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Identifying and measuring the economic effects of unfair dismissal laws

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Abstract

Theory cannot provide an unambiguous prediction regarding the economic effects of employment protection laws. Such laws confer benefits on employees and shift the labour supply curve to the right. But they also impose costs on business and therefore shift the labour demand curve to the left. The net effect on employment is ambiguous and depends on the magnitudes of the costs and benefits as well as the elasticities of labour supply and labour demand. The net effect on welfare is also ambiguous. However, since many businesses did not provide protection against unfair dismissal in the 1990s one can argue that that indicates that the costs exceed the benefits and thus the unfair dismissal laws introduced in 1993 reduced employment and welfare.

Reduced form models that use employment or unemployment as the dependent variable are useless for identifying and measuring the economic effects of unfair dismissal laws. Structural models or survey based evidence is required to answer these questions.

Evidence from a survey of 1800 businesses establishes that unfair dismissal laws impose significant costs on businesses and cause them to make major changes to the way in which they hire and fire workers. An estimated lower bound on these costs is \$296 per full time employee. This is a lower bound in part because some business said unfair dismissal laws raised their costs but were unable to quantify by how much. Also, the opportunity cost in terms of lost productivity of continuing to employ those workers whose performance is unsatisfactory is excluded from the calculation above.

Evidence from the 1990 and 1995 AWIRS survey shows that dismissal rates for cause declined from 4.4 per cent to 2.1 per cent and may have declined even further in the past decade. This suggests that the lost productivity from retaining unsatisfactory employees is likely to be high.

The AWIRS data shows that in 1990 small and medium sized businesses were more likely than larger business to dismiss employees for cause. The 1995 AWIRS survey shows that small and medium sized businesses made much larger adjustments to their firing practices and thus shouldered more of the burden of these laws.

Discussion of unfair dismissal laws has ignored the fact that these laws increase the risk born by businesses. Small business is unable to pool this risk and so it poses a much greater cost for such businesses. This feature may also explain why small businesses reported that they spent more on complying with and reducing their exposure to unfair dismissal laws.

These considerations suggest that the Government's policy of exempting businesses with fewer than 100 employees from the unfair dismissal laws will most likely not cause major resource allocation costs. But a better policy would be to abolish the unfair dismissal laws.

Using a labour demand elasticity of 0.7 percent I estimate that the existing unfair dismissal laws reduce employment by at least 0.46 per cent (about 46,000 employees).

Freyens and Oslington question my findings. There are two mistakes in their paper that account for their position. First they underestimate by a factor of 10 the probability that a worker is dismissed for cause. Second, they exclude the costs incurred by business in avoiding exposure to the law and focus only on the cost of complying with the law. Both their paper and my paper can be criticised for underestimating costs because we exclude the foregone productivity that arises where businesses retain some employees whose performance is unsatisfactory and who would have been dismissed under an employ-at-will regime.

1 Introduction

The Australian Government's WorkChoices (2005) Bill makes major changes to unfair dismissal laws and related legislation. These changes are in three main parts.

1. All businesses falling within the corporations powers will be brought under Federal Unfair Dismissal laws;
2. An exemption from the Federal Unfair Dismissal laws is provided for businesses with up to 100 employees;
3. The Minister for Employment and Workplace Relations will be able to prohibit employees and employers from placing certain provisions in agreements — the so called prohibited content. At this stage no regulations are in place but in the WorkChoices document the Government says that it will prohibit the inclusion in agreements of provisions related to unfair dismissals.

The debate about these laws is concerned with the following questions:

- Do existing unfair dismissal laws have any economic effects?
- If so, what are those economic effects?
- Will the government's proposed changes to unfair dismissal laws make things better or worse?

Many authors have used reduced form regressions with either employment or unemployment as the dependent variable in attempting to answer the question of whether employment protection laws have any economic effects. Addison and Teixeira (2003) provide a summary of that literature. As is discussed in section 2, economic theory tells us that this approach is unable to provide a conclusive answer. The reason is that employment protection laws can have important economic effects without influencing either employment or unemployment.¹

Given that reduced form regressions are largely uninformative on this issue, researchers need to use other sources of information such as identified structural models, surveys of business or revealed preference arguments.

Identified structural models are costly to construct and thus survey based evidence and revealed preference arguments have a role in establish whether there is sufficient evidence to justify developing structural models to study the effect of employment protection laws. Using revealed preference arguments and evidence from a survey of 1800 businesses with less than 200 full-time employees I show that unfair dismissal laws do have economic effects.²

Given that unfair dismissal laws have economic effects attention then turns to the task of identifying the nature of those effects, quantifying them and assessing whether the net benefit is positive or negative. Sections 3 and 4 summarise the evidence from the survey reported in Harding (2002) on the intended and unintended effects of unfair dismissal laws.

The costs imposed on business is quantified in section 5 drawing on both the information in Harding (2002) and in Freyens and Oslington (2005). I show that Freyens and Oslington (2005) underestimate the costs of unfair dismissal laws. This arises for three main reasons. First, evidence from the 1990 and 1995 Australian Workplace Industrial Relations Surveys (AWIRS) shows that Freyens and Oslington underestimate by a factor of ten the probability that a worker is dismissed for cause. Second, Freyens and Oslington focus solely on the cost incurred in making a dismissal. That is, they ignore the cost incurred by business in managing and dealing with those poor performers who would have previously been dismissed for cause. These costs are included in Harding (2002) and this explains the remaining part of the difference between Harding (2002) and Freyens and Oslington (2005) in the estimated average cost per employee of the unfair dismissal laws. The third source of cost is the difference between the marginal product of those who would have previously been dismissed for cause and the cost to the business of continuing to employing these workers. This last cost is ignored by Harding (2002) as well as Freyens and Oslington.

Unfair dismissal laws also increase a businesses exposure to risk. Section 6 explores how this exposure to risk is related to business size and shows that this

¹This point seems lost on the OECD who have initiated a mini industry producing such reduced form regressions.

²The survey is described in appendix A.

feature provides a partial rationale for the exemption of businesses with less than 100 employees.

Policy issues and conclusions are discussed in section 7

2 Do existing unfair dismissal laws have any economic effects?

Lawyers, policy makers, politicians, business people and journalists find this an unusual question since they typically assume that employment protection laws modify behaviour and thus have economic effects. What they disagree about is the nature of the effects. One side typically sees the laws as having beneficial effects in terms of protecting "employees rights" the other side typically sees the laws as imposing costs on employers who respond by reducing employment. The latter group gained support from Lindbeck and Snower (1988) who argued that hiring and firing costs increase the bargaining power of insiders (the employed) relative to outsiders (the unemployed). According to Lindbeck and Snower the insiders use their increased bargaining power to obtain higher wages which results in increased unemployment.³

Some academic economists became sceptical during the 1990's about the effects of employment protection and minimum wage laws. Nickell and Layard (1999, p3030), for example, observed that compared with worrying about the effects of unions and social security systems "time spent worrying about strict labour market regulations, employment protection and minimum wages is probably time largely wasted".

This scepticism has a theoretical foundation that is based on Jovanovic (1979) and Lazear (1987). Jovanovic points out that in a world of wage flexibility a firm never needs to dismiss a worker rather they can adjust the wage so that it is below the employee's reservation wage, thereby inducing the employee to voluntarily quit. Jovanovic's point is an important one because it makes it clear that concepts such as quits, redundancy and fires for cause are all endogenous and can only be interpreted against the institutional framework of a particular economy. For example, if a mandated minimum wage is binding or if employees

³It is not clear that Lindbeck and Snower's (1988) proposition is valid in general. In a bargaining model, tighter employment protection laws have several counteracting effects. First, to the extent that they increase business costs they will reduce the business profit per worker. Also if employment protection laws reduce the probability a worker is hired from the pool of unemployed then those laws will reduce the weight placed on the outside wage, increase the weight placed on unemployment benefits and thus reduce the expected value of the employees outside alternative when bargaining. That is, in a bargaining context, tighter employment protection laws may not increase the wage and they may not reduce employment.

are covered by collective agreements that do not allow adjustment of an individual employee's wages then it becomes necessary for the employer to terminate the employment relation in the case of redundancy or poor performance.⁴

Lazear (1987) goes further and points out that if firms and workers are free to contract then they can implement efficient agreements that undo the effects of employment protection laws. Lazear's point is important but one should not overemphasise its reach. It only operates when the employment protection laws result in efficient transfers between firms and workers as these can be undone by an efficient contract. Lazear's point does not apply where the hiring and firing laws result in deadweight loss such as legal costs and transactions costs. The latter cannot be undone by efficient contracting.

In some circumstances the optimal contract between a firm and its employees will include provisions that impose firing costs on the firm. These contractual arrangements can arise, for example, where firm-specific training is required and it is optimal to share the costs between the firms and its workers — Booth and Chatterji (1989) develop such a model. However, this model relates to redundancy in the event of demand shocks and it does not have many implications regarding dismissal for cause. Pissarides (2001) develops a model in which employment protection arrangements arise as part of an optimal risk sharing contract between a firm and its workers. Pissarides' model relates to redundancy and not to dismissal for cause. It is doubtful if a risk sharing argument could be made in defense of unfair dismissal laws.

Thus, two additional considerations need to be taken into account when assessing the impact of employment protection laws. The first, and more obvious consideration, is that the laws are only restrictive to the extent that the mandated provisions are stricter than the provisions that would arise endogenously through optimal contracting. A second, and less obvious consideration, arises because, in the presence of costs of writing and enforcing contracts, the existence of a body of law related to hiring and firing will influence what provisions are included in contracts related to hiring and firing. For example, it may be that it is no longer worthwhile for businesses and employees to include in contracts provisions related to firing that are close, in effect, to the mandated provisions.

The discussion above makes the point that one cannot use economic theory to determine the effects of employment protection laws, empirical evidence is required. The strongest evidence that these laws have economic effects is arises from the amount of lobbying effort that is put in by unions who seek to defend and extend the laws and by employer groups who typically oppose the laws and seek to have them weakened or reduced in their coverage. Time and money are scarce for both of these groups and it is inconceivable that they would seek to

⁴If bonuses are a sufficiently large component of remuneration then this provides employers with a mechanism for inducing quits.

spend large amounts of these resources defending or attacking the laws if those laws did not confer benefits to employed labour and costs on employers.

Given the power of this revealed preference argument I feel that most time should be spent on

- Identifying the economic effects (including distributional and equity effects) of unfair dismissal laws;
- Accurately measuring those effects; and
- Weighing the costs and benefits to come to an overall assessment of the net effect of these laws.

Nonetheless because of the extensive econometric work that has been undertaken, some time needs to be spent on discussing whether that work can shed any light on the issue of whether unfair dismissal laws have any economic effects.

2.1 Econometric evidence

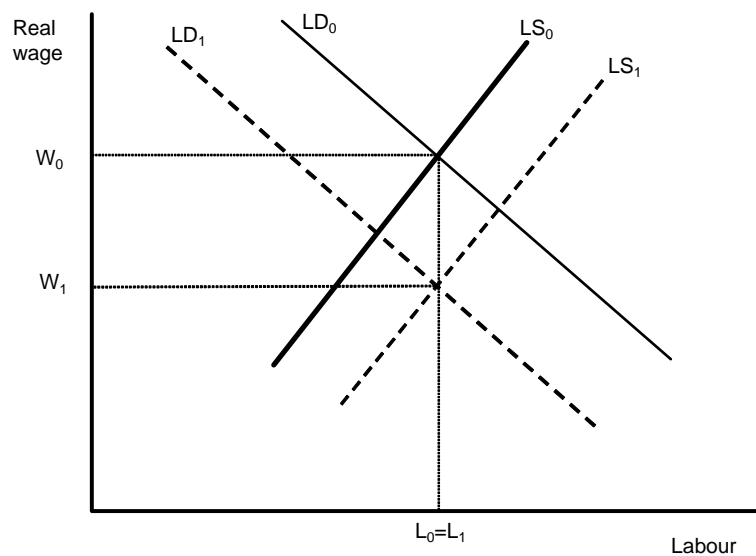
The empirical work on the effects of employment protection legislation that is surveyed in Addison and Teixeira (2003) has two distinguishing features. First, all of the empirical work involves estimating reduced form equation(s). Second, some measure of employment or unemployment is used as the variable to be explained in the reduced form equation. The fundamental problem with this approach is that the changes in employment protection laws can:

- have significant economic effects without changing the equilibrium level of employment; and
- result in an increase in the unemployment rate even if the increase change in the employment protection laws are welfare improving.

In a perfectly competitive economy without frictions the effect on employment of tightening employment protection laws is ambiguous. Tightening of such laws has two effects. First, it increases the costs to business of hiring labour and therefore shifts the labour demand curve down to the left from LD_0 to LD_1 as is shown in Figure 1. Second, tightening such laws provides a benefit to employees in terms of improved protection against procedural unfairness. If this is valued by employees it will result in an increased amount of labour being offered at each wage rate — that is the labour supply curve shifts to the right from LS_0 to LS_1 in Figure 1. I have drawn Figure 1 so that the net impact on employment is zero. Of course, in practice the net effect on employment could either be negative or positive and this demonstrates the problem of using employment as an indicator of whether employment protection laws have an economic effect. In a perfectly competitive economy the signal of whether

employment protection laws have an effect is provided by the real wage, as is shown in Figure 1, if the wage changes then it is clear that the laws have an effect.

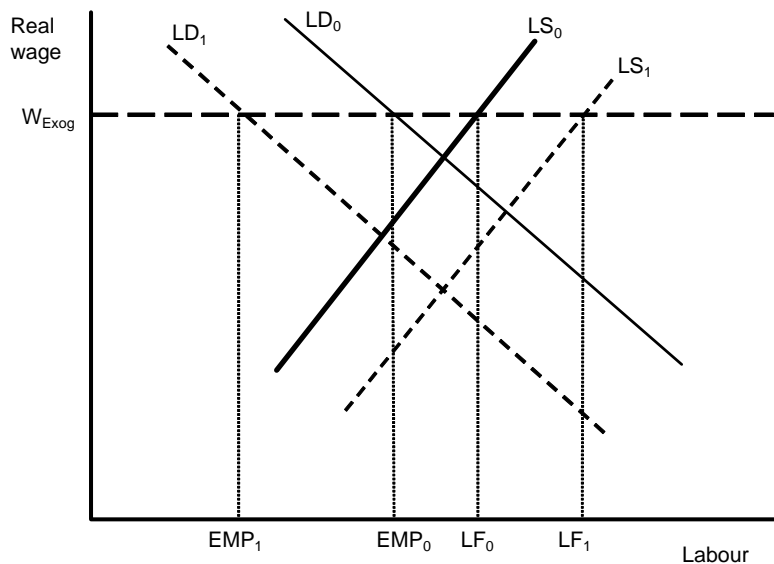
Figure 1: Effect on employment of increasing the tightness of employment protection laws is ambiguous in a perfectly competitive economy with no frictions



The point of the preceding example is to illustrate the problems with using employment as an indicator of whether employment protection laws have any economic effects.

Few people would argue that any labour market is well approximated by perfect competition so it is of interest to look at departures from that ideal. One important departure from perfect competition arises where the wage is set by a government authority such as the Australian Industrial Relations Commission (AIRC) or the Fair Pay Commission (FPC) rather than market forces. A useful starting point is to assume that the wage is set exogenously as in Figure 2 below. In this case tightening employment protection laws shifts the labour supply and demand curves in the same way as for Figure 1. But in this case the real wage is exogenous and all of the adjustment occurs via employment (which falls) and unemployment (which increases by more than employment falls because the labour force increases).

Figure 2: Effect of employment protection laws when the real wage is exogenous



So with an exogenous wage the effect of tightening employment protection laws is to unambiguously reduce employment and increase unemployment. Notice that if the law did not impose any cost to business (so the labour demand curve does not shift to the left), but does confer a benefit on employees (so the labour supply curve shifts to the right) then, the law would create unemployment even though it is welfare improving. This, admittedly constructed, example highlights the problem with the OECD approach of using changes in employment and or unemployment as an indicator of the welfare effects of unfair dismissal laws.

It is unlikely that wages are set exogenously in any economy. A more realistic view of the world is that wage setting bodies such as the AIRC take into account a range of factors including employment and unemployment.⁵ In this situation after employment protection laws are tightened there is an initial fall in employment and increase in unemployment and the wage setting authority responds by lowering the wage. So in this case we are in a situation that falls between the exogenous wage story and the market clearing wage story.

Thus, I conclude that reduced form econometric models with either, employment or unemployment as the dependent variable are of no use in determining

⁵It is difficult to sustain the position that the AIRC places no weight on employment and unemployment. Rather the issue is whether the AIRC places sufficient weight on these factors.

whether changes to employment protection laws have any economic effects. It is true that if an adverse employment effect is found to exist then one can conclude that economic effects exist. But as is illustrated in Figure 1 the finding of no impact on employment cannot be interpreted as evidence that the laws have no economic impacts. This point does not depend on perfect competition and will survive extension to search models, models of imperfect competition and bargaining models. Essentially the point is that identified structural rather than reduced form models are required if one seeks to evaluate the economic effects of changes to employment protection laws.

2.2 Survey based evidence

The problems associated with using reduced form econometric methods were one factor motivating the approach taken by Harding (2002) which relies on survey based evidence to establish whether unfair dismissal laws have any economic effects.

2.2.1 Methodological issues

Using survey based evidence raises some methodological issues that need to be addressed briefly.⁶ A useful taxonomy of these issues is provided by Boulier and Goldfarb (1998) who observe that survey questions fall into seven categories viz:

1. Facts of past or current economic life. Eg "Do you own a car?"
2. Facts about future intentions. Eg "Do you intend to buy a car next year?"
3. Measurement of hard to gauge variables. Eg "At what wage would you be indifferent between working and not working?"
4. Explanations of current or past behaviour. Eg "Why did you hire more people last year?"
5. Predictions of future behaviour under counterfactual conditions. Eg "If the minimum wage were frozen for five years would that alter your decisions about how many people to employ?"
6. Participant or observer opinions and ideas. Eg "Is this course well taught?"
7. Assessing the interviewees information set. Eg "By how much did the price level increase last year?"

⁶There is an extensive literature on these metodological issues with surveys, the literature starts with the debate between Lester (1946) and Machlup (1946). Friedman (1953) article states a strong methodological position against the use of certain types of survey questions that ask how business people or consumer's make decisions. Here Friedman's objection is not so much to the use of surveys rather he sees the research question that asks how people make decisions as being outside of the realm of economists working in the marginalist paradigm.

Rather than eschew any of these categories of question it seems to me that economists should proceed to assess these questions much in the same way as they assess econometric estimators. That is we should focus on the following issues

- Is the particular category of question subject to bias? The main source of bias arises where the respondent has an incentive to lie. Blinder (1991) has suggested that "If the respondent has an reason to conceal the truth or mislead the interviewer, this objection is probably a show stopper". This is very much like the reaction to biased estimators forty years ago. Today, econometricians frequently use biased estimators where some warrant can be given that the bias is small in some sense. It seems that such a mindset should be used with survey data.
- How big is the measurement error induced by the question;
- How robust is the question to alternative populations;
- What is the likely ratio of insight obtained from the question relative to the cost; and
- What are the alternative methods of obtaining the information and what are their ratios of insight obtained to cost.

2.2.2 Survey evidence that unfair dismissal laws have an economic effect

To provide evidence on whether unfair dismissal laws have any effect on businesses, 1800 businesses with fewer than 100 full-time employees were asked the following question,⁷

"Thinking about the processes and practices your business uses to: recruit and select staff, manage its workforce, and manage staff whose performance is unsatisfactory – which of the following statements best describes the extent to which unfair dismissal laws influence the operation of your business?"

1. The laws have a major influence on what we do.
2. The laws have a moderate influence on what we do.
3. The laws have a minor influence on what we do.
4. The laws have no influence on what we do.

⁷This question was used as a screening question to ensure that businesses reporting no effect were not asked leading questions.

The responses are in Table 1.

Because they are not asked whether the effect is positive or negative, businesses have no incentive to lie in answering this question. Moreover, in the taxonomy of questions given above it is simply a question of fact that is being asked. Thus there is no reason to expect any bias in the response. As can be seen from Table 1 the unfair dismissal laws have some effect on the behaviour of almost 70 per cent of small and medium sized businesses. But the extent of the reported effect varies from major to minor.

Table 1: Effect of unfair dismissal laws on the behaviour of small and medium sized businesses

Response	Weighted response (per cent)
The laws have a major influence on what we do	23.3
The laws have a moderate influence on what we do	24.6
The laws have a minor influence on what we do	21.9
The laws have no influence on what we do	30.2
Total	100.0

Given that businesses are heterogenous and some businesses will optimally include unfair dismissal procedures in their agreements with workers, this is the pattern of responses that we should expect. The value of this question is that it provides a useful insight into the proportion of businesses that are affected by unfair dismissal laws, something that cannot be achieved by regression methods on aggregate panel or cross section data for economies.

Having established that the unfair dismissal laws are not undone via efficient contracting and thus have real economic effects it is appropriate to turn to the question of the nature of these effects.

3 Intended effects of unfair dismissal laws⁸

The main objective of UFD laws is to encourage firms to engage in better human resource management practices particularly when dealing with workers whose performance is unsatisfactory. One effect of the law was to encourage 29.7 per cent of firms to seek advice as to how to mitigate the effect of UFD laws on their businesses.⁹ Part of this advice will relate to how to improve human resource management and can be considered as an intended effect of the laws. However, part of the advice will also relate to how to avoid being caught by the laws.

⁸This section is largely taken from Harding (2002).

⁹Source Table 10 of Harding (2002).

Unfair dismissal laws have induced 51.6 per cent of businesses to change the procedures that they use when dealing with workers whose performance is unsatisfactory.¹⁰ These changes are involve implementing the main practices that are considered to be part of good human resource management of poor performers:

- provide a warning;
- provide an opportunity to respond;
- provide workers who are about to be dismissed with reasons.

Table 2 provides details on the extent to which these practices are adopted by businesses. Adopting these procedures for all employees imposes costs on businesses. These costs are included in the estimates by Harding (2002) and reported in section 5 below but are not included in Freyens and Oslingtons' (2005) estimate of the costs of unfair dismissal laws.

Table 2: Procedures used when dealing with workers whose performance is unsatisfactory

Response Category	Uses formal procedures with worker whose performance is unsatisfactory	Documents in writing an employees poor performance	Provides a worker whose performance is unsatisfactory with a warning	Provides a worker whose performance is assessed as unsatisfactory with an opportunity to respond	Provides reasons to a worker whose performance is considered sufficiently unsatisfactory to justify termination
Describes very well	31.4	34.4	42.0	40.9	42.1
Describes somewhat well	15.3	8.9	7.8	7.2	7.0
Does not describe at all	4.8	8.1	1.7	1.9	1.6
Don't know	<0.05	<0.05	<0.05	0.6	0.2
Refused	<0.05	0.1	0.1	0.1	0.7
Screened out	48.4	48.4	48.4	48.4	48.4
Total	100.	100.	100.	100.	100.

The choice of a legal remedy for UFD also creates two intended effects that are not necessarily beneficial.¹¹ The first of these is increased formality in

¹⁰Source Table 10 of Harding (2002).

¹¹I categorise these as intended effects as they are central to a legal remedy. Without formalism and documentation the legal remedy would be unworkable as it requires evidence.

procedures with workers whose performance is unsatisfactory. The second is documentation in writing of a workers poor performance. As can be seen from Table 2, while these strategies were less strongly evident than the three beneficial strategies they were nonetheless very evident in firm responses to the UFD laws. This raises two questions about the equity effects of UFD laws. First do they treat workers equally? Or does the increased formalism and reliance on documentation disadvantage those workers that are less literate and less suited to formal modes of supervision? These questions cannot be addressed fully from the information in the current survey, however, in the next section I report evidence that the increased formalism is viewed by management as making their task more difficult.

The unanswered question here is how much do workers value the procedural improvements that are documented in Table 2.¹² The fact that many businesses did not provide coverage for unfair dismissal until the legislation was introduced suggests that the benefit to employees is less than the cost to business of protecting workers against unfair dismissal.

4 Unintended effects of the unfair dismissal laws¹³

Unintended effects of UFD laws fall into three categories. The first of these are effects on recruitment and selection procedures. The second category of unintended effects relates to adverse effects on management and supervision practices. The third category of unintended effect arises where the UFD laws result in firms being less willing to dismiss workers whose performance is unsatisfactory.

4.1 Effect on recruitment and selection procedures and decision

Given that UFD laws have the effect of making it harder to dismiss an employee for poor performance it is natural for firms to react by changing their recruitment and selection procedures so as to reduce their chance of hiring someone who turns out to be a poor match or a poor performer. Addison and Teixeira (2003) report evidence that this effect seems to disadvantage the young.

Some 47.9 per cent of businesses reported that the UFD laws influenced their recruitment and selection procedures.¹⁴ (see Table 3).

UFD laws have resulted in only a small increase in the use of fixed term contracts by small and medium sized businesses, this is probably because given

¹²Recall from the discussion earlier the extent to which procedural fairness is valued by employees determines the extent of the rightward shift in the labour supply curve.

¹³This section is largely taken from Harding (2002).

¹⁴See Table 13 in Harding (2002).

the high failure rates of small business such contracts would provide more permanency to employees than is afforded by the standard employment contract and it would be difficult for small business to credibly commit to such contracts. A more popular choice was the use of casual workers. This strategy has the advantage, for small business, of extending the use of a form of employment with which they are very familiar. Increased employment of family and friends was also about equally popular response by small business (see Table 3).

Table 3: Nature of effect on recruitment and selection procedures

	My business puts more employees on fixed term contracts	My business employs more casuals and permanent workers	My business employs more family and friends	My business uses longer probationary periods for new employees	Because of unfair dismissal laws there are certain types of job applicant that my business is less likely to hire
Describes very well	8.1	16.7	12.5	18.6	29.6
Describes somewhat well	3.5	4.6	8.2	8.0	9.9
Does not describe at all	35.8	26.6	27.3	20.7	6.9
Don't know	0.5			0.7	0.7
Refused	<0.05	0.1			0.8
Screened out	52.0	52.0	52.0	52.0	52.0
Total	100.0	100.0	100.0	100.0	100.0

The most frequently reported responses were use of longer probationary periods and screening out of certain types of job applicants. The former strategy while understandable makes the probation period more difficult for both employees and employers. This strategy also has important equity effects on workers. To understand this consider a worker who is a marginal match when viewed from the perspective of their new employer. The UFD laws create an incentive for the employer to lift the criteria used to determine what is satisfactory in the probationary period. Thus one effect of the UFD laws is that more people will be dismissed in the probationary period. Such dismissals show up on the worker's CV either as terminations or as changes in job for no apparent reason.

When asked about what categories of job applicants they would be less likely to hire 35.1 per cent of firms said that they would be less likely to hire

someone who had changed jobs a lot for no apparent reason (see Table 4). Thus the selection strategies UFD laws cause businesses to adopt, are likely to disadvantage certain types of workers with consequent adverse effects on equity and on efficiency. The latter arises because the increased rate of dismissal in probationary periods can lead to the person having a reduced chance of getting a job. This adverse effect of unfair dismissal laws on the probability of getting a job is compounded for workers who become unemployed for more than one year as the UFD laws make it far less likely that businesses will select job applicants with these characteristics (see Table 4).

Table 4: Types of job applicant less likely to be hired because of unfair dismissal laws

	A person who has changed jobs a lot for no apparent reason	A person who is currently unemployed	A person who has been unemployed for more than one year	A person who has been unemployed for more than two years
Describes very well	28.0	7.8	16.5	22.2
Describes somewhat well	7.1	8.1	10.9	8.1
Does not describe at all	4.1	23.3	12.0	9.1
Don't know	0.2	0.3	0.2	0.2
Refused	0.1	<0.05	<0.05	<0.05
Screened out	60.6	60.6	60.6	60.6
Total	100.0	100.0	100.0	100.0

4.2 Effect on supervision, management and performance of employees

Some 46.1 per cent of businesses reported that the UFD laws influenced the way in which their business supervised or managed employees. And, 44.3 per cent of businesses reported that the UFD laws made it more difficult to manage and supervise their workforce. See Table 5.

When asked about the nature of adverse effects some 38.9 per cent of businesses reported that the UFD laws reduced their authority over their workforce, 40.8 per cent reported that it now takes longer to resolve issues associated with poor performance, 37.9 per cent reported that poor performance by one worker is more likely to spill over and adversely influence the performance of other

Table 5: Effect of unfair dismissal laws on management supervision and performance of employees

	Law has effect on way business super- vises and manages employees	Law makes manage- ment of workforce more difficult than it would otherwise be
Describes very well	20.1	25.4
Describes somewhat well	26.0	18.9
Does not describe at all	22.9	25.2
Don't know	0.6	0.2
Refused	0.3	0.1
Screened out	30.2	30.2
Total	100.0	100.0

workers (see Table 6). Again these costs are not included in the estimate of costs presented in section 5.

Earlier it was observed that legal remedies require more formal interaction between employees and employers, when asked about this some 38.3 per cent of businesses reported that the increased formality required by the UFD laws made communication with employees more difficult. This is likely to be a significant problem for small businesses where flexibility is part of their competitive advantage. Moreover, as discussed earlier, the increased difficulty in communication may well disadvantage certain types of employees with consequent adverse equity effects.

4.3 Effect on decisions to terminate a worker whose performance is unsatisfactory

The objectives of unfair dismissal laws are to improve the fairness with which employees are treated by encouraging employers to engage in fair and transparent human resource management practices. Ideally, such laws would not discourage employers from dismissing an employee whose performance is unsatisfactory. However, as reported in Table 7 for 37.5 per cent of firms the UFD laws made it less likely that they would dismiss a worker whose performance is unsatisfactory. This finding underscores the finding made above that businesses felt that the UFD laws reduced their authority over their workforce.

It is useful to place this information against the perspective of the extent to which small and medium sized business dismissed workers for cause. The 1990 and 1995 Australian Workplace Industrial Relations Surveys show that businesses dismissed 4.4 per cent and 2.1 per cent of workers for cause in 1990 and 1995 respectively.^{15, 16}

¹⁵See Morehead (1997, p605 Table AA.5) for details.

¹⁶Presumably the reduction in dismissals for cause between 1990 and 1995 reflects the introduction of the federal *Industrial Relations Reform Act (1993)* which provided employees

Table 6: Nature of effect of unfair dismissal laws on management and supervision

	Reduce authority of business owners over workforce	Reduce authority of business owners over workforce	Takes longer to resolve issues associated with poor performance	Takes longer to resolve issues associated with poor performance	Poor performance by one worker is more likely to adversely affect the performance of other workers	Poor performance by one worker is more likely to adversely affect the performance of other workers	More formality in dealing with workers makes communication between management and employees more difficult	More formality in dealing with workers makes communication between management and employees more difficult
Describes very well	23.9		29.6		26.9		26.5	
Describes somewhat well	15.0		11.2		11.0		11.8	
Does not describe at all	5.2		3.1		6.1		5.8	
Don't know	0.2		0.4		0.3		0.1	
Refused	0.0		0.0		0.0		0.2	
Screened out	55.7		55.7		55.7		55.7	
Total	100.0		100.0		100.0		100.0	

Table 7: Effect of unfair dismissal laws on decision to terminate a worker whose performance is unsatisfactory

Unfair dismissal laws make it less likely that my business would dismiss a worker whose performance is unsatisfactory	Weighted response
Describes very well	19.9
Describes somewhat well	17.6
Does not describe at all	30.9
Don't know	1.2
Refused	0.1
Screened out	30.2
Total	100.0

As can be seen from Table 8 dismissals for cause are concentrated in businesses with less than 200 employees. This provides evidence as to why the federal *Industrial Relations Reform Act (1993)* was met with such intense hostility by small and medium sized businesses.

Table 8: Employees dismissed for cause as a percentage of all employees, 1990 and 1995

Number of Employees	1990	1995	Change between 1995 and 1990
5-19	4.5	2.5	2.0
20-49	5.7	2.5	3.2
50-99	3.9	2.2	1.7
100-199	3.0	1.3	1.7
200-499	1.8	0.8	1.0
500+	1.0	0.5	0.5
All firms	4.4	2.1	2.3

Source: Morehead (1997) Table AA.5 p. 605.

The reduction in dismissal rates between 1990 and 1995 was most heavily concentrated in businesses with less than 50 employees which again emphasises that small and medium sized businesses felt the impact of the federal unfair dismissal laws.

5 Cost impact of the unfair dismissal laws

5.1 The Harding (2002) survey¹⁷

Harding (2002) used the following question to obtain information on whether unfair dismissal laws imposed costs on businesses,

Compared with a situation where there were no unfair dismissal laws, unfair dismissal laws increase my businesses' costs.¹⁸

One third of businesses reported that UFD laws increased their costs when compared to a situation where there were no laws (see Table 9).

The cost impost of UFD laws is a very difficult thing for businesses to quantify. Most importantly, the economically relevant concept of cost is that of

with protection against, among other things, unfair dismissal.

¹⁷This section is largely taken from Harding (2002).

¹⁸This question was used to screen out those businesses where the law did not increase costs.

Table 9: Effect of unfair dismissal laws on businesses costs

Compared with a situation where there were no unfair dismissal laws, unfair dismissal laws increase my businesses costs	Weighted response
Describes very well	17.0
Describes somewhat well	16.4
Does not describe at all	34.7
Don't know	1.5
Refused	0.2
Screened out	30.2
Total	100.0

opportunity cost. The latter concept includes not only direct costs but also costs of actions or opportunities foregone as well costs of actions taken in response to the law. For example, where firms employ more casual workers there may be a difference between the cost to the firm of the same quantum of labour purchased at casual rates and at permanent rates. The person interviewed in the firm may not be fully aware of all of these costs as they are dispersed throughout the firm. Thus it is likely that some respondents incorrectly responded that the laws imposed no costs on their business. This latter concern is likely to be more relevant in larger firms where, for example, the human resource manager, line managers and supervisors may be more aware of the costs than is the CEO in small businesses these functions are all rolled into the one job and thus there is less likely to be under reporting of cost imposts by such firms.

In trying to quantify costs I felt that it was unlikely that those administering the survey would be able to explain the concept of opportunity cost to businesses. For this reason, I decided to focus on the costs of complying with the unfair dismissal laws and the costs of reducing the businesses exposure to the laws. The following question was then used to measure these components of the cost to business of complying with unfair dismissal laws:

You have said that unfair dismissal laws increase your businesses' costs. Thinking of the costs in time and money of complying with the law and reducing your businesses' potential for exposure to unfair dismissal claims. By how much, in dollars per year, do unfair dismissal laws increase your businesses' costs?

This question omits important components of opportunity cost such as lost productivity from employees that the business would have formerly dismissed. Thus, the responses provide an under estimate or lower bound on the cost to small business of complying with UFD laws.

Taking the reported costs and factoring them up to the population of small and medium business yields an estimate of \$1329 million as the cost to small and medium sized businesses of complying with the UFD law. This estimate is arrived at by assuming that the 18.2 per cent of businesses that reported a cost impost but could not quantify the size of that cost impost actually experienced a zero cost impost. Thus the estimate of \$1329 million should be seen as a lower bound (see Table 10). To put this figure in perspective it represents about 0.2 per cent of Australian annual GDP.

If those who could not quantify the cost increase have a similar cost increase as those that did provide an estimate then, a more plausible estimate of the cost increase would be \$1625 million. The bulk of this cost increase is borne by small business. However, one should exercise caution here as the discussion at the top of this page suggests that there may be systematic under reporting of costs by larger businesses.

Table 10: Estimated lower bound of cost impost from unfair dismissal laws by size of business

		Size of business (number of full-time employees)						Total
		1 to 5	6 to 10	11 to 20	21 to 50	51 to 100	100+	
Total cost	(\$million)	436.709	225.213	177.990	271.218	119.825	98.327	1329.282
Employees	(million)	1.195	0.677	0.637	0.832	0.535	0.622	4.498
Average cost per full time employee	(\$)	365	333	279	326	224	158	296

The average cost of UFD laws vary considerably by industry. As is shown in Table ??, Accommodation, Communications, Recreation, Transport and Manufacturing are the industries where unfair dismissal laws have their largest impact in terms of cost per full-time employee.

5.2 The Freyens and Oslington (2005) survey

Freyens and Oslington (2005) report the results of a careful survey in which they estimate the costs of redundancy and of firing a worker for cause.

I have no major issues with design and administration of the Freyens and Oslington survey.¹⁹ However, I do have two issues with the way that Freyens and Oslington interpret and use the survey results in policy analysis.

¹⁹The only minor issue that I have with their reporting of the survey results is that they could have provided a better description and breakdown of the survey response rate.

Table 11: Estimated lower bound of cost per full-time employee attributable to unfair dismissal laws by industry and size of business

Industry	Size of business (number of full-time employees)						Total
	1 to 5	6 to 10	11 to 20	21 to 50	51 to 100	100+	
Manufacturing	259	935	540	157	682*	184*	444
Construction	85	261	257*	220*	132*	74*	154
Wholesale trade	44	150	467	440*	26*	183*	227
Retail Trade	205	59	133	198	70*	94*	138
Transport	591	265	64*	504*	30*	55*	353
Communications	579	192	359	697	108*	251*	426
Finance	45	755*	0*	348*	17*	8*	142
Health	118	164	183*	23*	0*	263*	157
Recreation	957	290	22*	375*	89*	29*	410
Accommodation	1087	1027*	453*	295*	0*	0*	488

* Note average is based on very few observations and should be treated with care.

The first issue relates to what costs are to be measured. Freyens and Oslington measure only the costs involved in firing a worker for cause. There are several other costs that need to be measured. The first of these comprise the costs incurred by the business in reducing the businesses exposure to unfair dismissal claims. These costs include the costs of the additional management procedures necessary to reduce unfair dismissal claims. One reason that, compared with Harding (2002), Freyens and Oslington underestimate the costs of unfair dismissal is that they exclude these costs incurred by business in reducing their exposure to unfair dismissal laws.²⁰

The second issue is that Freyens and Oslington underestimate by an order of magnitude the percentage of employees that are dismissed for cause per year. Freyens and Oslington estimate, using the *ABS (2001) Retrenchment and Redundancy Survey*, that each year 0.4 of one per cent of workers are dismissed for cause. The problems with this number arise because it is calculated from a survey of people not businesses. People may feel some shame in reporting that they have been fired for cause and thus there will be under reporting. Second, the survey leads to an estimate of the number of people who have been dismissed at least once in a year this is different from the number of dismissals per year.

Fortunately the Australian Workplace Relations Survey provides independent evidence on the percentage of employees who were dismissed for cause in 1990 and 1995. The AWIRS survey indicates that 4.4 per cent of employees were dismissed for cause in 1990 — an order of magnitude larger than the estimate

²⁰Both Harding (2002) and Freyens and Oslington (2005) exclude the costs that arise because businesses dismiss fewer workers compared with a situation of no unfair dismissal laws. These costs arise because the unfair dismissal laws result in businesses retaining some workers whose marginal product is less than their wage — in the absence of the laws businesses would have dismissed these workers for cause.

used by Freyens and Oslington. The comparable number for 1995 was 2.1 per cent.

6 Effect of unfair dismissal laws on risk

So far the discussion has focused on the case where businesses are risk neutral, an assumption that is not attractive when dealing with small business. The following model allows us to obtain a ball park estimate of how much risk matters.

Assume that each worker contributes $\$R_0$ in revenue and wages are $\$W_0$ per person. Thus in the absence of dismissal costs The profit earned by a firm with N_0 workers is

$$\Pi_0 = (R_0 - W_0) N_0$$

Assuming free entry $\Pi_0 = 0$ in a long run equilibrium.

Now suppose unfair dismissal laws are introduced. The probability that a worker performs poorly is and is dismissed is p assuming that dismissals are independent the number of dismissals per firm (n) is distributed as a binomial with mean Np and variance $Np(1-p)$. I assume to make the maths simple that all dismissals have a cost c . The expected profit including dismissal now is

$$\Pi_1 = (R_1 - W_1) N_1 - Npc$$

In a long run equilibrium with entry $\Pi_1 = 0$ and so the variance of profits is

$$\begin{aligned} Var(\Pi_1) &= E(n - Np)^2 c^2 \\ &= Np(1-p) c^2 \end{aligned}$$

Thus the standard deviation of profit per worker is $c\sqrt{\frac{p(1-p)}{N}}$ so using Freyens and Oslington's estimated cost of a contested unfair dismissal claim of \$14,0000 and setting the probability of dismissal at 0.02 as in the AWIRS data and assuming that we find that the standard deviation of profit per employee is $\frac{1960}{\sqrt{N}}$. So for a business with 9 employees the unfair dismissal laws increase the standard deviation of profits per employee by \$653 per employee. But for a business with 100 employees the unfair dismissal laws increase the standard deviation of profit per employee by \$196. Clearly, unfair dismissal laws impose a much larger cost on smaller businesses in terms of the additional risk they must bear.

7 Policy discussion and conclusions

Unfair dismissal laws impose substantial costs on businesses they also confer benefits on employees in terms of increased job security. Prior to the federal unfair dismissal law being introduced 1993 few businesses provided protection against unfair dismissal, this suggests that the costs of providing that protection exceeded the benefits. Thus on balance the policy of removing the protection from unfair dismissal laws is welfare enhancing.

One important caveat to the policy stance just taken is that it assumes that employees and business are free to write agreements including unfair dismissal provisions if those provisions are mutually beneficial. The Workchoices document suggests that such provisions will be included in the prohibited material listed in regulations promulgated by the Minister for employment and workplace relations. If such regulations are promulgated and mutually beneficial provisions regarding unfair dismissal are excluded from agreements then my argument above would have no foundation as it is based on the assumption that business and employees are free to include in agreements provisions relating to unfair dismissal.

Wage setting is regulated in Australia via awards which set minimum rates of pay. Thus, when the unfair dismissal laws were introduced in 1993 business could not obtain compensation through lower wage rates in the way that they would in a less regulated labour market. The only margin on which Australian business could adjust.

If one assumes that business is risk neutral then the fact that unfair dismissal laws increase costs per employee by at least \$296 suggests that with an elasticity of labour demand of 0.7 employment is reduced by at least 0.46 per cent (about 46,000 persons). If the unfair dismissal laws are valued by employees then increased labour will be supplied at each wage rate and thus unemployment will increase by more than the fall in employment. It is important to emphasise two things about this estimate. First, as discussed earlier there is nothing in the Freyens and Oslington (2005) paper that would cause me to revise this estimate downwards. Second, I have excluded the cost in lost productivity from workers that business would have previously dismissed for cause. This means that I have substantially underestimated the cost to business from the unfair dismissal laws.

Small and medium sized businesses are more likely than large businesses to dismiss an employee for cause, this means that the unfair dismissal laws impacted more heavily on small business than it did on large business.

The possibility of being subject to an unfair dismissal claim is a source of risk for business. Small businesses have limited opportunity to pool the risk that an employee dismissed for cause might initiate an unfair dismissal claim. The costs imposed on a business by this inability to pool risk is 3.3 times higher

for a business with 9 employees than it is for a business with 100 employees. This provides a further reason why unfair dismissal laws impose larger costs on small business.

The fact that the unfair dismissal laws impose smaller costs per employee on larger businesses means that the policy of exempting businesses with less than 100 employees will most likely not cause significant resource misallocation. On the other hand it is not clear that the policy is necessary as larger businesses are less likely to dismiss employees for cause than are smaller businesses. Removing unfair dismissal laws for businesses of all sizes would achieve largely the same economic outcome with a shorter and less complex act.

Appendices

A The survey²¹

The survey was in the field from 17 July to 5 August 2002 administered by Sweeney Research. The sample frame used for the survey is the Desktop Marketing Systems (DtMS) telephone number database that lists all telephone numbers across Australia. The survey comprises a panel of small and medium sized businesses selected from this database. That is, the same respondents are contacted every three months. Each quarter some of the panel drop out. In the latest wave this figure was 458 (25 per cent).

The sample is stratified according to industry, location and business size. The details of response rates are in Table 1 below. The central point to emerge from Table 1 is that there were very few cases (0.8 per cent) where the respondents terminated during the interview. The main reason that a respondent was not interviewed after contact was that the quota for the category in which the respondent belonged was full. In total 1802 completed responses were obtained.

Sweeney Research uses the ABS Business Register to calculate weights that can be used to factor responses up to make statements about the population of firms. The weights are inversely related to the probability that a firm in each stratum is selected into the survey. The strata in the survey comprise business size (measured by full-time employees), sector, metro and non-metro region and State or Territory.

Table 12: Survey response rate

Category	Number	Per cent
Refused	186	5.7
Quota full	910	28.0
Appointment made but not required	329	10.1
Terminate during interview	25	0.8
Interviewed and completed response obtained	1802	55.4
Businesses contacted	3253	100

Results from the survey when factored up suggest that in the population 79.1 per cent of businesses had employees and 20.9 per cent had no employees. Separate questions were put to businesses with no employees on the extent to which unfair dismissal laws would affect their future hiring decisions.

²¹These appendices come from Harding (2002).

A.1 Methodological issues in the use of surveys to collect evidence on the effects of unfair dismissal laws

A.1.1 Open-ended versus closed ended questions

Much of the methodological debate in this area relates to the issue of the apparent conflict between survey based evidence obtained from open-ended questions and that obtain from closed-ended questions. An example of the former is provided by question 2h of wave 38 of the Yellow Pages Small/Medium Business Questionnaire which ask firms to list "any particular barriers or impediments which prevent you from taking on new employees at the moment". In the July 2002 survey 5.6 per cent of firms mentioned employment conditions/unfair dismissal/industrial relations/safety and health. Comparable findings were obtained in the 1998 Yellow Pages survey and from the 1995 Australian Workplace Industrial Relations Survey (AWIRS) which found that just 1.4 per cent of respondents mentioned UFD laws as an impediment to taking on new employees.

In commenting on the 1998 Yellow Pages survey Waring and De Ruyter (1999) state that²²

... 59 per cent of small business proprietors who believed there were barriers to taking on employees as of August 1998. It is also interesting to note the converse 41 per cent of these businesses saw no barriers to employment growth.

As can be seen, unfair dismissal laws do not even rate a specific mention. They could be construed to come under the categories of 'employment conditions' or 'red tape/regulations'. However, even these two responses together comprised no more than 17 per cent of respondents.

These interpretations of the survey evidence are incorrect as there will have been impediments that were of secondary importance to each firm, and thus were not mentioned, but which when aggregated over firms are important in determining aggregate employment. Moreover, the key phrase in the particular question is "prevent you from taking on new employees" many firms may agree that UFD laws would influence their decision to employ but would be unwilling to agree with the stronger statement centred on the word "prevent".

A related issue is that when asked an open ended question the respondent is likely to answer in terms of what is 'top of mind' at that instant. Even when prompted with 'anything else', respondents typically provide a small number of factors rather than being exhaustive. Some evidence on this is provided by Table 13 which shows that only 14.7 per cent of respondents cited two or more impediments to taking on new employees and 4.8 per cent cited 3 or more impediments. Because the responses are not exhaustive of the factors impeding

²²Similar comments were made by Associate Professor Rosemary Hunter and Paul Ronfeldt to the Senate hearing on 29 January 1999.

Table 13: Number of impediments to putting on new employees, question 2h July 2002 Yellow Pages survey.

Number of impediments mentioned	Percent
0	42.1
1	43.2
2	9.9
3	3.2
4	1.4
5	0.2
6	0
Total	100

firms in taking on more employees one needs to be very cautious in the statistical inferences that one draws from responses to such open ended questions.

The only valid inferences about UFD laws that can be made from the responses to open ended questions about factors impeding employment are:

- that for between 1.4 and 5.6 per cent of businesses (depending on whether one looks at the AWIRS survey or the Yellow Pages Survey) UFD laws are among the most important impediments to taking on new employees; and
- that for most businesses UFD laws do not rate as the first or second most important impediment to taking on new employees.

The key point here is that it is invalid to conclude, on the basis of few responses mentioning UFD laws, that such laws are unimportant in influencing firm's employment decisions. In order to quantify the effects of UFD laws on firms one must ask firms direct questions about UFD laws. And, for the reasons discussed above, in order to be able to make valid statistical inference about the nature and magnitude of the effect it is usually necessary to ask closed ended questions.

A.2 Piloting of closed-ended survey questions

When asking closed-ended questions it is important that:

- the wording of the question makes sense to the respondent and seeks information that the respondent can reasonably be expected to possess;
- the range of responses allowed encompass the responses that the typical respondent is likely to provide. That is one does not wish to 'censor' valid responses; and
- the range of questions asked cover the relevant issues that the respondent would canvass in a longer more conversational type interview.

In order to develop questions with these properties the questionnaire was piloted with six firms. The piloting was done sequentially whereby an initial questionnaire was developed and then put to the first firm. Questions that proved difficult were noted, as were response ranges that were inadequate. The respondent was then asked whether they thought that the questions adequately captured the effect of UFD laws on their business and their responses noted. The questionnaire was then adjusted in light of this information and put to the next firm in the pilot.

With pilot subjects selected randomly, at each stage one can infer that one-half of the population would have more problems with the pilot questions than the respondent and one-half would have fewer problems. Thus when one reaches the stage where the respondent raises no issues that would cause adjustment of the questions, then it can be inferred that one-half of the population would have no problem with the questionnaire. In the case at hand, the fifth and sixth respondents in the pilot raised no issues that would cause the questionnaire to be changed. Thus one can be reasonably confident that the questionnaire is an instrument that adequately captures the effect of UFD laws on small and medium sized businesses.

A.3 What are leading questions and how was the questionnaire designed to avoid them?

In evidence to the 1999 Senate Committee Associate Professor Hunter criticized much of the survey evidence regarding unfair dismissals as being based on 'leading' questions. She observes that

It is what we call in law 'a leading question'. A question that simply asks, 'Would you be more likely to recruit if you were exempted from unfair dismissal laws?' is inevitably going to achieve a response which is very different from the response that you would get if you said, for example, 'What would help you to hire people?' That is a more open-ended question which allows the respondent to take into account the range of factors that might be impacting on them rather than simply drawing attention to a single factor which is presumed to be the only factor operating in this situation ²³

The point made by Associate Professor Hunter is an important one but unfortunately in the discussion cited above there is some confusion as closed-ended questions are seemingly equated with 'leading questions'. This is not correct. To understand why it is useful to refer to the Oxford Dictionary of Law which states that a 'leading question' is

²³Professor Hunter, Senate 29 January 1999 EWRSBE 11.

A question asked of a witness in a manner that suggests the answer sought by the questioner (e.g. You threw the brick through the window, didn't you?) or that assumes the existence of disputed facts to which the witness is to testify.²⁴

Thus, a question can be considered as leading if it assumes the existence of a fact that has not yet been established at the stage at which the question is asked in the survey. Leading questions can be avoided in surveys by employing screening questions that first establish the existence of a fact and then asking only those respondents that have reported the existence of that fact to provide more information about the extent or nature of the effect.

For example, in the survey developed for this report, question 11 seeks to establish whether or not the firm had permanent employees. Firms that had employees were then asked the following question

Q12a Thinking about the processes and practices your business uses to: recruit and select staff, manage its workforce, and manage staff whose performance is unsatisfactory - which of the following statements best describes the extent to which unfair dismissal laws influence the operation of your business?

1. The laws have a major influence on what we do.
2. The laws have a moderate influence on what we do.
3. The laws have a minor influence on what we do.
4. The laws have no influence on what we do.

Those firms that responded that unfair dismissal laws have no influence on what they do were asked no further questions about the effect of those laws. Firms that reported some effect were asked questions about the nature and magnitude of those effects. Screening questions were used in this way later in the survey to establish the existence of facts about the cost imposed of UFD laws before asking respondents questions that presumed the existence of such a cost imposed. In this way the questionnaire avoided asking leading questions.

To reiterate, the central point to emerge from the discussion above is that one can only determine whether or not a question is leading by looking at its place in the whole questionnaire and particularly at whether respondents are asked appropriate screening questions to establish that an effect exists before they are asked about the nature or magnitude of that effect.

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