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Abstract

The literature on labor relations has been very much divided, mainly between the classical economic approach and the legal/sociological one. An economic analysis of labor law would benefit by abridging both perspectives and complementing with more. This entry provides brief comments of why whether a purely economic approach on labor or a purely legal approach based on capital vs. labor dichotomy is not sufficient to properly address the subject. Several topics related to labor regulation are discussed, and empirical references on those issues are provided.

Economic Analysis of Labor Law and Labor Relations

Since the beginning of humankind, labor was exercised for people's needs. The study of human labor, its relation with the environment and its impacts in human relations within groups, is possibly one of the oldest social studies. Since the Greek philosophers and the Medieval religious scholars, up to the modern and contemporary economists, social scientists, psychologists, industrial engineers – just to name a few – several brilliant minds have engaged their time and research to understand the phenomenon of human, either in a positive or a normative manner. Many of the classical titles in economics and sociology were inquiries on topics related to the nature and consequences of human labor, such as Karl Marx's *The Capital*, Max Weber's *The Protestant Ethic and the Spirit of Capitalism*, and, in some sense, Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations.*

However, in recent times, the study of labor has been absolutely divided. On one side, economics – and specifically labor economics – has been mainly concerned about players' benefits. The economic approach is concerned with the analysis of workers' jobs, income and benefits (short term and long term), pension, etc. For the employers' side, economic models have studied impacts on productivity, profits, flexibility, etc. This perspective sees workers and employers as if the only things these actors pursue in the labor arena are economic and material benefits and that the main relationship here is of sellers and buyers. This is the basic framework of labor economics: a market in which demand (workers) and supply (employers) interact.

On the other side, there is a wide range of scholars analyzing labor relations (until very recently also known as industrial relations) in a very different perspective. This group includes labor sociologists, labor lawyers, and labor historians – among others, who do not view employers and workers as merely in a seller vs. buyer relationship; instead, these researchers see a naturally antagonistic relationship at the labor *arena*. The model of capital vs. labor is the axis of this analysis, and all outcomes derive from it. Especially in the case of labor law, it aims at deriving rules that would smoothen this conflict (whenever possible) or that would balance the opposing forces, normally by protecting the weakest part, i.e., workers. These scholars consider the *locus* of labor as a battlefield, in which conflictive relations pervade, as if confronting with each other was the only thing that matters to these actors in their daily encounters at the workplace.

Needless to say, both approaches are limited and insufficient.

An economic analysis of labor law should take both sides of the view and complement with more. It incorporates features of the demand-supply model of labor and especially recognizes that workers and employers equally face several kinds of *incentives* and *constraints*, which affect their decision-making. However, it also gives significant importance to the formulation, application, and enforcement of rules, whether contractual or regulative ones, in the labor arena. It recognizes that the relationship between employers and workers is not a mere one of seller vs. buyer, or supplier vs. enterprise, and that labor is not a simple commodity. Human relations and power relations matter much here.

Although economic analysis of law a priori adopts the main economic framework, which considers labor *locus* a market, it recognizes that this is a special one, in which failures are the norm: asymmetric information (either from the employer to the worker or from the worker to the employer), externalities, uneven bargaining and political powers, monopoly, and monopsony, among others. Externalities are sources of high transaction costs, and as the normative approach of the Coase Theorem tells us, under these circumstances, legal rules have an important role in the determination of the levels of efficiency (Coase *1960*; Cooter and Ulen *2007*). In other words, in this market, institutions matter and matter a lot.

Special Rules for a Special Market

Market failures exist in all markets. Yet, in the context of labor, they are essential features, not exceptions.

Asymmetric Information

Whenever labor is done for others – i.e., not for one's own subsistence – it entails a contractual relation, either a formal or an informal one. It is a contract because it is a *promise* made by someone to deliver something in exchange of another thing, and this is an enforceable promise. Workers promise to work under such and such conditions, to deliver certain tasks and/or to obtain certain results, in exchange of salary and a certain set of benefits. Employers, in their turn, promise to provide certain working conditions in exchange of workers' labor, which is used to produce goods and services, which, in turn, generate receipts and profits. The presence or absence of a written paper does not alter the fact that this relationship has a contractual nature, because both formal and informal contracts have their valid mechanisms of enforcement; it does not mean that written contracts are less effective in the guarantee of productive outcomes. The comparison between formal and informal types of contract is not the main issue of this brief entry, and, for our purposes, one should only bear in mind that labor entails, indeed, a contractual relation.

Besides that, most of the transactions between employers and employees are non-instantaneous, long-term interactions. The longer the relationship, the stronger are the impacts of uncertainties. For instances, neither the employer nor the employee knows, at the time of the recruitment, whether the economy will be booming or will be slowing down in the following years (which may impact in the employer's ability to pay higher salaries); both parties do not even know how long will the company survive in the market.

Finally, human interactions are characterized by imperfect and unbalanced information: one is never able to access the whole set of information related to the other party, due to limited cognitive capability and due to high transaction costs. This is true even for noneconomic human relationships such as marriage, friendship, etc. In the case of employers, even if they try hard to access candidates' true ability (even by means of sophisticated processes of screening), they will not be able to fully acknowledge the candidate's adequacy for the position. Employers will also not be able to access the candidate's real interests in joining their firm ("Does this candidate plan to stay here long? Or will she/he leave the company as soon as another opportunity appears in the rival company?"). On the employee's side, she/he, at the time of the recruitment, is not able to fully access the challenges of the new job (even if one seeks information with current employees); she/he might not be able to understand the easiness or difficulty to interact with the new boss. Not even is the candidate able to access vital information about the company's finances and organizational challenges.

Externalities and Interdependence of Utility Functions

Employers depend on workers to reach some of their desired outcomes; workers, on their side, depend on employers to reach their economic benefits. This is what economist calls an *interdependence* of their utility functions. Whenever it happens, negative externalities might be created: one's decisions or actions might inflict undesired costs to the other party.

However, positive externalities might also be created. In the labor context, whenever an employer decides to train or educate his/her workers, he/she creates benefits not only for the company, for the trained workers, but potentially to the whole society, since a highly skilled labor force generates technology and knowledge that may benefit the whole society, directly or indirectly. This is true both for general and for firm-specific skills. The same happens when employers invest in workers' health and safety conditions and so on. Thus, giving incentives for employers to invest in his/her employees' well-being also generates social efficiency. Yet, one knows from economic models that externalities – both negative and positive – drive the economy away from the point of efficiency: in the presence of *negative* externalities, private parties tend to provide *excessive* amounts of products and services; on the other hand, *positive* externalities lead to *insufficient* amounts. In both cases, regulation is necessary to guarantee efficiency: for negative externalities, taxes and quotas must be stipulated; for positive externalities, public policies must provide subsidies or other incentives to stimulate their production.

Uneven Bargaining and Political Powers

Economists are unable to deal with the concept of power relations. This is a phenomenon that cannot be explained by economic rules nor economic models. Yet, they significantly affect bargaining outcomes, even in the context of Coasean bargaining, with impacts on efficiency (e.g., Galiani et al. *2014*; Barnes *2004*, among others). It is also unrealistically naïve to consider this market as having “normal” supply and demand forces, with equal bargaining power. For most systems, employer and employees – especially if these ones are treated individually – do *not* have equal stands in the negotiation of working conditions. Thus, to assume that this is an ordinary contract relationship, in which clauses are outcomes of cooperative and voluntary agreement, does not truly mirror reality. Sociological, cultural, and political variables may explain why workers’ bargaining powers are, on average, stronger in one system than they are in others, but the common-law tradition which views labor regulation as another ordinary type of contract regulation might not be well suited for other countries; probably, there are places in which power imbalance between workers and employers is larger. Then, other types of labor rules must be considered, so to take the “power effect” into consideration.

Monopoly-Monopsony

The historical answer to uneven bargaining and political powers in labor relations was labor organizations, mostly (but not exclusively) trade unions. Yet, this creates a problem of another sort: unions operate, most of the time, as monopolies in the labor market. As one knows, monopolies create deadweight loss: due to the existence of unions, wages tend to be higher, and as a response, employers are willing to hire less labor. In addition to that, because membership is never mandatory, the presence of unions creates an even worse outcome, dual labor markets, in which unionized workers have higher benefits but at the cost of nonunionized ones. In poor countries, this is materialized, in its extreme, into the case of formal vs. informal labor markets, with a large portion of the labor force belonging to the second one. Needless to say, working and living conditions here are strikingly adverse. We will discuss some empirical findings about trade unions in a specific section ahead.

It is also not unusual to find cases of monopsony in labor markets: one or a few firms are the sole employers of a certain type of workers in a region. Under these circumstances, employers have abnormal market power to unilaterally set wages, working conditions, etc., to which workers have little chances to react. A monopsony may be as damaging for social welfare as monopolies.

Litwinski (*2001*) discusses both problems in the labor market and, within the American context, defends the application of antitrust law to unions (as it has happened in the USA since the beginning of the twentieth century, in the *Loewe* vs. *Lawlor* case in 1908) and of labor and antitrust laws to firms, whenever they operate as labor monopsonies. Further, he claims that “antitrust law and labor law are somewhat like Siamese twins unhappily separated at birth. The natural affinity between their subject matter and concern was recognized by the early cases and statutes” (p. 50). According to the author, in the same manner that labor unions should be prohibited to exercise their monopoly power, firms should also be disciplined in their monopsony power.

Labor Laws for the Labor Market

Summing up, labor relations are based on contractual, (usually) long-term relationships, characterized by high levels of uncertainties and asymmetric information. Different to what happens in some other markets, bargaining power here is inherently uneven between suppliers (i.e., workers) and demanders (i.e., employers), and monopolies and monopsonies occur frequently. Besides that, workers’ and employers’ utility functions are interdependent. All this shows that market failures are abundant in this case. As economic theory tells us, regulation is needed to solve these failures. A third party –

usually the government – must step in; otherwise, efficiency will not be achieved, and maximum welfare will be missed.
However, bad regulation might be worse than no regulation, and many times, the problem lays here.

The Dilemma of Labor Law in an Economic Perspective

Summing the previous discussion, one may consider the *locus* of labor as a market, but in which (legal) rules are of particular importance to equilibrate powers and interests. In this manner, both economists' and sociologists'/lawyers' perspective on labor can be equally considered, in a balanced manner. The main goal of labor law in modern democracies should be to provide sound institutions that will equilibrate information, bargaining power, and contractual relationships while fostering economic growth by promoting firms' efficiency boosting. This task should involve the *creation* of rules by the executive and legislative powers and also their *enforcement* by the judiciary. Besides that, if rules to promote social indicators (such as education, health, pension, etc.) are also developed, a country should be able to truly achieve economic development.
Yet, it seems that many countries have failed in this task, either by pending too much to one side – overregulation or "bad" regulation of the labor market, hindering potential economic growth (e.g., Latin American countries, Spain, Italy, etc.) – or by pending to the other side: lack of regulation leading to low welfare, working conditions, or inequality (e.g., Asia's developing countries and, to some degree, the USA, as compared to other industrialized countries). In some sense, this reflects a one-sided view of labor, either excessively economic or excessively based on the balance of powers.

Special Topics

In this section, we discuss the main types of regulation in some areas of labor relations. We refer to some empirical studies that try to access the impacts of these regulations in the economy.

Labor Regulation (In General)

Botero et al. (2004) analyze regulation of labor, specifically laws on employment, unionization, and collective bargaining, and social security in a sample of 85 countries. Their main result is that countries in which labor regulation is overall more invasive, have higher unemployment rates – especially of the young.
In a theoretical study, Blanchard and Giavazzi (2003) show that labor regulation creates sharp intertemporal trade-offs for workers. In the short run, workers are better off with more regulation, because their wages will be higher; yet, in the long run, regulation brings higher unemployment. In a dynamic approach – in which there are new entrant firms in the future – their model predicts that employed workers will be worse off with deregulation, both because wages will be lower and the probability of them being unemployed will be higher. On the other hand, workers who would have been unemployed without the entrance of new firms benefit either by the new possibilities of being hired or with an increase in their wages. Although this study does not include empirical observation, it seems to be a more careful analysis of the implications of regulation and deregulation in the labor market, compared to those done initially in the classical economic literature.

In the other side of the discussion – the legalistic, noneconomic literature – there have been claims that labor regulation should be (also) approached in a transnational manner, specifically under regional integration pacts (Trubeck et al. *2000*). Although the idea seems coherent, these studies would greatly benefit from a more analytical and empirical approach, which could evaluate the concrete outcomes on the overall economy, and specifically on the variables directly affecting workers and employers.

Unions

Basic economic models show that unions impact markets by raising wages of unionized workers. Consequently, employment levels decrease, since employers try to substitute those more expensive workers with nonunionized, cheaper ones. In a context where there is no perfect mobility of factors (in this case, labor is the main factor), this creates a long-lasting, perverse effect in the economy: the presence of a dual labor market (Piore *1969*; Doringer and Piore *1971*), in which the first one is marked by the presence of unionized, high-skilled workers, earning high wages, but in which the level of employment is lower. On the other hand, low-skilled workers are trapped in the market with lower wages and, usually, worse labor conditions. This happens because due to the lack of skills, inferior workers cannot move to the first market; on the contrary, firms tend to have higher mobility and may choose to operate in either the superior or the inferior market, depending on the presence of unions and their bargaining power. If it is the case that firms are not able to choose in which market to operate, in the long run, those facing unions will lose their comparative advantage and lose business to those who do not face unions. The result will be a decline in unionization in the overall economy (Posner *2003*). In countries where unionization does not happen at the firm level, the analogy holds true for different sectors of the economy: those who face unionization will lose competitiveness and may perish in the long run; the opposite is true for those sectors not facing unionization.
For some decades, empirical literature has systematically brought evidence in this direction (e.g., Borjas *2016*). Yet, one study shows these effects in a careful and detailed manner and deserves a more careful attention. Aidt and Tzannatos (*2008*), besides linking union activities to monetary policies in an original but important fashion, show that it is not the simple, cross-country variation in union density that affects economic outcomes (as the literature has traditionally implied). The authors bring the *coordination* and *bargaining coverages* to the spotlight. They empirically associate the existence of coordinated bargaining systems – via labor unions or other formal and informal labor organizations – to better macroeconomic outcomes (e.g., lower unemployment) and more flexible labor markets, what may sound odd at a first glimpse. On the contrary, high bargaining coverages are associated to poorer economic performance. According to these authors, bargaining coordination guarantees positive outcomes and also enables labor markets to respond more adequately and in a less adverse manner to external shocks. In an effort to employ the classical economic theory of labor, coupled with an institutional perspective, these authors conclude that “it is the total ‘package’ of (formal and informal) institutions that matters for economic performance” and that “labour market coordination cannot and should not be thought of in isolation from the broader institutional environment” (p. 290).

Minimum Wage

Economists usually regard the effects of mandated minimum wages as similar to those of unions, because unions’ most usual demand is on higher wages. As the models predict, minimum wages create unemployment, especially for marginal workers, i.e., female, young and old, and black (Posner

2003). The effect is explained by a change in relative prices between less- and high-skilled workers, the first becoming more expensive (because minimum wages are set lower than the level of high-skilled workers' productivity, not affecting, thus, their wages). If minimum wage is applicable only to some sectors and not to others, the effect is again equal to that when there is a dual labor market, of unionized vs. nonunionized firms: it may increase unemployment in the sector covered by minimum wage and decrease unemployment in the sectors in which no mandatory wage prevails. Finally, as Posner (2003) explains, minimum wage may hinder on-the-job training of marginal workers (those who need it the most), because employers may not compensate the costs of the training investment by paying lower wages.

This topic has brought much attention to the economic literature, and Alan Krueger calls for a "History of Economic Thought on the Minimum Wage" (2015). Traditionally, evidence brought by this literature has corroborated the classical microeconomic model, as explained above. Yet, recently some studies have questioned that explanation, by showing that the effects of minimum wages on unemployment have been overstated. Hoffman (2016), for instance, finds no impacts of increases in minimum wages on young and low-skilled workers' unemployment. In fact, the author finds some *positive* effects of wage increases on employment for a few states in the USA. The study also presents some other recent literature corroborating its findings.

Undoubtedly, although a "history of economic thought" already exists for this theme, more empirical studies, which carefully analyze the broad implications of minimum wages on economic variables, are still needed. The story is not over.

Unemployment Compensation

Traditional economic models predict that longer and more generous unemployment compensation leads to lower rates of employment and higher wages. The explanation is that, besides having less incentives to find a job, workers are comfortable to calmly search for better jobs, i.e., their outside options increase. Yet, empirical evidence coming from the literature is not strikingly convincing in this direction. By analyzing changes in the rules of unemployment compensation in the USA during the 2008–2009 recession, Nicholson et al. (2014) find that "[unemployment coverage] extensions may indeed have had detectible effects on the U.S. labor market, but some of the studies are contradictory" (p. 212). Ludsteck and Seth (2014) for Germany in the late 1990s and beginning of 2000s, and Howell and Rehm (2009) for the OECD countries in a period of 30 years, also find contradictory empirical evidence.

This is certainly a subject which deserves more in-depth empirical and analytic studies.

Outsourcing and Subcontracting

The current phenomenon of labor outsourcing takes place under two variations: cross-border outsourcing (transnational subcontracting) and within-border outsourcing (local subcontracting). The first one is a relatively recent trend, which intensified in the last three to four decades, in which companies from industrialized countries, mainly the USA and Western Europe, move their fabric plants abroad, to countries in which labor is cheaper. They may also simply stop their own national production and purchase products from other firms and factories in those poorer locations. The second type of outsourcing happens nationally and is a much older phenomenon: a firm, with its own employees, specializes in some activity – either manufacturing, assembling, or servicing – and hires other firms and/or outside workers to do activities in which it is not specialized. For instance, an automobile firm does not produce all the automotive parts, a bank may hire another firm to provide specialized security services, a movie theater may subcontract people and firms to offer popcorns, and a school may hire a company to be responsible for the cleaning services. Subcontracting, in this sense, materializes Adam Smith's idea of division of labor which occurs in a society.

As the technology advances, the economy gets more specialized, and outsourcing – either transnational or local – becomes more pervasive. Along with this process, trade unions and other advocates of labor's interests (labor sociologists, labor attorneys, public prosecutors, etc.) have loudly manifested their opposition to the increasing trends in labor outsourcing. They argue that it has been responsible for the degradation of labor conditions, including the decrease in wages and the increase of unemployment: *inside* workers lose their positions, and lower-paid jobs are created for *outside* workers (located in the same country or abroad). Once again, employers and workers seem to be in opposing sides, headed to divergent directions. What does evidence show?

Actually, very controversial results. In the topic of international outsourcing, literature is almost split: those who argue that it is beneficial for workers and others showing that it is very deleterious to workers – for those in rich and in poor countries. Bachmann and Braun (*2008*) show part of the controversy in the literature. However, after analyzing a big panel of data, their conclusions are positive toward outsourcing, at least for some workers in Germany. They show that German companies cross borders to hire labor in cheaper countries, workers face higher job is stability, and the effect is more significant for those in the service sector and less in the manufacturing sector. Yet, the authors remark that effects are strongly heterogeneous across the skill levels and age. Specifically, international outsourcing is significantly hazardous for medium-skilled and lower workers in the German manufacturing sector.

Anner (*2011*) evaluates the impact of outsourcing on the other side of the story, i.e., in countries of *destination*, and finds evidence of very negative results. In Central America – specifically Nicaragua and El Salvador – outsourcing reduced workers' bargaining power (due to spatial dispersion) and led to lower wages.

With regard to domestic outsourcing, or subcontracting, Autor (*2003*) shows that unionized firms in the USA tend to outsource *more* than nonunionized firms. This is a counterintuitive result and offers hints that unions are not always able to guarantee rules that benefit labor. Yet, the author is cautious about welfare impacts. In Brazil, Stein et al. (*2015*) use official data on eight million workers and employ the methodology of "fixed effects panel data," i.e., they compare wage effects for a particular person when he/she migrates from being an inside worker to an outsourced one and vice versa. The main goal is to control for each worker's personal (observable and nonobservable) characteristics. Their results show that, after controlling for fixed effects, wage differential between inside and outsourced workers is of 3% only. Besides that, significant wage differentials are created when outsourcing occurs for low-skilled workers under such situations, wages are 12% lower compared to inside workers with the same characteristics.

Such controversial evidence in the literature shows the need for more detailed and careful analysis on this topic.

Other Labor Issues

Posner (*2003*) provides brief discussions on a long list of other labor issues, such as child and female labor, health and safety at the workplace, maternity leave, employment discrimination (race, sex, age, disability), pension law, etc. However, more empirical analysis on each of these themes is still needed, and many other themes are also still left uncovered by the literature. It is also important to directly

link the explanation coming from economic models to institutional evaluations: What are the effective impacts of specific labor rules? (For instance, "What are the effects of creating quotas – based on gender, race, age, etc. – at a workplace?") What are the political, sociological, etc., concerns behind the stipulation of some labor laws? (For example, "Why should the employer be always strictly liable for damages in case of accident at the workplace? Is this the manner to minimize damage costs and probabilities of accidents? If not, what kind of rule would be more effective?")
Our discussion above offered some initial hints. But much should be assessed empirically.

Summary

We started this entry by arguing that the literature on labor relations has been very much divided, mainly between the classical economic approach and the legal/sociological one. An economic analysis of labor law would benefit by abridging both perspectives and complementing with more. It seems that the model of labor market is a plausible one. However, it is crucial to remember that, more than other usual markets, there are strong failures in place here. There are also problems of unbalanced bargaining and political powers. Because of this, labor regulation cannot mirror simple, ordinary contract regulations. A special look is needed.
Empirical literature, unfortunately, mirror the dichotomy of the economic vs. legal approach and, for several (if not all) issues, provide contradictory, inconclusive evidence. Many times, problems might have happened due to imperfect data or inadequate methodologies. As information technology advances, as well as the quality of databases, one might expect higher quality and, hopefully, more conclusive evidence.
No matter what, although this topic is one of the oldest themes in the social sciences, there is still room for much research.

Cross-References

Contracts, Incomplete
Efficiency Wage

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