outcome because it is unclear whether it is the fact that employees are placing a high value on the benefit or whether it is the relative inelasticity of labor supply that is responsible for the outcome. The repetitive pattern of successful cost shifting, across numerous mandates, suggests that inelasticity of labor supply is a significant factor because it is highly unlikely that all of the benefits studied in these surveys were efficient.

These empirical studies strongly suggest that although, in theory, employment and wage effects of mandated benefits are a function of the value employees attach to the benefit and the relative elasticities of the

L and dL represent the initial employment level and the employment level after the imposition of the mandate, respectively. W_0 and W_2 represent the initial wage rate prior to the imposition of the benefit and the wage rate after the imposition of the benefit, respectively. C represents the employer's cost of providing the benefit and η_d represents labor demand elasticity. This "indicates that the amount of employment sacrificed because of [the mandate] is inversely related to the wage offset." Gruber & Krueger, *supra* note 45, at 115-16.

59. DANIEL S. HAMERMESH, LABOR DEMAND 135 (1993) (using this value as the upper end of his labor elasticity).

60. Gruber & Krueger, *supra* note 45, at 112. The authors studied the employment effects of providing workers' compensation benefits in compliance with state mandates. They found that changes in employers' cost of providing workers' compensation are largely shifted to employees in the form of lower wages, with insignificant effects on employment rates. The elasticity of labor demand resulted in $\eta_d = -0.5$. *Id.* A 1% increase in workers' compensation costs was associated with a .011% decline in employment rates. *Id.* at 139. The effects of the Pregnancy Disability Act (PDA) are considered in Jonathan Gruber, *The Incidence of Mandated Maternity Benefits*, 84 AM. ECON. REV. 622-23 (1994). This mandate requires employers who provide health insurance benefits to cover pregnancy-related medical benefits in a non-discriminatory manner. *Id.* at 623. The PDA raises the costs of employing women of childbearing age and, to some extent, married men in the same age group. *Id.* at 625-26. Gruber found that the costs associated with providing pregnancy-related medical benefits were shifted in the form of lower wages to the demographic groups enjoying the provision of this mandate, with little effect on employment levels of the affected groups. *Id.* at 622. Similarly, Norman K. Thurston, *Labor Market Effects of Hawaii's Mandatory Employer-Provided Health Insurance*, 51 INDUS. & LAB. REL. REV. 117, 117-18, 130-31 (1997) documents the cost shifting of the employer-provided health insurance mandate in Hawaii, with no employment effects. However, Thurston reports an increase of employment in exempt jobs. *Id.* at 133. Krueger estimates employment effects of mandating an employer-provided national health insurance scheme. Krueger, *supra* note 1. Calculations do not take into account employee valuation of the benefit ($\alpha = 0$). *Id.* Basing calculations only on benefit costs and supply and demand elasticity, Krueger estimates a 0.2% fall in employment. *Id.* Using a wider range of supply and demand elasticities, estimates of the decline in employment range from 200,000-500,000 jobs, which represent 0.2-0.5% of the American workforce.

supply and demand for labor, in practice, the bulk of the cost is shifted in the form of lower wages with no significant employment consequences. This pattern occurs regardless of employee value of the benefit, due to the highly inelastic labor supply. Employees unfortunately bear the cost of the dead weight burden of the mandate, i.e., the excess cost of the benefit, which they do not value. But redistribution from employers to employees does not occur.

IV. DISTRIBUTIONAL EFFECTS OF MANDATED BENEFITS: THE INTRA-EMPLOYEE MATRIX

A. Preface

The redistributive consequences of mandated benefits among groups of workers, vis-a-vis themselves, has received scant attention.⁶¹ The price theory model suggests that where employers cannot shift the entire cost of the benefit, and thus must decrease employment levels, the burden of the mandate is passed on to those workers who have to pay with their job.⁶² The employees who receive the benefit, i.e., health insurance or protection against unjust dismissal, are rewarded at the expense of fellow employees who are laid off or cannot find initial

61. Christine Jolls, *Accommodation Mandates*, 53 STAN. L. REV. 223 (2000–2001), addresses the intra-employee redistribution effects of accommodation mandates (targeted mandates). Targeted mandates are mandates that benefit a discrete protected group of employees, such as women or disabled workers. *Id.* at 225, 231. Jolls' argument is that whenever targeted mandates are implemented, employers face an economic incentive to discriminate against the protected group in either wages (paying them lower wages to offset the cost of providing the targeted benefit) or in employment levels (lowering the demand for employees triggering the accommodation mandate). *Id.* at 246. If non-discrimination mandates are binding and enforced, as is the intention of accommodation mandates, redistribution will take place in the direction of the accommodated group of employees at the expense of the non-accommodated group of employees. *Id.* at 270–71. Employers, who are prohibited from adjusting wages and/or employment demand for targeted group members, must spread the labor cost associated with the mandate across their entire workforce. *Id.* at 248. This results in redistribution because all workers are financing the cost of the targeted benefit, while only the accommodated group of employees is benefiting. *Id.* at 246. Jolls does not discuss the redistribution effects of universal mandates, which are directed to all or virtually all employees. See John J. Donohue III, *Understanding the Reasons for and Impact of Legislatively Mandated Benefits for Selected Workers*, 53 STAN. L. REV. 897 (2001) (discussing Jolls' framework and applying it to other antidiscrimination mandates, such as sexual harassment and disparate impact law). Donohue correctly points out that Jolls relies on a partial equilibrium model and does not address the possibility that labor markets do not follow the simple price theory model, but are rather more complex. *Id.* at 909–12.

62. Jolls, *supra* note 61, at 246.

employment.⁶³ As explained, when there are no wage adjustment constraints, as in the case of minimum wage standards, wages will adjust but employment levels generally will not be affected. Where, then, are the intra-employee redistribution effects?

Today it is well accepted that labor markets operate within dual channels.⁶⁴ There is a primary internal labor market in which wages and benefits tend to be higher than in the secondary market. It is also argued that in the internal labor market, employers do not respond immediately to changes in the supply of labor by depressing the compensation package.⁶⁵ The secondary or external market is assumed, by contrast, to be operating according to the price theory model. Therefore, fluctuation in the supply and demand for workers is likely to disproportionately affect wages and employment levels of the workers employed in the external market.

The main argument in this section is that mandated benefits often involuntarily promote dual market practices. Mandated benefits policies shift covered employment relationships into the internal labor market, as they impose fixed labor costs on employers. Some of these costs, such as firing costs, are one-time costs, which encourage employers to depress turnover rates. This may seem a welcome outcome since internal employment settings typically are beneficial to workers. However, because mandates cannot effectively eliminate the external labor market, mandates may well be redistributing wealth from external labor market employees to internal labor market employees. Employers are passing some of the costs associated with mandates to uncovered employees by depressing their wages to finance the costs of the mandates. Employers are able to engage in exempt sector cost shifting due to labor supply inelasticity. This effectively means that employers can choose which group of employees will carry the costs of the mandates. Employers may find it beneficial that exempt sector employees will carry some of the costs. They may believe that differentiating between internal and external market employees raises the commitment and productivity of internal market employees as their relative compensation package increases.

63. See Steven L. Willborn, *Individual Employment Rights and the Standard Economic Objection: Theory and Empiricism*, 67 NEB. L. REV. 101, 109-15 (1988), for a discussion of this line of argument.

64. See RONALD G. EHRENBERG & ROBERT S. SMITH, *MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY*, 396-412 (7th ed., 2000).

65. *Id.*

The avowed purpose of most mandated benefits programs is not to enforce employment within the primary labor market. Each mandate has its own discrete purpose, whether it is eradicating discrimination, providing job security, unpaid leave or health insurance. However, the mandate often has the effect of entrenching dual market practices.

B. Dual Market Theory

Dual labor market models can roughly be divided into two main categories, the efficiency wage model and the lifetime or career employment model. The efficiency wage model is based on the observation that firms usually do not find it profitable to cut wages in the face of involuntary unemployment, resulting in downward wage rigidities.⁶⁶ The model's main objective is to offer a convincing explanation for the existence of involuntary unemployment.⁶⁷ Involuntary unemployment is antithetical to the price theory description of the labor market because when unemployment occurs supply and demand do not clear. Price theory proponents must argue, then, that what is assumed to be involuntary unemployment is actually voluntary unemployment. The efficiency wage model suggests, however, that involuntary unemployment is due to the fact that employers find it profitable to pay above-equilibrium wages, and therefore wages will not clear. If labor productivity depends on the wage paid by the firm, that is productivity increases with pay, then decreasing wages will decrease productivity. For this reason, employers are reluctant to cut wages and downward wage rigidities are common.

The various efficiency models differ in their account of this phenomenon, that is in their explanation of why productivity increases with higher wages. The shirking model criticizes the price theory framework for assuming that all workers devote the same amount of effort at the workplace and that this amount is not subject to choice by either the worker or his employer.⁶⁸ In real life, employers have come to learn that productivity rises with higher wages, i.e., that you can extract greater effort by paying higher wages. In this model, involuntary

66. See George A. Akerlof & Janet L. Yellen, *Introduction to EFFICIENCY WAGE MODELS OF THE LABOR MARKET* 1, 2 (George A. Akerlof & Janet L. Yellen ed., 1986), for a review of the various efficiency wage models.

67. *Id.* at 1-2.

68. See, e.g., Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Disciplined Device*, in *EFFICIENCY WAGE MODELS OF THE LABOR MARKET* 45, 45-48 (George A. Akerlof & Janet L. Yellen eds., 1986).

structural unemployment serves as a disciplining mechanism for internal labor market employees: workers will produce the greater effort expected of them for fear that if they are caught shirking, they will find themselves relegated to inferior jobs in the external labor market.

Another efficiency wage model, the turnover model, emphasizes information barriers from a different angle. It is concerned with the ability of employers to evaluate prospective employees.⁶⁹ By offering above-equilibrium wages, the firm can attract a better pool of candidates.⁷⁰ This model suggests that by paying above-equilibrium wages, employers can depress worker turnover rates.⁷¹ If an employer is paying above market wages, it reduces the likelihood that employees will voluntarily exit. If an organization is encountering high recruiting and training costs, paying efficiency wages will lengthen retention rates. The price theory model, by contrast, assumes that one can always find a job at the external market wage.⁷²

Lastly, there is the sociological model, which explains wage rigidity as an outcome of social conventions and principles of appropriate behavior.⁷³ The employer can succeed in raising group work norms and average effort by paying workers a gift of wages in excess of the minimum required in return for a gift of effort above the minimum required.

The second major theory attempting to explain the phenomenon of dual labor markets could be labeled the lifetime or career employment model.⁷⁴ This model is not concerned with involuntary unemployment; rather, it seems to address the issue that some employees enjoy a stable, long-term employment relationship with internal promotion ladders.⁷⁵ Employment relationships with a single employer may last throughout an individual's entire working career. Lifetime employees are identified usually by an up sloping wage curve which is correlated with seniority within the firm and explicit or implied promises of job security.⁷⁶

69. See, e.g., Andrew Weiss, *Job Queues and Layoffs in Labor Markets with Flexible Wages*, in EFFICIENCY WAGE MODELS OF THE LABOR MARKET 102 (George A. Akerlof & Janet L. Yellen eds., 1986).

70. *Id.* at 103. The turnover model is based on the adverse selection theory.

71. See, e.g., Steven C. Salop, *A Model of the Natural Rate of Unemployment*, in EFFICIENCY WAGE MODELS OF THE LABOR MARKET 93 (George A. Akerlof & Janet L. Yellen eds., 1986).

72. *Id.*

73. See, e.g., George A. Akerlof, *Labor Contracts As Partial Gift Exchange*, in EFFICIENCY WAGE MODELS OF THE LABOR MARKET 66 (George A. Akerlof & Janet L. Yellen eds., 1986).

74. See generally EHRENBURG & SMITH, *supra* note 64, at 400-08.

75. See *id.*

76. See *id.*

These employees usually enjoy extended benefits, which in some cases are accumulated with seniority.⁷⁷ On the other hand, other employees do not fare as well in the labor market; their jobs do not carry any meaningful job security, they are provided with fewer benefits and they may hold many different jobs in the course of their working life.

From an efficiency perspective, it is argued that the lifetime employment scheme will be adopted in organizations that rely heavily on firm-specific human capital.⁷⁸ When employers need their workers to acquire firm-specific skills, which have little or no value in external labor markets,⁷⁹ an opportunity for strategic behavior on both sides arises.⁸⁰ The employer is vulnerable to the ability of his employees to leave after the employer has invested in costly training.⁸¹ Meanwhile, workers possessing specific skills are susceptible to opportunistic behavior by their employer⁸² because their opportunity wages are lower compared to similar workers, who have acquired general skills.⁸³ In order to deter both sides from acting strategically, the parties implicitly agree to a form of lifetime employment during which wages diverge from the employee's marginal product.⁸⁴ This employment arrangement serves as a self-enforcement contract mechanism. Employees are deterred from exiting because some of their compensation is deferred, whether by seniority-based wage and benefit ladders or by vesting periods. Employers are deterred from laying off workers by the explicit or implicit promises of job security, supplemented by reputation concerns.⁸⁵

77. Initial treatment was descriptive. It was sometimes assumed that lifetime employment practices were motivated by the desire to curtail the importance of economic forces, as in the case of unionized establishments. See Clark Kerr, *The Balkanization of Labor Markets*, in LABOR MOBILITY AND ECONOMIC OPPORTUNITY 92, 97-99 (1954). For a discussion of the evolution of the lifetime employment theory, see Gillian Lester, *Careers and Contingency*, 51 STAN. L. REV. 73, 105-10 (1998-1999) (viewing the model according to the segmentationist school of thought).

78. See GARY S. BECKER, *HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION* 26-37 (2d ed. 1975).

79. *Id.* at 26. However, the value of general skills does not depreciate in the external market. *Id.* at 19.

80. See Wachter & Wright, *supra* note 4, at 243-44.

81. See *id.* at 243-44.

82. See *id.* at 244, 260.

83. See *id.* at 244-45.

84. *Id.* at 244. The model assumes that total compensation will equal the worker's lifetime marginal product, but it relaxes the price theory requirement of simultaneousness.

85. See Edward P. Lazear, *Why Is There Mandatory Retirement?*, 87 J. POL. ECON. 1261, 1261 (1979). Prior to the outlawing of mandatory retirement by the Age Discrimination in Employment Act (ADEA), many lifetime employment relationships were based on mandatory retirement. Mandatory retirement was the end point of the relational contract. At retirement, the present value of the stream of wages and other compensation components should equalize the present value of the compounded productivity of the employee during the career-long work period,

Efficiency wage and lifetime employment models overlap to some extent.⁸⁶ In the literature they are not well distinguished from one another. This may be because both theories attempt to offer a coherent explanation of the presence of dual labor markets, in which the internal labor market does not seem to follow the textbook economic model of supply and demand.⁸⁷ Nonetheless, it is important to distinguish between the two models. Efficiency wage models are primarily concerned with the existence of involuntary unemployment. In contrast, the career-based employment model is concerned with curtailing strategic behavior within the labor market and developing self-enforcing mechanisms for employment contracts. Moreover, the job security clause, whether explicit or implicit, is critical in the career-based employment model but is fatal within the efficiency wage shirking model. The shirking model assumes that employers can respond immediately and costlessly by firing shirking employees. Any form of job security, be it explicit, implicit or merely procedural, burdens the employer and alters the rules of the game. Employees will not increase effort if they estimate employers firing costs as significant.

According to these distinctions, Silicon Valley's high velocity labor market can be categorized as an external labor market pursuant to the career-based employment model. The workers' retention rates are short and there are no commitments on behalf of employers or employees for an ongoing long-term relationship.⁸⁸ In contrast, within the efficiency wage model, these workers can be categorized as internal market employees. The employees are sufficiently compensated and their compensation packages, which include shares and option plans, operate as an efficiency wage tool to increase effort and productivity.

thus leaving intact the underlying assumption of the price theory that wages cannot exceed the marginal productivity of the worker.

86. Paying efficiency wages deters voluntary turnover on behalf of employees. This may cause retention rates to rise, even if employees do not enjoy explicit or implicit job security. Employers can now invest in training their workforce. Similarly, the fact that higher wages raise productivity assures workers, according to the efficiency wage model, that their employer will not depress wages in the face of an increased supply of labor. This again resembles the pattern of employment according to the lifetime employment model, in which the wage graph is determined internally within the establishment. One can also describe the lifetime employment model in terms of paying efficiency wages. The up sloping wage curve and job security granted to employees are raising productivity not only due to human capital accumulation but also due to increased efforts by employees, or in terms of the sociological gift exchange model, with a "present" of increased effort.

87. Wachter & Wright, *supra* note 4 (providing an example of an amalgam of both theories).

88. See Alan Hyde, *Silicon Valley's High-Velocity Labor Market*, 11 J. APPLIED CORP. FIN. 28 (1998); see also ANNALEE SAXENIAN, *REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128*, 132-59 (1994).

C. The Demand for Labor

To understand how mandated employee benefits redistribute wealth and alter the employment setting, it is imperative to gain a better grasp of the nature and the variety of labor costs. The mix of these labor costs will govern the route of labor into or out of internal markets.

In his book, Daniel Hamermesh lays out a typology of labor costs.⁸⁹ The initial distinction is between fixed costs which vary only with employment level and variable costs which vary with hours worked or the wage itself.⁹⁰ A fixed-cost mandate requires employers to provide the same benefit package irrespective of the hours worked or the wage earned.⁹¹ Fixed cost benefits increase low wage earners' overall compensation relatively more than that of highly paid employees, which induces employers to substitute high-skilled labor for low-skilled labor.⁹² In addition, employers affected by the fixed cost mandate will tend to utilize more hours per worker.⁹³ Within the category of fixed costs, there are recurring costs such as health coverage, which generate the same premium every time period.⁹⁴ The other subcategory of fixed costs are one-time costs, which are incurred only when a triggering event occurs.⁹⁵ One-time fixed costs are usually associated with workers' mobility.⁹⁶ They include hiring costs (training costs and antidiscrimination mandates) and firing costs (severance pay, antidiscrimination mandates, job security mandates and WARN rights).⁹⁷ These mandates also curtail mobility rates because these costs are incurred only when entrance into or exit from the employment relationship takes place. One-time fixed

89. HAMERMESH, *supra* note 59, at 46-55.

90. *Id.* at 46.

91. Daniel S. Hamermesh, *The Demand for Workers and Hours and the Effects of Job Security Policies: Theory and Evidence*, in *EMPLOYMENT, UNEMPLOYMENT AND LABOR UTILIZATION* 9, 10 (Robert A. Hard ed., 1988).

92. *Id.* at 11. Take, for example, health insurance benefits. Presently, employer-provided health insurance is mandated only in Hawaii. In other states, many employers offer voluntary health insurance coverage as part of their compensation package. Health insurance is a fixed labor cost. Providing a certain package of health benefits costs employers exactly the same whether an employee works part-time or full-time, or whether an employee is earning minimum wage or an hourly wage well in excess of the minimum. It is therefore apparent that as a percentage of total compensation, the share of health benefits increases as the wage rate decreases.

93. *Id.* at 10.

94. HAMERMESH, *supra* note 59, at 47-48.

95. *Id.*

96. Jack E. Triplett, *Introduction to THE MEASUREMENT OF LABOR COST* 1, 19-21 (Jack E. Triplett ed., 1983); HAMERMESH, *supra* note 59, at 207.

97. See HAMERMESH, *supra* note 59, at 48; Hamermesh, *supra* note 91, at 12; Triplett, *supra* note 96, at 19.

cost mandates enforce career based, long-term employment work arrangements.

The distinctions among variable costs are harder to articulate.⁹⁸ All variable labor costs are prorated to the wage rate. One can differentiate among the regular hourly wages (reflected in minimum wage mandates), overtime wage costs⁹⁹ and non-wage variable costs (such as premiums for social security, unemployment and workers' compensation benefits, which are computed based on the employee wage rates).¹⁰⁰ Next we will investigate how the different types of labor costs, i.e., types of mandates, affect the employment setting.

1. Fixed Recurring Cost Mandates

A simple function of labor output assumes that twenty employees working a forty-hour work week is equivalent to ten workers working an eighty-hour work week, and in both cases labor input is eight hundred hours per week. No account is taken here of differences in the prices and productivity of these two means of altering the input of labor.¹⁰¹ In reality, employers face many choices about how many employees to employ and how many hours they will work,¹⁰² even if employment output, i.e., total amount of hours worked by all employees is held constant.¹⁰³ Because mandated benefits are part of the compensation package, i.e., labor costs, we should inquire how mandates affect employers' decisions on substitution between hours and employment levels.

Fixed cost mandates are sensitive to the size of the workforce rather than to wages. All other factors being equal, this feature encourages employers to employ fewer workers and have them work more hours.

98. See HAMERMESH, *supra* note 59, at 48.

99. Both regular and overtime wage costs are mandated by the FLSA.

100. See HAMERMESH, *supra* note 59, at 48. Some non-wage variable costs are transformed into fixed costs whenever the mandate has a cap. When this occurs an employer who employs workers who reached the cap will treat these costs as fixed. This is because the employer owes nothing beyond the cap. For example, the employer might work these workers longer hours and hiring fewer employees in order to save on the mandates' costs pertaining the new hires. The variable cost in these cases "transforms" beyond the cap into a fixed cost. This is relevant to Social Security payments, which are capped.

101. See *id.* at 45. Hamermesh gives the following intuitive example: doubling weekly hours from 60 to 120 per worker will probably not double the amount of effective labor, as there is a limit on an employee's ability to work effectively beyond a certain amount of hours. *Id.*

102. *Id.* at 45-46 ("Hours H are measured per time period . . . The convention is to measure H as hours per week. . .").

103. *Id.* at 45.

To minimize the labor costs of producing at any level of output, an employer should adjust his employment levels and work week so that the cost of producing an additional unit of output is equal between those two means of adjustment.¹⁰⁴

$$\frac{ME_m}{MP_m} = \frac{ME_h}{MP_h}$$

ME_m denotes the marginal costs of hiring another employee.¹⁰⁵ This marginal expense is a function of hourly wages, fixed labor costs and variable employee benefit costs.¹⁰⁶ ME_h represents the marginal costs of working incumbent employees for an additional hour.¹⁰⁷ This marginal expense will equal hourly wages, variable employee benefit costs and overtime pay, if applicable, multiplied by the number of employees working the additional hour.¹⁰⁸ MP_m and MP_h represent the marginal productivity of hiring an additional employee and working incumbent employees for an additional hour, respectively.¹⁰⁹ If ME_m rises relatively to ME_h , a profit-maximizing employer will want to substitute hours for workers, hiring fewer workers but having each work more hours.¹¹⁰ Many mandated benefits are of a fixed cost nature and thus increase ME_m relative to ME_h when implemented. Empirical studies indicate that average weekly overtime has been steadily increasing.¹¹¹ This may be principally due to the increase in fixed labor costs.

Employer-provided health insurance coverage is a good example of how fixed recurring labor costs drive employers to substitute hours for

104. EHRENBERG & SMITH, *supra* note 64, at 149-50.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. EHRENBERG & SMITH, *supra* note 64, at 149-50.

110. *Id.*

111. Ron L. Hetrick, *Analyzing the Recent Upward Surge in Overtime Hours*, 123 MONTHLY LAB. REV. 30 (2000). Between March 1991 and early 1997, average manufacturing overtime increased by 1.6 hours, reaching the highest level of 4.9 hours since the Bureau of Labor Statistics began publishing the Current Employment Statistics Survey in 1956. *Id.* at 30. Overtime is defined as "hours for which premiums were paid because they exceeded the number of straight-time workday or workweek hours." *Id.* "Average overtime is computed by dividing the total number of overtime hours in a given industry by the number of production workers in that industry, including those that work no overtime at all." *Id.* The author computed the full-time equivalent of the overtime increase. *Id.* at 32. This tells us how many full-time jobs could have substituted for the increase in overtime. From March 1991 to January 1998, the full-time aggregate overtime hours in manufacturing was equivalent to 571,000 jobs. *Id.* At the same time, production jobs in the manufacturing industry increased by 601,000 jobs. *Id.* This means that if employers had substituted overtime hours for new hires, nearly twice as many production jobs would have been created. *Id.*

employment levels. Not yet required outside Hawaii,¹¹² health insurance provisions are encouraged by favorable tax treatment.¹¹³ Health insurance is a fixed recurring cost. Once an employer is providing health insurance coverage, cost does not vary with hours worked or wages. Employers incur premium costs on a recurring basis, monthly or yearly.

A study of the labor markets' response to rising fixed costs suggests that rising health insurance costs during the 1980s increased the hours worked by those with health insurance by up to 3%.¹¹⁴ The study argues that this occurred because health insurance is a fixed cost, and as health insurance became more expensive to provide, firms faced an incentive to substitute hours for employment.¹¹⁵ This means that even when employers can offset the entire cost of providing the benefit by lowering incumbent workers' wages,¹¹⁶ they will choose to increase incumbent employees' hours, which will decrease the cost per hour of providing the benefit.¹¹⁷

The experience of Hawaii's mandatory employer-provided health insurance program offers an example of how fixed cost mandates shift labor demand for uncovered employees.¹¹⁸ Thurston found that the

112. Thurston, *supra* note 60, at 118.

113. *Id.* at 120.

114. David M. Cutler & Brigitte C. Madrian, *Labor Market Responses to Rising Health Insurance Costs: Evidence on Hours Worked*, 29 RAND J. ECON. 509, 510 (1998). The authors concentrate on health insurance because "half of the increase in nonwage compensation costs from 1980 to 1990 is accounted for by increased expenditures on health insurance." *Id.*

115. *Id.* at 509.

116. *Id.* at 509, 527. Because health insurance outside Hawaii is voluntarily provided, perfect cost shifting must be assumed. Employer-employee matches that do not find the cost of health insurance to be outweighed by its value to employees will decline to provide the benefit altogether. *Id.* at 509. The Cutler and Madrian study shows that even in a voluntary setting, fixed costs benefits are not neutral pertaining to the choice between hours and employment levels. Cutler & Madrian, *supra* note 114, at 527. It is still more efficient to increase hours while letting other employees crowd the uninsured labor market. *Id.*

117. A similar point is advanced in a 1989 survey of childcare centers, which examines the effects of voluntary fringe benefits on the demand of covered part-time teachers and teacher aides. Mark Montgomery & James Cosgrove, *The Effect of Employee Benefits on the Demand for Part-Time Workers*, 47 INDUS. & LAB. REL. REV. 87, 87, 93-94, 96 (1993). As the level of fringe benefit payments rose, hours of work by eligible part-time workers fell significantly relative to the hours worked by full-time teachers and aides. *Id.* at 87. An increase in benefit of 1% of the wage bill decreased the proportion of part-time hours by 0.43 percentage points for teachers and by 0.35 percentage points for teacher aides. *Id.* at 94-95. Particularly influential were insurance payments such as health care and dental care, which are fixed recurring costs, as opposed to prorated variable benefits such as pensions and paid vacation. The effect detected was more than twice as large. *Id.* at 96. This indicates that in response to universal fixed cost mandates (which cannot exclude part-time employees or other subgroup of workers), employers will not respond by decreasing the wages of all incumbent employees. Instead, they will reduce employment rates of part-time employees.

118. Thurston, *supra* note 60, at 117, 130.

percentage of Hawaiian workers employed less than twenty hours per week, thus exempt from coverage under the statute, increased.¹¹⁹ This result is in accordance with a price theory model in which minimum wage mandates initiate increased demand for labor in the uncovered sectors.¹²⁰ In the Thurston study, the detected shift into the uncovered sector is explained by the fact that employers do not have to provide insurance for these workers.¹²¹

Two insights pertaining to fixed recurring mandates are suggested. The first is when employers encounter an increase in fixed cost mandates they will increase overtime and restrict new hiring.¹²² The second point is that demand for exempt employment relationships will also increase as fixed cost mandates increase.¹²³ These practices parallel dual labor market models: employees who are covered by the mandate are working more hours and are probably being paid overtime premiums for these extra hours, while other employees are crowded into exempt jobs.¹²⁴ As discussed below, there is no empirical data supporting the frequently offered claim that uncovered employees are paid compensating wages to offset the fact that the benefit program does not cover them.¹²⁵

2. One-Time Fixed Cost Mandates

Some fixed labor costs can be defined as one-time costs.¹²⁶ They are incurred only once during the tenure of a specific worker and are linked to the quit rate in the workplace.¹²⁷ The higher the one-time costs, the greater the employer's incentive to reduce turnover rates and to increase

119. *Id.* at 130, 133. "For a 10 percentage point increase in the fraction of employees in an industry who receive health insurance, about 1% more jobs were shifted into the exempt, low-hours sector in Hawaii than in the United States as a whole." *Id.* at 130.

120. The two-sector model is introduced in Jacob Mincer, *Unemployment Effects of Minimum Wages*, 84 J. POL. ECON. S87 (1976).

121. Thurston, *supra* note 60, at 131. *See generally* Rebecca M. Blank, *Contingent Work in a Changing Labor Market*, in GENERATING JOBS: HOW TO INCREASE DEMAND FOR LESS-SKILLED WORKERS 258 (Richard B. Freeman & Peter Gottschalk eds., 1998) (reviewing studies that report demand shifts to uncovered work arrangements when voluntary benefit programs are implemented).

122. Cutler & Madrian, *supra* note 114, at 527.

123. *Id.*

124. *Id.*

125. *See infra* Part IV.D; *see also* Cutler & Madrian, *supra* note 114, at 527. The Cutler & Madrian study indicates that hourly wages were higher for employees with health insurance than for those without it. *Id.* But this study, which uses inter-establishment data, cannot control well for disparate employees' characteristics and establishment working conditions. *Id.* at 516.

126. HAMERMASH, *supra* note 59, at 47-48.

127. *Id.* at 48.

the hours per employee ratio in order to avoid the incidence of the fixed cost mandate.¹²⁸ Such mandates serve as an enforcement mechanism for internal markets in the career-based employment model.

One-time fixed costs mandates, such as just cause dismissal rules, obviously promote internal markets and the same can be said of antidiscrimination mandates. If employers are vulnerable to litigation by protected group members at the hiring and firing stages, they will limit mobility by hiring fewer workers and by avoiding discharge of incumbent employees.¹²⁹ Voluntary adoption of career employment practices is motivated by the costs incurred by the mobility of labor, which can be extensive. Commonly mentioned costs include recruitment and loss of specific human capital, but other mobility costs, such as threat of expensive litigation or mandatory severance pay schemes, will also operate to encourage the adoption of internal labor market structures.

The impact of exit mandates is greater than entrance mandates for the simple reason that there are many more mandates which increase firing costs than mandates which increase hiring costs.¹³⁰ This is not surprising because the goal of most dynamic labor market policies is to increase employment and cushion layoffs. It is hard to find policies that deliberately seek to increase hiring costs.¹³¹ On the other hand, many mandates are aimed at raising firing costs. Most notable are the common law exceptions to the employment at will doctrine, severance pay schemes, plant closing notification statutes and the antidiscrimination statutes, which are enforced primarily in the dismissal context.¹³²

128. *Id.* at 49.

129. It is fairly obvious that a policy that effectively taxes hiring reduces it and therefore, leads to employment being held constant longer during an upturn in product demand. It also produces a reduction in firing rates which can be understood by noting that any fired worker must eventually be replaced in a future boom. Mandates that add costs to firing decisions operate in a similar manner. It taxes layoffs, but also hiring, as encumbered employees may have to be fired in the future.

130. John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 STAN. L. REV. 983, 1027 (1990-1991).

131. The relevant groups of mandates that indirectly raise hiring costs are the various employment antidiscrimination statutes. *Id.*

132. *Id.* The authors find that "firing cases are six times more likely than hiring cases" and that "the likelihood of suit when an employer fires a protected applicant is thirty times greater than the likelihood of suit if the employer simply fails to hire the worker." *Id.* The authors also note that the "dramatic shift to firing cases has greatly increased the likelihood that Title VII will create a drag on the hiring of protected workers rather than the positive inducement it originally provided." *Id.* The authors then conclude that

the effects of Title VII have changed from the opening up of access to jobs for traditional victims of discrimination to the protection of those who already have jobs. We may now

Perhaps the best current example of a one-time fixed cost mandate is the common law exception to the employment at will doctrine, which is now recognized in most states.¹³³ The three doctrines at play are the implied contract exception,¹³⁴ the public policy exception¹³⁵ and the covenant of good faith and fair dealing exception.¹³⁶ The impact of these judicial mandates on employment and wage rates is the focus of three recent empirical studies.

Autor, Donohue III and Schwab found that only the implied contract exception appears to have affected employment rates.¹³⁷ Negative employment effects were not detected following the adoption of the tort-based public policy exception and/or the good faith dealing exception.¹³⁸ Little evidence of the impact of the common law exceptions

have a sort of implicit tort of wrongful discharge . . . for virtually all workers except white males under age 40.

Donohue III & Siegelman, *supra* note 130, at 1033. See Ian Ayres & Peter Siegelman, *The Q-Word as Red Herring: Why Disparate Impact Liability Does Not Induce Hiring Quotas*, 74 TEX. L. REV. 1487, 1490 (1996) (noting that since 1993, only one out of four disparate impact decisions in federal courts involves claims of discrimination in hiring).

133. Charles J. Muhl, *The Employment-At-Will Doctrine: Three Major Exceptions*, 124 MONTHLY LAB. REV. 3, 4, 7, 10 (2001) (noting that as of October 1, 2000, forty-three states recognized the public policy exception, thirty-eight states recognized the implied contract exception, and eleven states recognized the covenant of good faith and fair dealing exception).

134. *Id.* at 7-10. The implied contract exception to "the employment-at-will doctrine is applied when an implied contract is formed between an employer and employee, even though no express, written" contract pertaining to job security exists. *Id.* at 7. An employer can present oral, written or other behavioral representations to employees pertaining to "job security or procedures that will be followed when adverse employment actions are taken." *Id.* The courts may find these representations as contractually binding. *Id.*

135. Muhl, *supra* note 133, at 4-7.

Under the public policy exception to employment at will, an employee is wrongfully discharged when the termination is against an explicit, well-established public policy of the State. For example, in most States, an employer cannot terminate an employee for filing a workers' compensation claim after being injured on the job, or for refusing to break the law at the request of the employer. The majority view among States is that public policy may be found in either a State constitution, statute or administrative rule. . . . The majority view is not based on a vaguer sense of public policy.

Id. at 4.

136. *Id.* at 10-11. Recognized by only eleven states, this exception "reads a covenant of good faith and fair dealing into every employment relationship." *Id.* at 10. It has been interpreted to mean that an employer is in breach of her covenant when terminating an employee to prevent the employee from enjoying the benefits of her employment. *Id.*

137. David H. Autor, John J. Donohue III & Stewart J. Schwab, *The Costs of Wrongful Discharge Laws* 3 tbl.1 (Oct. 2, 2001) (paper presented at the New York University Labor and Employment Law Center Workshop). The adoption of the exception was followed by a decline of 0.41 to 0.62 percentage points in the ratio of employment to population. *Id.*

138. *Id.* at 3. One possible explanation to these findings is that the public policy and good faith dealing exceptions do not have a bite they do not burden employers with additional costs. They legally exist, but employers do not find them monetarily meaningful, as they are rarely enforced

on hourly wage was traced.¹³⁹ These findings parallel our explanatory discussions of the nature of one-time fixed costs. The implied contract mandate had a greater impact on low-waged, young, uneducated employees than on educated, older employees.¹⁴⁰ As previously discussed, fixed cost benefits increase low-wage employee compensation relative to highly paid employees. This encourages employers to substitute high skilled employees for low skilled employees as their relative employment costs decrease.¹⁴¹

The Miles study¹⁴² reports that the common law exceptions did not affect employment or unemployment rates in the United States.¹⁴³ However, following the adoption of the implicit contract exception, temporary help supply (THS) employment was observed to increase by 15%.¹⁴⁴ Autor investigates the relationship between the common law exceptions and the growth of the temporary help industry.¹⁴⁵ He estimates that 20% of the growth of THS employment between

against them. Another explanation is that when these two exceptions are enforced, it is in a manner that is not regulating the employment contract, but rather interpreting and enforcing the authentic mutual understanding of the parties. Therefore, these exceptions do not translate into additional labor costs. Employers do not view them as external interventions with their dismissal prerogative.

139. *Id.* at 30 tbl.16. The authors concede that the price theory would predict a dampening effect on wages as employers shift the cost of the mandate over to their employees, but no such effect was traced. Autor, Donohue III & Schwab, *supra* note 137, at 30.

140. *Id.* at tbl.4. The highest impact was found in relation to the group consisting of low-educated, young males (1.9%) and a 1.1% impact in relation to the employment of younger, less educated females. No impact was detected pertaining to the elder, better educated portion of the workforce. Autor, Donohue III & Schwab, *supra* note 137.

141. It should be noted that other explanations could be attached to these findings. It could be argued that the elder, more educated portion of the workforce enjoys, on average, more voluntary job security protection. The judicial mandate did not confer costs pertaining to this segment of the workforce and therefore, its employment rates remained unaffected. The segment of the labor market, which was regulated, i.e., those employees who did not previously enjoy job security the young and uneducated labor market participants were the ones encountering the employment consequences of the mandate. Summers, *supra* note 1, at 180, advances the same point. When assessing the impact of mandates we have to differentiate between employers whose prior voluntary policies were in compliance with the new standard (those employers and their employees are not affected by the mandate) and those employers who now must adhere to the new standard and face the consequences of additional labor costs.

142. Thomas J. Miles, *Common Law Exceptions to Employment at Will and U.S. Labor Markets*, 16 J.L. ECON. & ORG. 74 (2000).

143. Autor, Donohue III & Schwab, *supra* note 137, attempt to reconcile the differences.

144. Miles, *supra* note 143, at 74 (suggesting, as well, that the other two exceptions are monetarily meaningless).

145. DAVID H. AUTOR, *OUTSOURCING AT WILL: UNJUST DISMISSAL DOCTRINE AND THE GROWTH OF TEMPORARY HELP EMPLOYMENT* (Nat'l Bureau of Econ. Research, Working Paper No. 7557, 2000) (reporting that temporary help industry employment has grown five times more rapidly than overall employment).

1973–1995 can be attributed to the recognition of the implicit contract doctrine.¹⁴⁶

The detected growth in the temporary help industry resulting from the adoption of the implied contract exception fits well within the dual market theory. Job security, representing a one-time exit fixed cost, interferes with labor market mobility as it encourages employers to retain incumbent permanent employees in a career employment setting. Firms have an incentive, however, to structure all other employment relationships outside the reach of the mandate, i.e., in the exempt sector. In the context of the employment at will exceptions, this means employers will tend to hire temporary help employees, who are less likely to trigger judicial interference. Courts are generally unwilling to extend the protection of the common law at will exceptions to contingent workers, including employees of temporary help agencies.¹⁴⁷ Both studies support the argument that end users of temporary help agency workers increase their demand for temporary workers precisely because they view these employees as exempt from the implicit contract exception.¹⁴⁸ The labor market impact of the mandate is that covered employees (protected by the job security mandate) are now part of the internal career-based employment setting, while the transition to THS employment arrangements represents the low-end external exempt sector.¹⁴⁹

D. The Redistribution Effects of Fixed Cost Mandated Benefits

The fact that an increase in the demand for exempt employees often follows the implementation of a mandated benefit program does not yet prove that regressive intra-employee redistribution occurs. To the contrary, the price theory model suggests that wage differentials will compensate exempt employees for the lack of mandated benefits.¹⁵⁰

146. *Id.* at 2. Half a million workers found themselves employed within the THS industry due to the recognition of the implicit contract exception. *Id.*

147. *See, e.g.,* Mark Berger, *Unjust Dismissal and the Contingent Worker: Restructuring Doctrine for the Restructured Worker*, 16 YALE L. & POL'Y REV. 1, 8, 28-35 (1997) (detailing the extensive case law that declined to extend the protection of the common law at will exceptions to contingent workers, including employees of temporary help agencies).

148. *Id.* at 5-6 (discussing employers' willingness to hire from leasing agencies because there are no long-term employment expectations).

149. *See id.* at 6-7.

150. Under this model, markets always reach equilibrium, and total compensation for comparable employees must be equivalent as well.

Attempts to verify this theory, however, prove opposite results. Studies in the 1980s involving non-mandatory benefit policies found that compensating wage differentials were not associated with the presence of pension benefits and paid holiday¹⁵¹ or sick leave and health insurance benefits.¹⁵² These studies deal with voluntarily provided benefit plans and were not completely successful in controlling for all relevant employer and employee characteristics.¹⁵³

More recent studies have been able to control for working conditions and employee characteristics by using intra-establishment comparisons.¹⁵⁴ But these studies did not find compensating wage differentials to offset non-coverage of the benefit plan.¹⁵⁵ Rather, they suggest that workers can be paid similar wages even though some are denied coverage of voluntary benefit plans.¹⁵⁶

Lettau's study comparing compensation of part-time and full-time employees within the same establishment,¹⁵⁷ reports that hourly wages, hourly benefit costs and total compensation per hour were substantially lower for part-time jobs than for full-time jobs, even for workers who

151. See Robert S. Smith & Ronald G. Ehrenberg, *Estimating Wage-Fringe Trade-Offs: Some Data Problems*, in *THE MEASUREMENT OF LABOR COST* 347, 347 (Jack E. Triplett ed., 1983). Using employer-based data on employee compensation packages, Smith and Ehrenberg were unable to trace the predicated tradeoff between wages and fringe benefits. *Id.* at 364. One explanation to this finding was that maybe the "theory is wrong, or at least not predictive of 'real world' behavior." *Id.*

152. See, e.g., Arleen Leibowitz, *Fringe Benefits in Employee Compensation*, in *THE MEASUREMENT OF LABOR COST* 371 (Jack E. Triplett ed., 1983). In this study, hedonic wage equations showed that for employees receiving benefits from their employer, the level of benefits was positively related to wages (contrary to the compensating wage differential theory). *Id.* at 386. Men did not seem to pay any significant price in terms of lost earnings for receiving sick leave. *Id.* Accident insurance benefits also did not affect wage rates, and for life insurance and health care coverage, the amount of employer paid premiums was positively related to wages, i.e., the more generous the plan was the wage rate was higher. *Id.* The price theory model must explain these findings in terms of uncontrolled differences in the human capital of workers or other job traits. Dual market theory can offer efficiency enhancing justifications for these findings.

153. See *id.* at 371-72. Failure to control for all establishment/worker characteristics cannot eliminate the possibility that we are not comparing two identical jobs. Ehrenberg and Smith suggest that failure to control for non-pecuniary job characteristics (working conditions) can generate distortions. See Leibowitz, *supra* note 152, at 389 (discussing the importance and difficulties of controlling for employee and employer characteristics).

154. See *infra* notes 156-57.

155. *Id.*

156. Susan N. Houseman, *Why Employers Use Flexible Staffing Arrangements: Evidence from an Establishment Survey*, 55 *INDUS. & LAB. REL. REV.* 149, 159, 161 (2001).

157. MICHAEL K. LETTAU, *COMPENSATION IN PART-TIME JOBS VERSUS FULL-TIME JOBS: WHAT IF THE JOB IS THE SAME?*, 1 (Bureau of Labor Statistics, U.S. Dep't of Labor, Working Paper No. 260, 1994).

were actually working side by side.¹⁵⁸ This study confirms that lower benefits may not translate into higher wages for part-time employees even within the same establishment. This indicates within a single workplace, full-time employees are part of the internal labor market, and part-time employees should be viewed as external market employees.¹⁵⁹

Houseman's study attempts to explain why employers use contingent work arrangements.¹⁶⁰ The need to adjust workload fluctuations and to cope with staff absenteeism are among the reasons given by employers to use contingent work arrangements.¹⁶¹ However, Houseman finds the use of flexible staffing arrangement decreased labor costs significantly even though not many employers stated this as a driving factor.¹⁶² For three of the surveyed work arrangements, hourly pay cost was about the same for regular employees in similar positions.¹⁶³ But when benefits costs were taken into account for all three arrangements, the majority of establishments reported that hourly wage cost plus benefit costs were lower for staffing arrangement employees than for regular employees holding similar positions.¹⁶⁴ This confirms

158. *Id.* Jobs from the same establishment and occupation were compared. The estimated part-time/full-time difference was true for the hourly wage component (-.164), hourly benefit cost component (-.475) and total compensation per hour (-.227). *Id.* at 15, tbl.4A.

159. See Blank, *supra* note 121, at 270. After surveying the literature on the part-time/full-time compensation disparity, Blank reaches several conclusions. First, part-time workers earn less than full-time workers. *Id.* at 269. Second, the effect of part-time work on the probability of benefit coverage clearly reveals that part-time workers are less likely to receive benefits, and if they do receive benefits, the dollar amount of their benefit package is substantially lower than those of full-time workers. *Id.* at 269-71.

160. Houseman, *supra* note 156, at 149. The following arrangements were surveyed: temporary help agency workers, short-term hires (workers hired "directly by the organization for a limited or specific period of time"), regular part-time employees, on-call workers ("called into work only as needed") and contract workers (workers "who are employed by another organization to perform tasks or duties as specifically contracted by the organization"). *Id.* at 151.

161. *Id.* at 149 (citing the additional reason that using agency temporaries and part-time workers were useful screening methods for permanent positions).

162. *Id.* at 167. Only 11.5% of establishments specified that saving wages and benefits motivated them to use THS workers (8.1% for short-term hires, 21.3% for part-time workers and 6.0% for on-call workers). *Id.* at 158 tbl.5. These are substantially lower than stated rates for other reasons. For example, 47.0% and 52.2% of the establishments mentioned the need to fill in for absent regular workers and the need of assistance in peak time, respectively, were driving them to use THS workers. Houseman, *supra* note 156, at 158 tbl.5.

163. *Id.* at 159. Sixty-three point nine percent (63.9%) of establishments reported that hourly pay for short-term hires was approximately the same for regular employees holding a similar position (74.6% for part-time workers and 61.3% for on-call workers). *Id.* at 159 tbl.6. A noted exception was the THS workers; 62.1% of the establishments reported that agency temps' hourly pay was higher than regular employees holding a similar position. *Id.*

164. *Id.* Fifty-six point six percent (56.6%) of establishments reported that hourly pay plus benefit cost was lower for short-term than for regular employees holding a similar position (62.9% for part-time workers and 72.7% for on-call workers). Houseman, *supra* note 156, at 159 tbl.6.

Lettau's findings that there are no compensating wage differentials for the lack of benefits for part-time employees within the same establishment.¹⁶⁵ The fact that the disparity in compensation manifested itself in the benefit portion of total compensation rather than hourly wages¹⁶⁶ supports the claim that many of these benefits represent fixed costs and help entrench dual market practices.¹⁶⁷

In my view, non-eligible employees carry some of the costs of the mandate. If the labor supply is inelastic, compensation rates are determined mainly by labor demand and the competition among the various employers over the existing supply of labor. Employer leverage enables some of the costs of providing the benefit to be shifted to the exempt sector.

Employers may prefer not to target the beneficiaries of the mandate but rather to spread the costs of the mandate across the entire workforce. This practice assists with the establishment of a well-compensated internal market workforce that will reward employers with higher productivity and a greater core of employee willingness to engage in specific human capital attainment. Employers have a strong incentive in that the non-beneficiary (non-covered) group of employees will carry some of the benefits' cost burden. This advances the compensation disparity between internal and external market workers. If employers choose to target cost shifting to the beneficiaries of the mandated benefit, no internal markets could be established because both compensation packages would be equal in value.

Truman Bewley, in his well-publicized book¹⁶⁸ documents the downward wage rigidities characterizing internal markets through extensive interviews with managers.¹⁶⁹ These rigidities manifest

Pertaining to THS employees, 38.3% of establishments reported lower compensation packages for agency temps. *Id.*

165. *Id.* at 162 n.19.

166. This finding is also consistent with Lewis M. Segal & Daniel G. Sullivan, *The Growth of Temporary Services Work*, 11 J. ECON. PERSP. 117, 125-26 (1997) (documenting a small wage gap but high benefit coverage gap for permanent versus THS employees).

167. The Miles and Autor studies did not address the compensation levels of THS employees relative to regular permanent employees of the end users; they only report growth in the industry employment rate in response to the judicial mandate. *See Miles supra* note 144; *Autor supra* note 143. *But see* Segal & Sullivan, *supra* note 166, at 126 (reporting a gap of 21.8% in the wages of THS employees and permanent workers, but only a 3.1% wage gap after controlling for employees, demographic and occupational characteristics; documenting substantially lower benefit coverage, especially pertaining to health insurance).

168. TRUMAN F. BEWLEY, *WHY WAGES DON'T FALL DURING A RECESSION* (Harvard Univ. Press 1999).

169. *Id.* at 173-92.

themselves in a reluctance by management to cut wages in the presence of unemployment and an unwillingness to accept workers' underbidding offers to work for less than the wages currently paid.¹⁷⁰ According to the study, a major reason employers refuse to cut wages is the fear that wage cuts will adversely affect employee morale and productivity.¹⁷¹ Bewley reports that in the external market, these practices are not prevalent and downward wage flexibility is very common.¹⁷² These findings suggest that, contrary to the assumptions of the standard price theory competitive model, wages in the internal market are affected not only by demand and supply conditions but are also impacted by workers' effort, work and behavior. This means that, theoretically, employers could cut wages and their employees would not withhold their labor,¹⁷³ but employers *choose* not to do so in order to keep work morale and productivity intact. This pattern perhaps explains why employers are targeting external market employees in order to finance part of the benefits granted to internal labor market employees. Downward wage rigidities in the internal market motivates employers to shift the costs of the benefit to external labor market participants.¹⁷⁴

Studies pertaining to the use of contingent work arrangements further suggest that one of the reasons employers contract out employment is to differentiate their internal market employees from their external market employees.¹⁷⁵ Although non-unionized establishments can offer better compensation packages to some workers and not others, employers avoid this strategy for fear that perceptions of inter-employee inequality will damage morale and productivity.¹⁷⁶ Using non-standard employment arrangements, especially temporary agency employees and contract workers who are not company employees, may

170. *Id.* at 173-74 (supporting efficiency wage models).

171. See Carl M. Campbell III & Kunal S. Kamani, *The Reasons for Wage Rigidity: Evidence from a Survey of Firms*, 112 Q. J. ECON. 759, 761 (1997) (reporting similar findings on usage rigidities).

172. Bewley, *supra* note 168, ch. 17 (discussing secondary market behavior).

173. This confirms the claim that the labor supply curve is highly inelastic.

174. In summarizing his findings on external labor market employees Bewley notes that Because of high turnover and heavy use of part-time labor, workers in the secondary sector do not get to know one another well enough to make internal equity as important as it is in the primary sector. For this reason, hiring pay is more flexible downward in the secondary market than in the primary sector.

Bewley, *supra* note 168, at 326-27.

175. See, e.g., Segal & Sullivan, *supra* note 166, at 132-34 (explaining that the growth in the use of THS employees is motivated by a need to establish a two-tier compensation structure); Blank, *supra* note 121, at 259-61 (expanding this line of argument to all contingent practices).

176. See generally Bewley, *supra* note 168, chs. 6, 8.

enable management to lower wages for these employees with minimal adverse repercussions on core employee morale.¹⁷⁷ Mandated benefits programs that permit employers, on the one hand, to exclude secondary market employees from coverage, and on the other hand, to depress their wages in order to finance the cost of the mandate, provide a vehicle to achieve the same objective that of sustaining intra-establishment dual labor markets.

E. The Redistribution Effects of Variable Costs Mandated Benefits

The literature tends to group all employee benefits together and to treat all of them as fixed labor costs. Some mandated benefits such as unemployment insurance, payroll taxes for social security and workers compensation are variable cost mandates.¹⁷⁸ Non-mandatory benefit plans, such as sick leave, paid vacation and defined contribution pension plans are also variable cost benefits.¹⁷⁹ Variable costs are prorated to cash earnings and thus are incurred proportionally to the wage rate.

In theory, variable labor costs should not distort market decisions on employment practices and the mix of hours and employment levels.¹⁸⁰ Thus, from an intra-employee group distributional perspective, these

177. Katharine G. Abraham & Susan K. Taylor, *Firms' Use of Outside Contractors: Theory and Evidence*, 14 J. LAB. ECON. 394, 397 (1996).

178. HAMERMESH, *supra* note 59, at 48.

179. *Id.*

180. Exceptions are variable overtime costs. The Fair Labor Relations Act (FLRA) requires, in addition to the payment of a mandatory minimum wage, an overtime pay of one and a half for each hour worked above the weekly maximum of 40 hours. 29 U.S.C. § 207(a)(1) (1994). Approximately 70% of all workers are subject to the overtime pay provisions of FLRA. The mandate has two objectives. One is to restrict the weekly hours an individual is working by taxing an employer who works his employees above the maximum. This objective represents a concern for incumbent employees. The other objective is to allow work sharing and to expand employment rates. As employment is negatively correlated to the share of fixed labor costs, a countervailing force is needed to mitigate the incentive to substitute hours for additional workers. Taxing overtime, may encourage employers to employ additional workers at the standard wage, rather than to pay incumbent employees overtime pay. There are continuous increases in the fixed cost share of total compensation and therefore the deterring effect of the overtime mandate is decreased overtime. Overtime pay is relevant mainly to minimum wage earners. Standard wages of workers earning more than the minimum wage can be adjusted downward to keep the overall wage intact. Empirical evidence supports the claim that overtime pay regulation has no discernible impact on overtime hours because straight time hourly wages adjust partially to changes in overtime premium. Employees in these organizations who do not engage in overtime work are made worse off, as their standard wages are depressed. See generally Stephen J. Trejo, *The Effects of Overtime Pay Regulation on Worker Compensation*, 81 AM. ECON. REV. 719 (1991); Stephen J. Trejo, *Does the Statutory Overtime Premium Discourage Long Workweeks*, IZA Discussion Paper No. 373 (Oct. 2001), at

http://www.iza.org/en/webcontent/ProductFunctions/papers_discussions/1005575.../index_html.

schemes are more equitable than fixed labor costs.¹⁸¹ Nonetheless, variable costs may carry redistributive effects. An obvious effect is added costs. When these costs cannot be shifted to covered employees in the form of lower wages, as in the case of minimum wage mandates, the textbook argument is that employment levels will fall whether in the form of fewer hours worked or fewer workers working the same amount of hours. This is the main distributional objection to minimum wage mandates.¹⁸²

Card and Krueger's study suggests that a modest increase in the minimum wage does not result in a lower employment rate.¹⁸³ Putting aside the controversy of whether these findings are plausible both on empirical and theoretical grounds,¹⁸⁴ concentration should be placed on the efficiency wage explanatory theory. One explanation to these findings is that the minimum wage serves as an efficiency wage.¹⁸⁵ This is an abstraction of the Shapiro-Stiglitz shirking model.¹⁸⁶ The Shapiro-Stiglitz model does not address minimum wage directly. It explores, within the shirking model, how structural involuntary unemployment can serve as the disciplining-productivity enhancing tool.¹⁸⁷ The same can be argued about mandatory minimum wage. Employees affected by the new wage standard are deterred from shirking, as the costs of losing one's job are higher. Less shirking results in higher productivity, which can sustain the mandated wage increase without laying off incumbent employees. In the minimum wage setting, wages do not adjust

181. Mitchell, *supra* note 50, at 306 (arguing that on equity grounds variable cost mandates have more appeal). They do not distort employers' choices between hours and employment levels and higher versus lower compensated employees.

182. See, e.g., Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV 405, 406 (1997) (emphasizing that even if minimum wage increases the earnings of low-wage workers as a group, it creates winners and losers among that group and it benefits low-wage workers able to find and keep their job at the expense of those who lose their job).

183. See DAVID CARD & ALAN B. KRUEGER, MYTH AND MEASUREMENT: THE NEW ECONOMICS OF THE MINIMUM WAGE 389 (1995).

184. See Houseman, *supra* note 29, at 174-80, for a survey of a variety of studies supporting the Card-Krueger finding of positive employment effects of a moderate increase in minimum wage mandates, those rebutting the findings both on their empirical and theoretical soundness and those studies finding that empirical data and theory are inconclusive.

185. James B. Rebitzer & Lowell J. Taylor, *The Consequences of Minimum Wage Laws: Some New Theoretical Ideas*, 56 J. PUB. ECON. 245, 245 (1995) (demonstrating "that in a conventional efficiency wage model, a minimum wage may increase the level of employment in low wage jobs").

186. Carl Shapiro & Joseph E. Stiglitz, *supra* note 68.

187. Structural involuntary unemployment is defined by Shapiro & Stiglitz as "a situation where an unemployed worker is willing to work for less than the wage received by an equally skilled employed worker, yet no job offers are forthcoming." *Id.* at 45 n.1.

downward due to legal constraints, while in the Shapiro-Stiglitz model, wage rigidity is an outcome of a voluntary employer decision.

Assuming that this hypothesis is valid,¹⁸⁸ wage mandates still redistribute wealth between groups of employees. If wage mandates serve as efficiency wages, uncovered employees and the unemployed¹⁸⁹ serve as the external disciplinary labor market. External workers will not be successful in attaining minimum wage paying jobs because if all workers could successfully be employed in minimum wage jobs, paying minimum wage would not enhance productivity.

All mandates that cannot be offset by wage decreases may be operating as efficiency wages.¹⁹⁰ Workers who value these benefits are receiving more than the market-clearing wage albeit through regulation. The uncovered sector and the unemployment waiting outside, in the event of being laid off, are serving as the disciplinary secondary labor market.

V. CONCLUSION

Whether mandated employee benefit policies are efficient depends on the ratio of the aggregate value attached by employees to the benefit to the aggregate employer cost of providing the benefit. The higher the aggregate value/cost ratio, the stronger the justification for implementing the policy. High value/cost ratios are indicative of the existence of market failures in the voluntary provision of the benefit.

Mandated benefits, efficient or not, do not entail employer-employee redistributive outcomes. The fact that no employment rate changes can be traced following the enforcement of a mandate program is usually indicative of full employer cost shifting. Policymakers treat

188. Houseman, *supra* note 29, at 171-80 (discussing a vast body of literature that is resisting these findings).

189. Assuming that the rate of unemployment has not increased (because employers were able to sustain the size of their workforce due to increased productivity) we are still facing the problem of the existing unemployed. According to the Shapiro & Stiglitz definition of involuntary unemployment, unemployment rates must have risen. Some individuals who were technically counted as unemployed prior to the minimum wage increase were not involuntarily unemployed at that stage. These individuals were, prior to the minimum wage increase, frictionally unemployed (caught in transition between jobs or just entering the labor market) or unwilling to work at the market wage rate and searching for above market wage jobs, but now are unable to find employment at the new going minimum wage.

190. For minimum wage earners, variable costs (and fixed costs) mandates cannot be offset by lower wages and therefore, are transformed to wage mandates. Workers, who are paid the minimum wage or near the minimum wage, obviously cannot have their wages adjusted to fully offset the compensation increase caused by the mandates.

the magnitude of cost shifting as a proxy of the value workers place on the benefit, disregarding the fact that full cost shifting can also result from the inelasticity of labor supply. When cost shifting occurs because of the inelasticity of the labor supply, workers are simply carrying the dead weight cost of the mandate.

From an intra-employee perspective, it seems apparent that the public is mainly concerned with whether mandates are increasing the unemployment rate. This is true of the minimum wage discourse and the discussions pertaining to the prospects of mandatory employer-provided health insurance. Again, it is assumed that if employment rates are unharmed, the mandates are efficient and equitable because employees are financing the cost of the benefit through decreased wages (health insurance) or increased productivity (minimum wage).

The fact that employers do not respond to mandates by decreasing total demand for labor does not rule out intra-employee redistribution. Mandated benefit schemes, similar to voluntary benefit schemes, reinforce dual labor market practices, in which exempt employees are to some extent financing the costs of providing the benefit to covered employees. This structure of cross-subsidy is efficient from the employer's perspective. It raises productivity and commitment on the part of internal workers. However, it increases compensation disparity between internal and external labor market employees.