

NEW YORK UNIVERSITY LAW REVIEW

VOLUME 77

APRIL 2002

NUMBER 1

FOREWORD

HUMAN BEHAVIOR AND THE ECONOMIC PARADIGM AT WORK

SAMUEL ESTREICHER*

The *Law Review* deserves kudos for publishing this Symposium drawn from Articles and Essays presented at last year's Research Conference on Behavioral Law and Economics in the Workplace, sponsored by New York University's Center for Labor and Employment Law. Authored by leading scholars in the field, these Articles and Essays promise to spark debate on the implications of the growing, largely experimental behavioral literature for employment law and workplace governance.

The insights from the behavioral studies, building on the pioneering work of Kahneman and Tversky,¹ offer not so much an assault on the "law and economics" paradigm, now reigning in the law schools, as a richer account of how people, in fact, make decisions. For those who teach, write or practice in the labor and employment field, it may not come as a shock that (1) employee preferences are not always well formed, (2) a "fairness" or "reciprocity" ethic strongly influences compensation practices, and (3) default rules set either by law or custom can be fairly "sticky." It is good to know, however, there is more than hunch at work, that these rough intuitions have been largely confirmed in experimental settings.

* Professor of Law and Director of the Center for Labor and Employment Law, New York University.

¹ See generally *Choices, Values, and Frames* (Daniel Kahneman & Amos Tversky eds., 2000).

Professor Issacharoff's able Essay² reminds us of some of the challenges that still need to be addressed before what might be termed a "behavioral law and economics" (BL&E) movement truly can influence the path of the law. In the main I see three such challenges. First, how generalizable are the experimental findings? Is there reason to believe, for example, that the behavior exhibited by the students in the laboratory can be generalized to all or many workplace environments? Student subjects know that very little is at stake in these games, and may act in ways they think consistent with classroom norms, while perhaps acting very differently in their workaday lives when they have to make decisions requiring real tradeoffs.

Second, even if we find some basis for generalizing to the larger society, we do not yet have a metric for evaluating the magnitude of the "endowment effect," one of the more frequently replicated findings in the BL&E literature. For example, employers since the 1980s have successfully inserted disclaimers in their personnel handbooks, which have negated much of the practical effect of state court decisions finding binding job security promises in those documents,³ suggesting that this effect, however real, may not strongly influence decisions.

Third, and perhaps most critically, it is far from clear what implications these behavioral findings hold for public policy. One area where the lessons for policymakers seem clear is the design of employee benefit plans, the subject of Professor Stabile's contribution.⁴ Building on the empirical research of Professor Madrian⁵ (also a participant in the N.Y.U. Conference)—which, notably, went outside the classroom to examine how real-life plan participants act in different settings—Professor Stabile makes a strong case for a more deliberate employer role in encouraging employees to contribute towards their retirement security. Employer plan sponsors, Stabile argues, should actively encourage employee participation in 401(k) plans by setting automatic enrollment as the default rule, thus requiring employee-participants affirmatively to opt out if they do not wish to participate. Given the public policy in favor of encouraging pension saving, the

² Samuel Issacharoff, *The Difficult Path from Observation to Prescription*, 77 N.Y.U. L. Rev. 36 (2002).

³ See Andrew P. Morriss, *Bad Data, Bad Economics, and Bad Policy: Time to Fire Wrongful Discharge Law*, 74 Tex. L. Rev. 1901, 1917 (1996); J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts; Resolving the Just Cause Debate*, 1995 Wis. L. Rev. 837, 868, 890.

⁴ Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. Rev. 71 (2002).

⁵ See, e.g., Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 106 Q.J. Econ. 1149 (2001).

demonstrated predilection of employees to pick up perhaps unintended signals of employer advice from the default provisions of 401(k) plans, and the quite limited intrusion on employee autonomy involved in changing the default rule, her policy suggestion would seem unassailable. The issue becomes considerably more difficult, as Professor Stabile recognizes and the Enron scandal typifies, when default rules also contain investment advice, particularly where the default rule directs the placement of contributions in undiversified investments, notably employer stock. Here, the behavioral finding of employee passivity argues for closer regulation of employer-set plan design.

Professor Sunstein's Essay⁶ canvasses the considerations that should inform the more general subject of the utility of workplace regulation by means of switching default rules. There is much here that will clarify thinking about what the law can, and should, do to improve firm efficiency and employee welfare. Sunstein emphasizes the information-forcing effect of default rules, a topic that Professor Estlund also addresses in the wrongful discharge context.⁷ Estlund, in particular, advances the argument, based on the employee attitude surveys conducted by Pauline Kim,⁸ that employees tend to overstate by a wide margin the degree to which the law in fact protects them against wrongful discharge, and heavily discount the legal effect of disclaimers of such protection they are often required to acknowledge as a condition of employment. This has the effect, in her view, of affording employers the advantages of a contented workforce, secure in the (erroneous) belief that they enjoy meaningful job security, while retaining for employees the formal authority to terminate the relationship for insubstantial or no reasons at all. For Estlund, the policy prescription is to reverse the background rule—from at-will to “for cause” employment—and require employers to make detailed disclosures of the practical consequence of an at-will rule, should they wish to negotiate away from the new “for cause” default regime. The argument, while intriguing, raises the question why employer overvaluing of the extent to which their dismissal decisions are regulated by law does not merit a reciprocal solicitude, leaving ambiguous the policy implications of the behavioral insight.

⁶ Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. Rev. 106 (2002).

⁷ Cynthia L. Estlund, *How Wrong Are Employees About Their Rights and Why Does It Matter?*, 77 N.Y.U. L. Rev. 6 (2002).

⁸ See Pauline T. Kim, *Norms, Learning, and Law: Exploring the Influences on Workers' Legal Knowledge*, 1999 U. Ill. L. Rev. 447; Pauline T. Kim, *A Study of Worker Perceptions of Legal Protection in an At-Will World*, 83 Cornell L. Rev. 105 (1997).

Moreover, is it clear that employees are having difficulty processing information or evaluating termination risks? Perhaps the situation is equally well explained as an instance of rational risk assessment by both sides. For employers, there are a sufficient number of exceptions from the at-will rule—with perhaps only nondisabled white males under the age of forty (outside of New Jersey and some other states where even the young can sue for age discrimination) standing bereft of any conceivable cause of action—that it may be the wisest course to assume that virtually all employment decisions will be subject to legal scrutiny. (That is the advice I give clients and they have little difficulty accepting it.) And, for employees, the reality is one of considerable *de facto* job security, outside of situations where firms are reducing their staffing levels (and where a wrongful discharge cause of action would be of scant assistance). As Professors Freed and Polsby⁹ have argued, the actual incidence of wrongful dismissal, when viewed as a percentage of the U.S. labor force or a percentage of hires in a given year, is quite small, and employees rationally attach little significance *ex ante* to the need for “insurance” against this improbable occurrence.

This brings us to Professor Jolls’s piece,¹⁰ which offers the quite interesting insight that employers often are motivated by a “fairness dynamic,” because they are seeking to elicit quality performance from employees under conditions where direct monitoring of employee effort would be quite costly. Her paper provides a behaviorist analogue to the work of Nobel Laureate George Akerlof and Janet Yellen¹¹—holding that employers often pay an above-market “fairness wage” as a means of attracting above-average employees and eliciting higher levels of effort than could be expected of employees hired at the market wage. Jolls also gives us an original perspective on the implicit premises of the overtime exemptions for professional and administrative employees under the Fair Labor Standards Act, for these are typically employees who cannot be closely monitored as a practical matter.

All in all, this Symposium issue marks a promising launch to a new vantage on the decisionmaking process in which employers and employees actually engage. What distinguishes labor and employment law from other branches of business law is the pervasive salience

⁹ See Mayer G. Freed & Daniel D. Polsby, *Just Cause for Termination Rules and Economic Efficiency*, 38 *Emory L.J.* 1097 (1989); see also Morriss, *supra* note 3.

¹⁰ Christine Jolls, *Fairness, Minimum Wage Law, and Employee Benefits*, 77 *N.Y.U. L. Rev.* 47 (2002).

¹¹ See, e.g., George A. Akerlof & Janet L. Yellen, *The Fair Wage-Effort Hypothesis and Unemployment*, 105 *Q.J. Econ.* 255 (1990).

of the human element, or as I quip to my students, this is an area where “the law hits the flesh.” The Articles and Essays that follow should enhance understanding along these lines, to the betterment of the law and public policy.