

# Submission to the Inquiry into the Workplace Relations Framework

## Employee Protections – Unfair Dismissal

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In view of the terms of reference specified in the Workplace Relations Framework Inquiry - issues paper #4 (Employee protections, January 2015), and based on my research experience with some of these questions, I wish to make the following submission:

### Summary

***1. Do Australia's unfair dismissal processes achieve their purpose, and if not, what reforms should be adopted, including alternatives (or complements) to unfair dismissal provisions?***

- Australia's unfair dismissal provisions successfully balance workers' demand for job security and firms' demand for flexible use of workforce discipline.
- *Areas of improvement* to our laws:
  - reducing transaction costs for the smallest businesses (who benefit least from the laws) by simplifying (or removing) procedural constraints.
  - reducing the number of frivolous and jurisdictional cases reaching arbitration, e.g. by introducing penalties or empowering conciliators.
  - safeguarding the independence of our labour courts (the Fair Work Commission - FWC) by entrusting FWC appointments to the judiciary.
- *Alternatives* such as:
  - the highly decentralised and deregulated US model of wrongful discharge increase the degree of risk in dismissal dispute resolution.
  - large-scale exemptions from unfair dismissal laws are politically difficult to implement and rarely observed elsewhere in the OECD.
  - privatising dismissal dispute resolution, as experimented in the US in the 1990s, is likely to prove too controversial and adversarial.
- *Complements* to unfair dismissal laws such as general protections and redundancy laws appear to be in no particular need of reform.

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**Disclaimer:** The views presented in this submission are derived from 10 years of independent research on unfair dismissal policy in Australia and overseas. These views are my own and should not be assumed to represent the views of my employer, of those who have funded the research or of those who have collaborated to it.

**Acknowledgments:** I gratefully acknowledge the longstanding support and continuing funding of this research by University of Canberra's Faculty of BGL and the University's Research Office. I am also in debt to Paul Oslington who kindled my interest in unfair dismissal policy research, and to Carl Francia and Nathalie Easter for invaluable research assistance that went well beyond the call of duty.

**2. *Are the tests used by the FWC appropriate for determining whether conduct is unfair, and if not, what would be a workable test? Are the exemptions to unfair dismissal appropriate, and if not, how should they be adapted?***

- *Substantive criteria:* the FWC adopts a systematic approach, which consists, after establishing jurisdiction, of examining and verifying the facts behind the dismissal. This involves establishing a valid reason for the dismissal and ensuring due process (as specified in the Act) has been followed by the employer. There is much variation in practice in the extent to which specific commissioners test for substance (unfair, unreasonable or harsh dismissal behaviour), at least as measured through published decisions, and this is no doubt due to the unique context and facts of each case.
- *Procedural criteria:* there is some room for making unfair dismissal processes more efficient, particularly when litigation involves a small business.
  - FWC arbitrators could adopt the rule that the substance of a dismissal should always prevail over claims of procedural deficiency (this is currently not the case).
  - In the case of a claim brought against a small business, this argument could be extended to provide the small business with exemption from procedural requirements.
  - Germany has long exempted its smallest businesses (less than 5 employees) from any coverage by unfair dismissal laws, more recently extending this exemptions to firms with less than 15 employees.
  - Without going this far, an exemption from the mere procedural requirements would enable smallest businesses to concentrate their efforts in justifying the substance of the claims lodged against them. It may also reduce the incidence of 'go away' money.
- *Exemptions:* Current business exemptions based on jurisdiction (probation, high income level) are relatively generous to businesses by OECD standards.

**3. *What are the strengths and weaknesses of the Small Business Fair Dismissal Code, and how, if at all, should the Australian Government amend it? Should the employment threshold be maintained, raised or lowered?***

- The SBFD Code is fundamentally a procedural device. I am not convinced that the Code offers significant benefits to small businesses owners, other than better informing and educating them about the procedural requirements of the laws (an area in which they are assumedly less experienced than larger organisations).
- The Code provides some clarity about procedural requirements but these requirements are essentially what the FWC will check at conciliation and arbitration stages. SMBs would assumedly be better prepared to defend a claim by knowing the Code and ticking its checklist. But if the facts are disputed, conciliation and arbitration is again the sole pathway to resolving the

dispute. So the Code, while useful and well-meaning, makes no major change for dismissal dispute resolution.

- Enforcing compliance with dismissal procedures makes sense for large organisations, whose recruitment processes and employee career plans partly depend on the discipline imposed by these procedures. How large firms have centralised dismissal decisions across all managerial levels (down to foremen and immediate supervisors) has been well documented in the literature on dismissal. In large firms, procedures imposed by unfair dismissal laws merely complement pre-existing control processes.
- Unfair dismissal laws (employment security more generally) may have positive labour productivity effects in firms, which rely on firm-specific skills, teamwork and use advanced technology (e.g. the Japanese model) but these conditions are usually not found in SMBs.
- So why should procedures be applied with equal force to SMBs? SMBs have little resources to devote to procedure compliance or indeed to the screening of employees, face much higher labour turnover rates, and derive few benefits from the laws (smaller firms rely more on unskilled or general skill labour)
- If small businesses are to be provided any substantial relief from the costs of unfair dismissal laws, then, as argued above under point 2, it would perhaps be timely to consider exempting them from the current procedural requirements of the law.
- If such exemptions were to be considered, there may be a point in initially exempting only the smallest businesses (e.g. less than 5 employees, as was long the case in Germany). Exemptions of this type can be controversial and there would be merit in considering their introduction (and evaluating their effects) through an incremental approach.

***4. In cases where employers are required to pay compensation in lieu of reinstatement, are the current arrangements for a cap on these payments suitable?***

- The income threshold and the six months cap on compensation help define an absolute upper bound for compensation payments.
- This upper bound reduces the potential benefits from unfair dismissal action to dismissed employees but help reduce the risk associated with unfair dismissal action for employers.
- In my view, the current cap is a positive feature of our unfair dismissal laws, balancing economic and fairness interests, and it should be retained.

***5. What are the effects of unfair dismissal arrangements on firm costs, productivity, recruitment processes, employment, and employment structures?***

- Effects of unfair dismissal laws on firm costs, productivity, recruitment processes, employment, and employment structures are notoriously difficult to quantify and not well known in Australia.
- There is much more research of these effects overseas but it tends to focus excessively on the costs of redundancy laws (legislation-imposed costs for labour adjustment when the business cycles deteriorates, i.e. when separations are for economic reasons) which is a different policy issue.
- I summarise conceptually what economists believe are the costs and benefits of having a system of unfair dismissal laws relative to having none, and derive some implications for small business policy.

**6. *What are the impacts on employees of unfair dismissal, both personally and in terms of altered behaviours in workplaces?***

- Likewise, effects on Australian employees of unfair dismissal, both personally and in terms of altered behaviours in workplaces, are mostly unknown.
- There should nonetheless be no doubt that dismissal (fair or unfair) must be a shattering experience for those who experience it.
- Providing an avenue for redress and healing through unfair dismissal protection is certain to have significant mental and physical health benefits for at least a substantial portion of the dismissed (even if their claims turn out to be unsuccessful)
- For such benefits to accrue, it is critical that the decision of Fair Work Commissioners appear to be fair and ideologically unbiased.
- Preliminary evidence in Australia suggests that appointment of commissioners by governing political parties is a source of decision bias.
- We don't know whether this bias is an important issue, as it may only be exercised in knife-edge cases (where 'something' has to decide the case).
- Relying on the judiciary or some other peer-governed institution to make appointments may nonetheless improve employers and employees' trust in the impartiality of decisions.

**7. *What are the main sources of costs (including indirect costs), and how could these be reduced without undermining the fundamental goals of unfair dismissal legislation?***

- The direct costs imposed on business by compulsory resolution of dismissal disputes consist of the cost of legal representation (if any) and the cost of any monetary payments (settlement, compensation, and backpay in case or reinstatement order).
- The indirect costs are possibly much larger than the direct costs: they include time loss (value of working time lost while complying with procedural requirements, and during legal proceedings to settle the claim), the opportunity cost of disruption, particularly for SMBs, the implicit costs of stress and risk aversion (which inflate the direct costs), and potential morale loss or shirking effects from the laws (which reduce labour productivity).
- The central thrust of unfair dismissal protection is to make sure that unfair, harsh or unreasonable employer behaviour is not accepted, and likewise, to make sure that employers dealing with unacceptable employee behaviour will be supported rather than punished.

**8. *Under current or previous arrangements, what evidence is there of the practice of 'go away money'? Have recent changes, such as those that provide the FWC with expanded powers in relation to costs orders and dismissing applications based on unreasonable behaviour, improved matters?***

- There is no research that I am aware of on the practice of go-away money and how regulatory changes may have affected patterns amongst these payments.
- But it is widely accepted that its use is significant (DEEWR 2012), particularly in workplaces where the time and resource cost of litigating a

dismissal dispute is likely to be very onerous to the business owner, relative to the compensation sought.

- A critical factor is the relative importance of time, stress and risk aversion (the ‘hassle’ factors) compared to the monetary gains (losses) from litigation. DEEWR (2012) using FWA conciliation records, and Freyens (2011) using survey data both show that if explicit litigation costs are usually modest, so too are the average claim recoveries for claimants. In such a context, ‘hassle’ factors (time, perceptions, stress) would drive rational responses such as pre-empting disputes before they even start through use of go-away pay. This response will be rational even if claims are unmeritorious.
- Therefore, the smoother and the more uncomplicated dismissal dispute resolution is, the less the use of go-away money should be. Forsyth and Stewart cited in DEEWR (2012) suggest empowering the FWC to weed out claims early on if it thinks they are frivolous, and that would probably be the least controversial approach to addressing this issue, but how effective it would be would depend on the degree of legislated discretion awarded to the FWC.

**9. Do unfair dismissal actions disproportionately affect any particular group of employees (for example, by gender, ethnicity, geographical location, industry, union affiliation, and occupation or business size)?**

- We have very little information about claimant characteristics in the bulk of cases lodged with the FWC, and we have no information at all about the number and characteristics of individuals dismissed for cause in any given year.
- DEEWR (2012) suggests an annual claim rate of about 1.5% but that rate is worked out against all separations, not just dismissals for cause, which should be our reference group. Buechtemann (1993) provides a 10% rate for the UK, which suggests 9 out of 10 workers dismissed for cause do not contest the dismissal.
- *Minority groups* - We can only observe the characteristics of claimants at arbitration stage (the tip of the iceberg). Out of the several thousand arbitrated cases I examined between 2001 and 2015, the claimant was female in 29 percent of the cases, union member (27 percent), union activist (3 percent), minority ethnic groups (6 percent) - as approximated by needing a translator at the hearing, not being born in Australia or having one’s ethnic group prominently mentioned at the hearing) and was indigenous Australian in 1 percent of the cases.
- If these figures were representative of the mass of cases lodged, I would see no particular reason to believe that minority groups are more prominently affected by unfair dismissal.
- *Union members* - With union density currently around 17% in Australia, a 27% incidence of union members at arbitration stage seems large. The success rate of dismissed union members is larger than average, and larger still for dismissed union activists.
- *Firm size* - large firms makes 56 percent of arbitrated cases, followed by small businesses (23 percent) and medium-sized businesses (21 percent). Again, there is no reason to believe that this is a representative distribution of the bulk of lodged cases. Small businesses are probably more likely than large firms to settle early or pay go-away money than go for arbitration.

**10. What are the main grounds on which people assert unfair dismissal, and what types of claims are most likely to succeed?**

- Again, I can only comment on published decisions that are in the public domain and that I have examined over the period 2001 – 2015. There are some caveats about this data but that information indicates that commissioners decide in favour of unfair dismissal claimants 46 percent of the time (across all substantive, procedural and jurisdictional decisions). Cases litigated on claims the dismissal was an overreaction to a minor issue were the most successful in arbitration (60 percent success rate), followed by claims of flawed dismissal procedures and of unrecognised employee illness.
- Among the least successful cases, were those litigated on claims of harassment and constructive dismissal (27 percent success), most often this is because these claims are made by employees having resigned as a consequence of the alleged employer behaviour. An employee having resigned has very low chances of success at arbitration because the separation is then not considered a dismissal. Similarly, cases litigated on grounds of ‘personal objection’ (tasks too dangerous, against the law, or against personal beliefs and principles) were not very successful at arbitration (34 percent)

**11. How does Australia compare internationally with regard to the unfair dismissal protections? Are there elements of overseas approaches and frameworks that could usefully be applied to Australia?**

- The OECD regularly compares the employment protection frameworks (of which unfair dismissal laws are a sub-component) of its members. Although these comparisons are purely theoretical and based on the stringency of the provisions, they show that Australia’s protections are neither as extensive as in most Continental European Nations, nor as deregulated and volatile as in the United States.
- It is noteworthy that unfair dismissal laws (wrongful discharge) were inexistent in the United States until the 1970s but they are now well established in a number of U.S. States. There seems to be a search for an acceptable capped system in various industries and States (Montana is the only State having legislated a capped system of unfair dismissal laws).
- Germany has witnessed considerable improvements in labour productivity over the last 15 years. While this success is due to a number of factors, a key factor is the non-adversarial approach to industrial relations disputes in Germany, a model increasingly being studied by New Zealand. Interestingly, Germany has long been one of very few OECD nations exempting small businesses from coverage by unfair dismissal laws but giving strong incentives to these business to retain workers in adverse economic times (a ‘flexi-security’ system), which benefits firms and society by ensuring firm-specific skills and know-how are retained in the long-run, rather than rendered obsolete by unemployment spells. The small and medium sized business sector (The “Mittelstand”) is thriving in many parts of Germany, such as Bavaria. Of course Germany’s experience may not be of much use to the Australian context, but there would certainly be gains from moving towards a less adversarial industrial relations system.

**1. *Do Australia's unfair dismissal processes achieve their purpose, and if not, what reforms should be adopted, including alternatives (or complements) to unfair dismissal provisions?***

- *Do the laws achieve their purpose?* Australia's unfair dismissal provisions balance workers' demand for employment security and firms' demand for flexible use of workforce discipline. As I will argue, our unfair dismissal laws neither provide prohibitive levels of protection from dismissal to workers nor do they exonerate businesses from observing fairness requirements in their dismissal decisions. Our laws therefore appropriately regulate the trade-off between social equity and economic efficiency in Australian labour markets. Unfair dismissal laws under the Fair Work Act 2009 (and preceding Acts of Parliament) meet their purpose, but this doesn't mean there is no scope for improvement.
- *Do the laws achieve a fine balance?* Unfair dismissal provisions generate controversy because they constrain firms' capacity to manage their labour resources optimally and independently. On the other hand, as in all Western democracies, Australian workers care about employment security, possibly more intensely than about wage increases and other working conditions. A social planner designing a system of unfair dismissal laws would then have to weigh the benefits of the laws to workers against the costs imposed on firms. Assuming we could measure and compare these costs and benefits (a very difficult task for researchers) an optimal set of laws would consist of increasing the strictness of the laws up until the point where all net benefits have been exhausted.

But that may not yet settle the matter. As the protection level where the cost to firms and benefits to workers just offset one another, there may be new considerations for the planner to take into account. For instance, costs to firms should perhaps be given a bigger weight because they may make firms less competitive relative to overseas competitors, which in turn endangers the jobs workers depend upon to maintain their living standards. On the other hand there is also evidence that large firms benefit partially from the laws, because the laws help correct negative externalities in the workplace, particularly in terms of firm-specific skills, career investment, and firm loyalty (more on this later). So it is important to think in terms of the *net costs* imposed on the business sector.

Conversely, benefits to workers could be given greater weight because beyond the individual benefits and labour market (supply) effects from job security there is likely to be positive externalities in terms of social inclusion or better mental and physical health, which would improve Australia's stock of productive human resources. There are countless considerations of this type in research about unfair dismissal laws and it would take too long to enumerate them. Suffice it to say that unfair dismissal laws are needed in every society and they perform a very important function. But achieving a perfect balance in the strictness of their legal provisions is nearly impossible. All we can do is amend the laws incrementally and regularly, and try to observe as best we can whether these changes engender net positive flow-on outcomes. The Productivity Commission's Inquiry is an excellent opportunity to do just this.

- According to OECD reports and other research evidence, Australia has an intermediary level of unfair dismissal protection, stricter than the complex but highly decentralised

and unpredictable system in place in the United States, but far less constraining than the unfair dismissal provisions that operate in Continental Europe, and the even more constraining systems in place in BRICS countries<sup>2</sup>, and developing nations where they have contributed to persistent and entrenched dual labour markets (protected/unprotected). It is probably fair to say that our unfair dismissal laws have for the last twenty years better balanced citizens' demand for job security with businesses' demand for flexibility than in most other countries.

- *Alternatives to the laws:* if our society cares about employment security, there are few attractive alternatives to an unfair dismissal statute (common law) or code (civil law countries). These provisions have been legislated in nearly all Western nations except in the United States, which has a highly decentralised and deregulated model of wrongful discharge. The US system imposes larger costs of dismissal dispute resolution on business but these costs are less frequently occurred. Levels of dismissal protection also vary greatly among US States and industries. For reasons I describe below, it is unlikely that this model would appeal to a majority of Australian businesses and employees.
  - *The U.S. system?* The US doctrine of employment 'at will' (or firing at will) governs dismissal dispute resolution in all American States except Montana, which has a capped 'good cause' termination statute (similar to Australia's unfair dismissal laws). Yet, even the highly deregulated US system of workplace relations has over time moved towards increased protection from arbitrary dismissal either through just cause statutes legislated in specific US States or through judicial decisions that set precedents for various court circuits. In part, this weakening of the 'at will' doctrine arose from the large losses of productivity and jobs in the US manufacturing sector in the 1970s and 80s and a perception that the high employment security regime in Japan had proved much more successful (Buechtemann 1993).

Employees in the union sector are protected by just cause statutes built into collective bargaining agreements, and all dismissal ('discharge') disputes are settled through labour arbitration. In addition, U.S. government employees (Federal, States, local) benefit from similar levels of protection against unjust dismissal as employees in the union sector. In addition 9 US States have legislated just cause statutes that apply to their non-union non-public service sector.

Prof. JH Verkerke, from University of Virginia, estimates that 34 percent of all US employees are protected against 'unjust' dismissal (Verkerke 2009). For the remaining 66 percent of workers, dismissal disputes have been much more volatile, unpredictable and increasingly frequent. Dismissed workers have increasingly sued their employers for unfair dismissal using every judicial precedent, statute or Federal Act relating to the specificities of their dismissal. Most of these cases appeal to state common law doctrines such as (1) public policy claims (refusing an employer command to perform an unlawful task) (2) implied contract claims (employers failing to apply progressive discipline, what we would call procedural fairness), and (3) good faith claims (employers firing underpaid or non-paid workers e.g. to avoid making due payments).

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<sup>2</sup> Venn (2009 p. 27) nonetheless cautions about the lack of enforcement of unfair dismissal laws and other worker protections in India, Brazil, Russia and Mexico.



These three statutory exemptions are also incorporated in Australia's unfair dismissal laws. The main difference is that Australia's statutory laws cap compensation and keep potential business liability down to reasonable levels. Compensation caps can be found in some parts of the US system (such as in Montana), but elsewhere US juries sympathetic to the economic losses and emotional distress of discharged employees have awarded multi-million dollar compensation payments (on average!) to unfair dismissal claimants. Verkerke (2009 : 453) aptly concludes his review on a cautionary note:

“Thus, the aggregate burden of employment protection law in the US and elsewhere is more similar than the conventional wisdom imagines. The US imposes larger costs less frequently while most other nations make comparatively more modest costs an expected consequence of most employment terminations.”

- *Privatisation of arbitration?* In response, US employers have since the early 1990 tried to reduce their exposure to very large compensation and reinstatement liabilities, through mandatory (private) employment arbitration, which was implicitly supported by the Supreme Court's 1991 *Gilmer* decision. This initiative has fuelled more controversy and adversity because it gives leeway to employers to insert the selection of private arbitrators in standard work contracts. The neutrality of private arbiters is often called into question. A good review of the pros and cons (mostly negative assessments) of the privatisation model is provided by Eaton & Keefe (1999).

It is a doubtful proposition that a majority of Australian firms and employees would see it beneficial to move towards a US-style deregulatory framework that reduces the incidence but increases the risk involved with dismissal dispute resolution.

- *Complements to the laws:* Complements such as *unlawful* dismissal laws (or the current regime of general protections) and retrenchment provisions (providing compensation for economic dismissals) appear much less controversial, have their counterpart in all OECD nations (even in the U.S.) and are adequate in the Australian context.
- *Potential improvements to our laws* - Although our unfair dismissal laws achieve their purpose and appear moderate by Western standards, there is still room for improvement. Reforms could enhance the current framework if they improving workplace flexibility and productivity and reduce the private and public resources used in settling dismissal disputes without harming the laws' fundamental role of providing workplace justice. Our legislated system of unfair dismissal justice could still be improved by reducing the transaction costs imposed on small businesses (SMBs).
  - *The small business question* - There is much evidence overseas that unfair dismissal laws achieve much more than just balance an equity-efficiency by providing security to workers and imposing adjustment costs to firms. In large organisations, the laws may help improve productivity by correcting information asymmetries preventing workers' investment in firm-specific skills, or resisting adoption of new technologies. Michael Emerson (1988 : 779) suggests these benefits are more likely to accrue to large firms:

“...the importance of the argument [positive productivity effects from dismissal laws] will vary greatly between enterprises whose activities rely on teamwork, high skills and changing technology; versus enterprises where jobs are simple to learn and to supervise. In the former category of enterprises job security provisions will be relatively more beneficial or less costly than in the second category.”

Hence, if unfair dismissal laws can elicit positive productivity responses from labour, such responses will generally be less important or inexistent in contexts where effort and jobs are easy to monitor, skill sets are basic, labour turnover high and dismissal cost significant relative to firm size, i.e. in small businesses.

So, given that the laws are very likely to benefit large firms more than small firms, there would be a case for relaxing dismissal protection provisions for small businesses. This case is strengthened by the fact that except for the Code and the longer probation exemption, the laws do not currently adjust compensation and transaction costs for firm size. Litigation and resolution of a standard unfair dismissal case is certain to cost significantly more, relative to economic resources, to a small business owner than to the manager of a large firm. It is not clear that the Small Business Fair Dismissal Code has done much to substantially rebalance this asymmetry for small business.

Reforms could aim at reducing the procedures, compliance, and time constraints that the laws impose on small business employers

**2. *Are the tests used by the FWC appropriate for determining whether conduct is unfair, and if not, what would be a workable test? Are the exemptions to unfair dismissal appropriate, and if not, how should they be adapted?***

- The FWC adopts a systematic approach, which is to first establish jurisdiction over claims, then resort to a preliminary assessment by a mediator (a commissioner or a FWC civil servant) aimed at conciliation and settlement, and failing this, arbitration by another commissioner, which consists of further examining and verifying the facts behind the dismissal. Arbitration involves establishing a valid reason for the dismissal and ensuring due process (as specified in the Act) has been followed by the employer. Too often it also involves establishing jurisdiction when conflicting claims or insufficient evidence prevented that to be done at earlier stages.
- But there is also much variation in practice in the extent to which specific commissioners test for unfair, unreasonable or harsh dismissal behaviour at arbitration stage, at least as measured through published decisions.
- Current business exemptions based on jurisdiction (probation, high income level) are relatively generous by OECD standards. There is still room for making unfair dismissal processes more efficient, particularly when litigation involves a small business. FWC arbitrators could adopt the rule that the substance of a dismissal should always prevail over claims of procedural deficiency (this is currently not the case). Also, jurisdictional cases should not reach the arbitration stage.

- In cases of conflict between substantive and procedural aspects of an unfair dismissal case, the Fair Work Act 2009, leave much discretion to commissioners to decide which aspect should prevail in the decision of the case. This ambiguity is not necessary; it complicates the task of commissioners and can lead to counterintuitive decisions. I submit that when the substance of a dismissal is valid and well-established (whether it is serious misconduct or not) then substance should always take precedence over any procedural deficiencies in the considerations of FWC arbitrators.
- Too many jurisdictional cases are the subject of a Commission hearing. These cases are a waste of Commission resources and should be decided earlier in the lodgement and conciliation process.
- There seems to be no need to vary current exemptions. The probationary and jurisdictional exemptions from coverage by unfair dismissal laws are already quite extensive. For instance, the length of probationary exemption (1 year for small businesses) is much more than the European average (3 to 6 months).

***3. What are the strengths and weaknesses of the Small Business Fair Dismissal Code, and how, if at all, should the Australian Government amend it? Should the employment threshold be maintained, raised or lowered?***

- The Code is no panacea. It reflects the substantive and procedural questions that an arbitrator would investigate through arbitration. It is difficult to see how ticking the boxes of the Code actually change much to the workings of unfair dismissal laws.
- The Small Business Fair Dismissal Code offers few benefits to small businesses. It is essentially an attempt to inform and ‘educate’ small business owners about the procedural requirements of the laws (an area in which they are assumedly less experienced than larger organisations). In practice, mere adherence to the code does not provide exemption since adherence itself needs to be checked by third parties (FWC personnel) and can be contested by claimants. Furthermore, employers need not adhere to the Code if serious misconduct is involved. Yet, the latter still needs to be proven at least on ‘the balance of probabilities’ standard used by FWC commissioners. Even if serious misconduct and summary dismissal is not involved, mere adherence to the code is insufficient to exempt a small business when facts about the substance of the claim are contested. Having examined unfair dismissal cases since 2001 I am not convinced that the code makes any real difference for small businesses compared to the procedural requirements in place prior to the Code. If small businesses are to be provided any substantial relief from the costs of unfair dismissal other policies should be formulated.
- Finally, employment thresholds are always difficult to determine. It seems fair that the smallest businesses (such as defined under the current threshold of less than 15 employees) should be provided with a faster or less costly pathway to deal with unfair dismissal disputes (for reasons explained in my ‘101’ introduction). There are grey areas in the application of the Code that prevent the Code from filling that role.

***4. In cases where employers are required to pay compensation in lieu of reinstatement, are the current arrangements for a cap on these payments suitable?***

- The income threshold and the six months cap on compensation help define an absolute upper bound for compensation payments. These restrictions are a defining aspect of our unfair dismissal protection system, relative to common law litigation in Federal courts. Because they specify in advance the largest possible payments owing to an unfairly dismissed claimant, these restrictions reduce the risk (and cost) to business of being sued for unfair dismissal. They also help define a ‘contract zone’ for settlement negotiations, which would otherwise be very difficult to ascertain. These restrictions are central to our balanced approach to dismissal dispute resolution, avoiding the excesses of the U.S. system (whereby juries can award unlimited amounts to plaintiffs), and they should be kept.

### ***5. What are the effects of unfair dismissal arrangements on firm costs, productivity, recruitment processes, employment, and employment structures?***

- This is a very broad question and we do not currently have sufficient information to answer it, at least in an Australian context. More research is needed, but given the cap and relatively low-cost approach to conciliation and arbitration by the Fair Work Commission, it is likely that these effects are not exorbitant, except perhaps for small businesses. I review below the key concepts and evidence behind the main productivity and employment effects of unfair dismissal laws.

Unfair dismissal laws generate costs and benefits to businesses and employees. Some of these costs and benefits accrue mainly through labour demand effects (changes in productivity and labour cost) but also, less conclusively, through labour supply effects (changes in the extensive and intensive margins of labour force participation, i.e. changes in how attractive work is relative to non-work time).

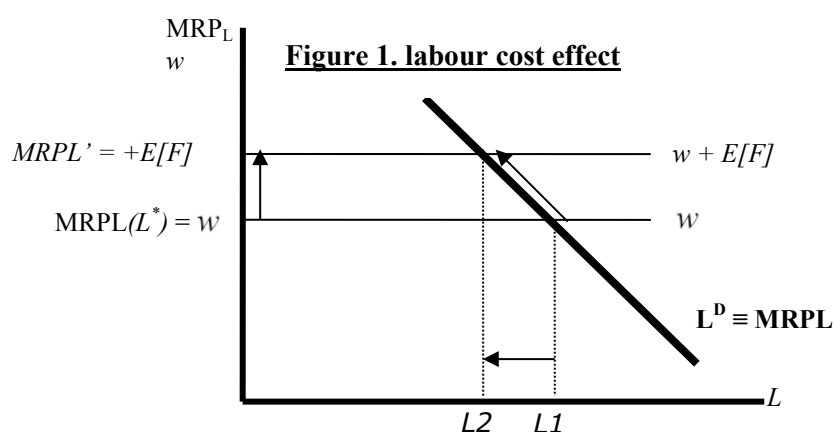
If we first look at the labour demand effects from introducing a regime of unfair dismissal laws in a hitherto perfectly competitive labour market, various market responses stand out.

#### **▪ Labour demand effects**

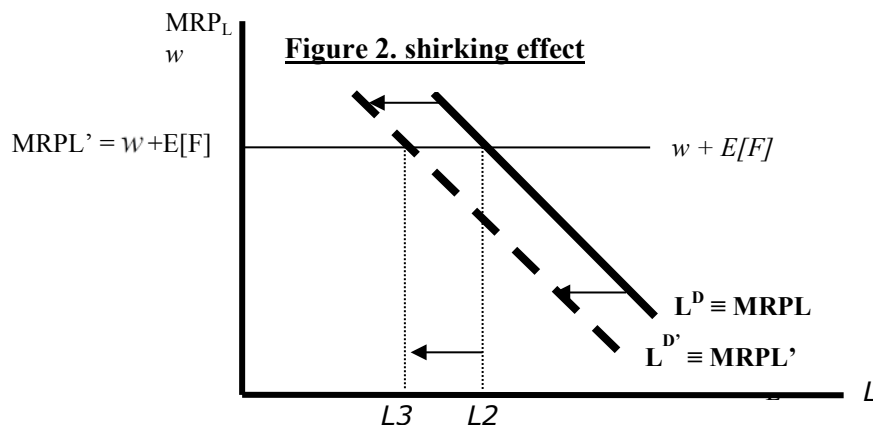
The first effect of the laws, *the labour cost effect*, raises the expected cost to business of employing labour. A business considering hiring an additional worker may now factor in the future cost of possibly having to later dismiss that worker for cause (poor performance, misconduct). Without unfair dismissal laws, the decision to dismiss unproductive or misbehaving workers is costless. With these laws in place, dismissing a worker may imply compliance costs, mediation and legal costs and possibly compensation and/or reinstatement cost. Any business owner or manager experiencing these costs once for the dismissal an employee is likely to take them into account in future recruitment decisions. This raises the overall cost of employing labour by a discounted future expected cost (of experiencing dismissal litigation).

Graphically, and assuming a perfectly competitive labour market as starting point, this labour cost effect is described in figure 1 below. The diagram shows how, starting from a competitive labour market the increase in expected labour cost reduces employment (from L1 to L2).

In joint work with Paul Oslington in 2004-5, I estimated the likely employment effect of this increase in the expected cost of labour in order to estimate the likely employment gains from the then forthcoming WorkChoices reforms (the exemption from the laws for businesses employing 100 or less employees). We concluded that removing this labour cost effect for that particular category of businesses could (by moving back from L2 to L1) create in the order of 6000 jobs (Freyens and Oslington, 2007).

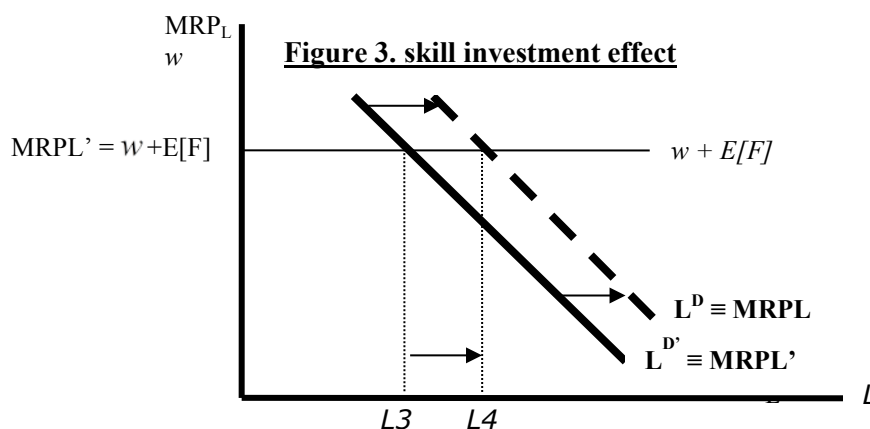


The second likely effect from a regime of unfair dismissal laws is the well-known *moral hazard effect*, which in this context is often referred to as the ‘*shirking*’ effect. With effective protection from dismissal, some workers may reduce their work effort in the knowledge that their jobs are safe, or at least that it is now costly for business to separate them for cause, such as for poor effort. Of course, the laws do not protect against fair dismissal for shirking, but allegations of shirking have to be proven in labour courts and this effort comes with significant transaction costs attached to it. These transaction costs may be sufficient for mildly shirking workers to expect employers to turn a blind eye on their reduced performance. In large organisations involving teamwork and various layers of management, shirking is hard to detect anyway and these firms use remedies such as efficiency wages to deter such behaviour. In smaller firms shirking is more likely to be visible but there will be few remedies to the issue (few SMBs do not pay efficiency wages). The result of poor effort is a reduction in the physical product of labour and therefore labour productivity (labour demand) shifts down. The result is a further contraction of employment ( $L2$  to  $L3$ ). In this case, laws-induced shirking creates a similar effect to an economic downturn (a fall in the revenue productivity of labour). Note that it is not necessarily ‘shirkers’ who bear the brunt of the adjustment (firms may not detect them, or may use ‘last-in first-out rules that penalise other workers).



There is some evidence of shirking effects (mostly higher absenteeism rates) from employment protection in overseas research, such as the work of Regina Riphahn, cited in the Commission's issue paper. In the Australian context, the only research I am aware of is that of Bradley et al. (2007), using the MOHRI database over absenteeism in Queensland's education sector. They find that teachers on temporary contracts have absenteeism rates 22-24% lower than those on permanent post-probation contracts.

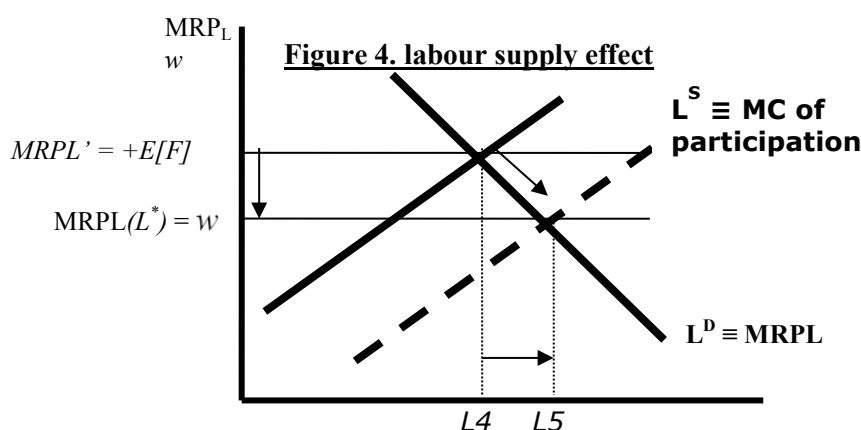
However, it by no means certain that shirking effects prevail in all or even most workplaces. There is more than anecdotal evidence that employment protection such as unfair dismissal laws can also make workers more productive (Figure 3) by inducing higher loyalty and commitment to their workplace and jobs, by forcing firms to be more careful in their screening of job applicants (and getting better job matches) and most of all, by providing the necessary condition for workers to invest in the acquisition of firm-specific skills. Such investment is otherwise risky for workers: hard-earned firm-specific skills are usually of no value elsewhere and losing one's job would involve the loss of that investment. As already discussed by Emerson (1988) and Buechtemann (1993) the conditions under which this effect is likely to be most prominent are usually present in large firms:



How much these benefits from unfair dismissal laws offset the productivity costs (shirking effects) is unknown, but it is likely that these offsetting effects will be small in the small business sector.

#### ▪ Labour supply effects

Finally, if workers greatly value employment security we can assume that a regime of unfair dismissal laws makes working more attractive relative to non-work use of one's time.



So the laws should increase the opportunity cost of leisure or non-work time ( $OC_l$ ). If we assume that employment security is a non-wage benefit, then providing it should increase labour supply. Positive labour supply effects (increased participation – extensive edge – or hours commitment – extensive edge) in a competitive market would boost employment provided employers can bargain lower wages for the more favourable working conditions offered. Again, we have no estimates of these effects and of course most labour markets are highly regulated and characterised by downward price rigidity.

These four graphs make no full justice to the quantity of potential economic effects (productivity, efficiency, employment) on labour and other markets from introducing unfair dismissal laws. We have not even discussed the various sources of negative externalities that arise from dismissals, which the laws would help to address, or the interaction of employment protection with other labour market institutions, which economists know are important.

But this short introduction provides a basic framework to think about the costs and benefits of the laws, and their wage and employment consequences. Clearly, employment and productivity impacts from strengthening or relaxing the laws would be very hard to establish quantitatively and many researchers have suggested they are probably very low in net terms. Others have stressed that main effects of the laws are distributional, imposing harsher conditions on those workers who are not covered (the young, the unskilled, those working in non-award industries, etc.) and may also have negative employment implications for the long-term unemployed, or indeed for some minority groups in society.

#### 6. *What are the impacts on employees of unfair dismissal, both personally and in terms of altered behaviours in workplaces?*

We have no quantified estimates of the hardships imposed by unfair dismissal (or fair dismissal for that matter). Both should be assumed to be shattering experiences for most employees involved, with scarring effects and possibly mental health consequences (such as giving up workforce participation etc.). Unfair dismissal laws provide a potential pathway to healing and closure, to conciliation, settlement and or arbitration. It is possible that even a case lost at arbitration stage may nonetheless help a dismissed employee come to terms with his or her dismissal, through better understanding of the causes of the dismissal. For such benefits to accrue, it is critical that the decision of Fair Work Commissioners appear fair and ideologically unbiased.

Although there have long been claims of Australian governments ‘stacking’ labour courts in charge of administering unfair dismissal justice, we do not know much about the presence and degree of political activism amongst labour courts commissioners. There is incipient evidence that ideological bias (from both sides of politics) is significant among labour courts commissioners (Southey and Fry, 2010, Booth and Freyens, 2014). This would hardly be surprising, as the international literature on judicial and political activism has very often found such biases amongst judges and courts, although little of that literature is specific to unfair dismissal and labour courts or industrial relations tribunals.

Nonetheless, claims of political activism in our labour courts need to be mitigated by several caveats. First, evidence of political activism alone is no demonstration that there is a problem with the provision of justice. It has long been commented by law and political science scholars that when cases are very difficult to decide (e.g. the evidence is inconclusive) then ‘something’ has to decide the case, and if it is the world view or personal beliefs of the judges, then so be it. It is the blatant exercise of ideological beliefs in cases where the evidence is glaringly conclusive that should be source for concern. In the context of the work of the FWC we are currently not in a position to comment on this issue. Second, the studies mentioned above could be viewed as pilot projects, studying 800 and 1000 cases respectively. But courts composition changes over time as new commissioners are appointed and older ones retire. We need a comprehensive study of labour courts decisions over long period of time.

**7. *What are the main sources of costs (including indirect costs), and how could these be reduced without undermining the fundamental goals of unfair dismissal legislation?***

- The direct costs imposed on business by compulsory resolution of dismissal disputes consist of the cost of legal representation (if any) and the cost of any monetary payments (settlement, compensation, and backpay in case or reinstatement order).
- The indirect costs are possibly much larger than the direct costs: they include time loss (value of working time lost while complying with procedural requirements, and during legal proceedings to settle the claim), the opportunity cost of disruption, particularly for SMBs, the implicit costs of stress and risk aversion (which inflate the direct costs), and potential morale loss or shirking effects from the laws (which reduce labour productivity).
- The central thrust of unfair dismissal protection is to make sure that unfair, harsh or unreasonable employer behaviour is not accepted, and likewise, to make sure that employers dealing with unacceptable employee behaviour will be supported rather than punished.



- Freyens (2010) lists a large number of direct and indirect costs from unfair dismissal laws, and suggests how they could be estimated through quantitative surveys.

**8. *Under current or previous arrangements, what evidence is there of the practice of ‘go away money’? Have recent changes, such as those that provide the FWC with expanded powers in relation to costs orders and dismissing applications based on unreasonable behaviour, improved matters?***

There is no research that I am aware of on the practice of go-away money, but it seems reasonable to assume that its use is significant, particularly in workplaces where the time and resource cost of litigating a dismissal dispute is likely to be very onerous to the business owner, relative to the compensation sought.

Given the six months and income caps on monetary compensation, average observed compensatory awards in the range of 2 to 3 months wages and a rough 50 percent chance of prevailing at a hearing, it is likely that for many employers who feel they are in the right in a dismissal dispute the opportunity cost of litigation (work time, stress, representation) will not be worth the benefits (averting a relatively small and half-likely compensatory payment).

There are no clear remedies to the practice of paying go-away money. The capped and reasonable dollar cost nature of unfair dispute litigation makes the time, stress and compliance costs appear large in comparison. Increasing the cap on monetary awards may only further increase incentives to pay go-away money.

It is unclear how much the practice of paying go-away money is an economic problem. If the dismissal is indeed unfair, unreasonable or harsh and the employee is covered by the laws, then go-away money may simply be an efficient transaction between two parties wishing to avoid incurring unnecessary transaction costs through dispute resolution.

On the other hand, if the dismissal is fair (e.g. due to gross misconduct or incompetence) resorting to go-away money is inefficient as it seals a failure to provide workplace justice. Unfortunately, the laws in this case give enough bargaining power to the dismissed party to impose an unjustified transaction cost on the dismissing party. As was earlier suggested by Forsyth and Stewart (DEEWR 2012) this issue can be partly remedied if the FWC uses more intense pre-screening procedures to weed-out unmeritorious claims at an early stage.

**9. *Do unfair dismissal actions disproportionately affect any particular group of employees (for example, by gender, ethnicity, geographical location, industry, union affiliation, and occupation or business size)?***

We have very little information about claimant characteristics in the bulk of cases lodged but later settled or withdrawn, and we have no information at all about the number and characteristics of individuals dismissed for cause in any given year.

We can observe the characteristics of claimants at arbitration stage (the tip of the iceberg). Out of 2877 arbitrated cases examined between 2001 and 2015, the claimant was female in 29 percent of the cases, union member (27 percent), union activist (3 percent), of minority ethnic groups in 6 percent of cases (as approximated by needing a translator at the hearing,

not being born in Australia or having one's ethnic group prominently mentioned at the hearing) and was indigenous Australian in 1 percent of the cases.

If these figures were representative of the mass of cases lodged, I would see no particular reason to believe that minority groups are more prominently involved in unfair dismissal cases than majority group employees, except perhaps for union members. With union density currently around 17% in Australia, a 27% incidence of union members at arbitration stage seems high. Unfortunately, there are many potential biases between the lodgement, conciliation, withdrawal and arbitration stages of unfair dismissal disputes and claimant characteristics at arbitration stage are probably unrepresentative of characteristics at earlier stages.

Interestingly, the arbitrated cases in which the claimant is member of a union exhibit a 55 percent success rate for the claimant (i.e. larger than the overall claimant success rate of 46 percent). The success rate is higher still (60 percent) if the claimant is an active union member (organiser, shop steward, etc.). I don't know yet what can be inferred from these results as I still have to control for a lot of other variables affecting 'union cases'. We could speculate that since almost all these cases involve union representation it may for instance indicate that unions are quite effective at defending unfair dismissal cases for their members, or perhaps it is a sign of political activism amongst arbitrators with a union background (Booth and Freyens, 2014). We don't know at this stage but I plan to do further research on these questions.

Most cases arbitrated by our industrial relation tribunals involve large firms (56 percent), then small businesses (23percent) and medium-sized businesses (21 percent). Again, there is no reason to believe that this is a representative distribution of the bulk of lodged (but settled or withdrawn) unfair dismissal cases. It is in fact likely that, given their scarce time, legal and other resources, small businesses will have stronger incentives to settle cases at earlier stages to avoid being drawn in further dispute resolution stages. This is in essence the same argument as for the practice of 'go-away money'.

#### ***10. What are the main grounds on which people assert unfair dismissal, and what types of claims are most likely to succeed?***

The Fair Work Commission would probably have a better record of that information. With only published decisions in the public domain I can but comment on the arbitrated cases for which I have collected allegations information over the period 2001 – 2015. There are some caveats about this data but I report below what I believe to know at this stage about the success rate of cases based on the central grounds alleged by dismissed workers<sup>3</sup>.

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<sup>3</sup>NB. The reported data may differ from FWC reports as we count multiple claimants cases as one, i.e. we examine the case based on a representative claimant - unless the FWC hands out a different verdict for each of the multiple claimants (which happens but is very uncommon). Of course, the FWC may record the success rate of multiple claimants cases differently. Another issue is that our records of arbitrated cases also include jurisdictional decisions handed out at arbitration stage. So, even if the claimant's allegation is say, constructive dismissal, the commissioner may still dismiss the case based on a jurisdictional objection that has no bearing with the substantive or procedural allegation, and the claimant's allegation will in that case play no or little role on the outcome.

Based on that information only, and for the period 2001 – 2015, the collected data indicates that commissioners decide in favour of unfair dismissal claimants 46 percent of the time (across all substantive, procedural and jurisdictional decisions)<sup>4</sup>:

- In 9 percent of these cases (about 250 cases) there was insufficient information to establish the key allegation made by the claimant. Cases litigated on claims the dismissal was an overreaction to a minor issue were the most successful in arbitration (60 percent success rate). Cases litigated on claims of flawed dismissal procedures were successful 56 percent of the time, and cases litigated on claims of the dismissal was due to employee illness were successful 54 percent of the time.
- Cases litigated on claims the facts behind the dismissal had been misconstrued or misrepresented by the employer were successful 50 percent of the time. Claims the dismissal was retribution for ‘frank and fearless’ behaviour (complaining about issues, disagreeing with manager) were successful 48 percent of the time, whereas claims the dismissal was a ‘sham’ (a redundancy disguised as dismissal or vice versa) were only successful 40 percent of the time.
- Cases litigated on claims of harassment and constructive dismissal were among the least successful (27 percent), most often this is because these claims are made by employees having resigned as a consequence of the alleged employer behaviour. An employee having resigned has very low chances of success at arbitration because the separation is then not considered a dismissal. The few successful cases arose when the employee managed to convince the arbitrator that resignation was the only possible course of action given the actions of the employer. Note that the low success rate was the same whether the claim was ‘harassment’ or ‘constructive dismissal’.
- Similarly, cases litigated on grounds of ‘personal objection’ (tasks too dangerous, against the law, or against personal beliefs and principles) were only successful 34 percent of the time (here too these cases often involve resignation and failure to convince arbitrators that there was no other course of action).

There are some other categories of claims but they involve less than 100 cases and the success rate is unlikely to be sufficiently representative of the results that a larger sample would establish. We are currently carrying out further analysis of claims arbitrated between 2001 and 2015, which we hoped to report on later this year before the Commission’s Inquiry is completed.

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<sup>4</sup> In some cases there were up to four different types of allegations and we had to exercise judgement as to what was the central allegation of the claimant. Our data set was constructed over many years, with different researchers working on it at different times. Although all researchers were briefed and trained the same way there are possible divergences in the way they interpreted the claims made in the published decisions. For these reasons there will unavoidably be some margin of error in the way we interpreted the main claims made by dismissed employees.

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