American versus French labor and employment law : a critical review of the analysis of employment relationship in contract economic theories

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AMERICAN *VERSUS* FRENCH LABOR AND EMPLOYMENT LAW: A CRITICAL REVIEW OF THE ANALYSIS OF EMPLOYMENT RELATIONSHIP IN CONTRACT ECONOMIC THEORIES

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ABSTRACT

Despite the numerous economic works on the nature of the firm, only a few studies have clearly taken into account the legal and institutional contexts of the employer-employee relationship. This paper aims at comparing the regulation rules of the employment relationship advocated by contract economic theories to the American and French labor laws in both a positive and normative perspective. From a positive perspective, the contract approaches to the firm – transaction cost economics, the nexus of contracts theory and the modern theory of property rights – are similar to the tradition of American labor law. However, from a normative point of view, it appears that if contract economic theories seem to be partially in line with certain principles of the French labor law, there is a strong inconsistency between these approaches and the role that the French legal system gives to the State and to the law courts (and judges).

KEYWORDS. Contract economic theories; employment relationship; American labor law; French labor law; contractual freedom; employers' powers; collective negotiation; disputes settlement.

JEL CLASSIFICATIONS. A12, J50, J80, K00, L20

1. INTRODUCTION

The seminal paper of Coase (1937) on '*the Nature of the Firm*' has been mainly used by economists to explain the elements that define the boundaries of the capitalist firm. Coase makes a distinction between two coordinating mechanisms, namely the entrepreneur's authority and the price system. Thus, he proposes to confront the economic definition he makes with the legal definition of the firm. According to him, 'it is all the more necessary not only that a clear definition of the word firm should be given but that its difference from a firm in the real world, if it exists, should be made clear' (ibid.: 386). To sum up, a definition of a firm that is realistic in that it corresponds to what is meant by a firm in the real world should be determined. To achieve such an objective, the 1991 Nobel laureate Coase analyzed the employment relationship from both an economic and legal point of view. Notably, he focuses on the legal realism of his definition of the capitalist firm. At the end of the article, Coase explains that 'we can best approach the question of what constitutes a firm in practice by considering the legal relationship normally called that of master and servant or employer and employee' (ibid.: 403). For him, the economic definition of the firm he proposes – i.e. the entrepreneur-co-ordinator who directs production – matches

very well with the legal one; he notes that 'we thus see that it is the fact of direction which is the essence of the legal concept of employer and employee just as it was in the economic concept' (ibid.: 404).

Coase finally considers that the definition of the firm he gives is close to the firm as it is considered in the real-world, which means that the boundaries of the firm are determined by the employment relationship. However, despite numerous economic works on capitalist firm's functioning rules, only a few studies have clearly taken into account the legal and institutional contexts of the employer-employee relationship and established a theoretical link between this 'real-world fact' and the nature of the firm. By and large, economic theories have traditionally neglected the legal nature of the firm.[1]

In this paper, we analyze the way contract theories (of American origin) consider the American institutional environment in order to study the firm and its legal basis, namely, the employment relationship (see Masten, 1988).

Among the heterogeneous works composing this mainstream research field, we selected three main theories that rely, at least in part, on law and legal theories. These three mainstream theories – generally called 'contract theories' – consist in: (1) the transaction cost economics[2] (TCE; e.g., Williamson, 1975, 1985, 1991, 2005); (2) the nexus of contracts theory[3] (NCT; e.g., Alchian and Demsetz, 1972; Jensen and

[1] It is important to note that the institutional economics of Commons (1924, 1931) proposed to consider the capitalist firm from an economic and legal perspective.

[2] This approach defines the firm as a governance structure that is coordinated by a hierarchical authority (Williamson, 2002). Williamson considers authority as the heart of the employment relationship individuals have with the firm. Thus, Williamson embraces the premise of Coase's analysis, in which the employment relationship is a superior/subordinate relationship, and the firm differs by nature from the market. For Williamson, the nature of authority is found at two distinct and complementary levels. The legal rules, embedded in an institutional environment, shape a legal framework. However, contractors have the latitude to modify this framework according to their preferences and goals in order to implement the best governance structure, that is, the best normative private ordering. Therefore, Williamson's transaction cost economics offers a better understanding of the internal organization of the firm when compared with the two other contract theories described here.

[3] This theory – also called 'agency theory' – considers that the nature of the firm is based on the organization of a bundle of different contractual arrangements. A contract is the central modular mechanism that is able to play both a coordinating and an incentive-providing role within and between

Meckling, 1976; and (3) the modern theory of property rights[4] (MTPR; e.g., Grossman and Hart, 1986; Hart et Moore, 1990; Hart, 1995; Hart and Holmström, 2010). These three theories do not constitute a homogeneous theoretical set and must be distinguished from each other (for a survey on these theories see Gibbons, 2005; Garrouste and Saussier, 2005; Foss and Klein, 2008). Nevertheless, TCE and MTPR represent the two main incomplete contract theories, whereas NCT is based on the assumption of complete and 'explicit' contracts. This difference is important because the firm as institution only matters in a world of incomplete contracts (Williamson, 1985).

Labor law is shaped by juridical culture, which is specific to certain national legal traditions. The real world is characterized by distinct conceptions of the employment relationship that took shape in different national systems and that reflect variations in economic conditions and legal cultures. Thus, we think it is important not only to question the relevance of these theories regarding the American law, but also to analyze these theories in the context of other institutional environments. In this comparative view, we consider the French law to be very interesting, because the French legal structure strongly differs from the American legal structure. In contrast to the French labor law, the American labor law is more intrinsic to the firm (Stone, 1981, 2009). Arguably, the notion that the firm is considered as an autonomous legal entity is important here. This normative autonomy relegates other sources of law such as legislators,

the firms. Jensen and Meckling (1976: 312) insist on the fact that 'most organizations are simply legal fictions, which serve as a nexus of contracting relationships among individuals.' Such a contractual analysis implies some sense of continuity between the firm and the market. Contractual relations are the essence of firms and human beings are the parties to this nexus of contracts. Individuals exist only in regard to the contracts. There are no strict ontological differences between a contract and an organization because the organization should be seen as contractual arrangements through which transactions pass smoothly. The firm conceals the features of an efficient market.

[4] This theory defines the firm as a collection of nonhuman assets and argues that firms arise where market contractual relationships fail. The collection of assets' view of the firm states that the nature and boundaries of the firm are intimately correlated and explains the firm boundaries in terms of the optimal allocation of asset ownership. The assets that are held by the firm form the firm. The holder of the residual rights of control over the nonhuman assets in a coalition has power over the human capital owners, who need nonhuman assets in order to be productive. The firm becomes a single 'owner' and has the residual rights of control on the assets. The nonhuman assets constitute the glue that keeps the firm together. Without this glue, the firm is 'just a phantom' (Hart, 1995: 57).

judges and law courts to the background, whereas we will show that in France these constitute the main sources of (positive) law.

French labor law is characterized by both social public order and employees' protection (in order to restore 'the balance of power'), whereas American labor law rests on the 'balancing of power' by actors themselves. In France, the balancing of power between employer and employees is the concern of the State, which implements specific rules and regulations. In other words, even though working relationships are considered as contractual relations of private law, they are subjected to public-order rules intended to protect the weaker party of the contract. According to Supiot (2007), the combination of contractual base and interventionist legislation better defines the 'French model'. In this perspective, we see a significant gap between the American model of working relationships and the French one. The former can be appreciated as an economic model whereas the latter is linked to a political conception of working relationships. However, the contract-based theory does not show this political dimension of the firm. Supiot (2007) rightly attributes these differences to distinct national models of labor law. The emergence of collective agreements can be based either on public regulations (the French model) or on collective autonomy (The US model). Labor law is shaped by juridical culture, which is specific to certain national legal traditions. It appears thus that differences in legal culture result in rules that are substantially different across legal national systems.

The issue of employment regulation thus raises the question of the relationship between economic analysis and the national legal environment. The application of economic theory to the regulation of employment relationship is necessary to provide positive and normative analyses (Dau-Schmidt, Harris and Lobel, 2009). More specifically, three questions should be addressed for contract economic theories: (1) what place is given to positive legal rules in the analysis of the employment relationship (positive view), (2) how are these rules perceived by mainstream economists from an efficiency perspective (normative view) and (3) in which way can these approaches to the firm 'portray' a specific labor law

developed in European institutional contexts, notably, the French context? These questions appear to be very salient notably because recent changes in employment practice seem to make contract economic theories outdated.

To answer these three questions, we will first analyze the links between contract economic theories and the American legal structure of the employment relationship. We show that from a positive point of view, these theories are based more or less explicitly on the American law tradition. In addition, the different contract theories of the firm are not homogeneous, but are complementary. We will then compare the normative conclusions of contract approaches to the firm with the French labor law. We argue that if a certain compatibility condition exists regarding some sources of law, a major inconsistency is produced in France by the importance of the role of the State and of the judges' actions.

2. THE CLOSE RELATIONSHIP BETWEEN CONTRACT ECONOMIC THEORIES AND LABOR LAW IN THE UNITED STATES: A POSITIVE ANALYSIS

In American labor law, the elaboration of workplace rules proceeds whether or not the firm concludes a collective agreement (Stone, 2009).[5] This distinction is crucial because there are two distinct branches of the American labor regulation, namely, labor law, which provides the mechanism for collective bargaining and other forms of employee collectives, and employment law, which sets minimal employment standards for all employees.[6] MTPR and NCT on one hand and TCE on the other hand implicitly (the first two theories) and explicitly (the third theory) propose positive analyses based on this legal context.

2.1. The 'organized firm' in transaction cost economics: the central role of collective relationships

[5] This fundamental distinction is notably valid in the USA, Canada and to some degree to many other systems like in the United Kingdom.

[6] The *Mutatis Mutandis* labor law would be the equivalent of the French collective relations, whereas the employment law would be the equivalent of the French law of individual relations.

The collectively organized firm is in line with the system referred to as industrial pluralism, according to which the collective aspect of labor relations and laws must overshadow the individual aspects.[7] Two stages should be distinguished. The first stage consists of determining the structure in which the collective negotiation, that is, the appropriate bargaining unit that constitutes the second stage, takes place. Although it can be an establishment, a profession, or units grouping several firms together, the selected unit for collective bargaining is often the firm or a sub-unit, such as a plant or a division. Furthermore, it is in this legal structure that the employees' rights are organized and exercised (see Morin, 2005). These rights rest on an absolute majority vote and are represented by a trade union with the employer. If the majority of employees accepts a specific trade union, it becomes the exclusive representative of all employees composing the unit.

The collective negotiation process results in a conventional law that governs labor relationships in the firm at two levels. The first level is based on all the aspects of the employment relationship, such as wages, qualifications, job schedules and job safety, among others. The second consists of administrative agreements, notably those related to individual and collective disputes. This grievance procedure constitutes a substitute to legal action in that the parties themselves try to resolve disputes and conflicts before having recourse to a third entity. Arbitration, which is often included in collective conventions,[8] plays a central role in settling disputes in the sense that it is the parties that choose the arbitrator, pay him, determine his competence and set the procedures he must follow. Conflicts are internal to the firm, which allows to avoid recourse to judges and courts. As a consequence, the autonomy of the firm regarding both negotiation procedure and settlement of disputes is complete (Williamson, 2002).

[7] The corresponding legal text is the National Labor Relations Act and the Wagner law, voted on in 1935 and modified and completed several times, notably by the Taft-Hartley law of 1947. This system functions under the control of the National Labor Relations Board.

[8] A total of 99% of collective conventions include a compromise clause.

The employment relationship has not been substantially investigated in the contract economic theories of the firm. In this regard, the early works of Williamson constitute an exception (the role of the employment relationship became less important when in the 1980's-1990's he decided to give more importance to the 'contractual men'). In his 1975 and 1985 books, the analysis of the employment relationship proposed by Williamson is clearly linked to the idea of the collectively organized firm. In 'Markets and Hierarchies: Analysis and Anti-Trust Implications', he defined the firm as a collective organization that is different (by nature) from the market and is characterized by an employer (who holds authority), a workforce and a productive activity. By working for a firm, an employee accepts a whole system of rules, which he does not necessarily agree with, because these rules are not negotiated in a bilateral way (i.e., between an employer and an employee). On the contrary, these rules are provided by the collective nature of the firm. In fact, these rules result from the internal labor market (see Doeringer and Piore, 1971). This market is at the heart of the employment relationship. In addition, Williamson gives unions a fundamental role by arguing that internal labor market agreements are made through collective negotiations and by defending the thesis according to which unions are more efficient as mediators in dispute settlements (see *infra*), and this argument strengthens the collective dimension of the firm.

In his 1985 book, Williamson uses several arguments developed by American labor lawyers representing the industrial pluralism who consider the firm as an 'island of self-rules' (see Stone, 1981, 1992). More specifically, according to Williamson (1991, 2002), the firm is a private normative ordering considered as both a hierarchical governance[9] structure and a private contractual arrangement. This approach to the firm as a private ordering is opposed to an other legal tradition, namely, legal centralism (see also Gallanter 1981 on this point).

[9] Governance is defined as the implicit or explicit contractual structure in which transactions work.

In addition, Williamson stresses the employee-employer contract. Following the view of Llewellyn (1931) who considers 'contract as framework', Williamson argues that the employment contract represents a 'simple legal framework'. However, Williamson adds that the employment contract is generally incomplete because of the bounded rationality of individuals. This contract, which is the basis of the hierarchy, is considered as a relational contract by Williamson (1985), who bases his analysis not on positive law but on the 'law' issued from the sociology of relational contracts developed in the seventies by MacNeil (1974, 1978). Williamson (1985, 1991) makes the distinction between the classical contract, the neoclassical contract and the relational contract. The classical contract is used when the transaction is similar to the ideal market model; the parties are autonomous, and their identity does not matter because the continuation of the relationship brings value. According to Williamson, only this contract creates regulatory and formalized rules. Similarly, potential disputes are treated in courts of law. On the contrary, the neoclassical contract requires 'mediation', that is, a flexible contractual mechanism used as a foundation for long-term incomplete contracts (such as franchising). Finally, relational contracts are similar to the employment relationship, where authority confers to the employer the ability to make decisions in situations where contracts fail.

Through this long-term (relational) contract, the hierarchical organization of the firm provides a commanding authority called *fiat*,[10] which allows distinguishing the internal organization of the firm from the functioning rules of the market. However, Williamson analyzes the nature of this form of authority. In this perspective, he considers that hierarchical authority is the object of 'an implicit contract law' (see Baudry and Chassagnon, 2010). Therefore, Williamson (1991) writes that 'it is the implicit contract law of forbearance that applies to intra-firm transactions' (1991: 274). In other words, there is a rule of forbearance such that the firm is 'its own court of ultimate appeal' (*ibid.*). According to Williamson, disputes can be resolved within the organization 'firm' as such and not by means of the courts. This

[10] After his 1985 book, the notion of authority – largely used in his 1975 work – is replaced by the concept of *fiat* (translated as 'command').

original point of view is consistent with the definition of the firm as a private ordering that he develops, that is, the representation of the firm advocated by the industrial pluralism school of labor law.

The employment relationship theorized by Williamson appears to be in line with the description of the collectively organized firm. However, the percentage of employees working in collective organized firms is very low (about 15% for US). Additionally, he also considers that the employment at will supports the doctrine of forbearance based on private ordering. However, collectively organized firms and firms with employment at will are significantly different and belong to mutually exclusive categories. Thus, it is essential to analyze and investigate the widespread case of the 'non-collectively organized firm'.

2.2. The 'non-organized firm' in other contract theories: the primacy of contractual freedom and individual relationships

Without collective relations in the workplace (i.e., when the workforce is not organized in a collective entity represented by a trade union), the non-organized firm is the sole center of individual labor relations (employment relations), which rest on the employment contracts between an employer and the employees of the firm he governs. Based on property rights and contractual freedom, the power of the employer, which can thus be freely exerted, consists of two powers: a normative power and a commanding power.

The normative power is related to labor law and employee handbooks. In the United States, the employment contract is the agreement (contract) between an employer and an employee through which the terms and conditions of employment are defined (Stone, 2009). Beyond this general definition, it is essential to dissociate 'organized firms' and 'non-organized firms'. In the former, employer and employee cannot be contractually shielded from the obligatory force of the collective convention. In other words, statutes take the place of contracts. In the latter, the agreement terms depend largely on the power relationships between employer and employee. Nevertheless, in both cases, the contract implies an obligation of obedience, loyalty and respect for an employee. For example, the employee must act in the

interest of the whole entity (the firm). Interestingly, Masten (1988) explains that, when an individual accepts entry into an employment relationship, he accepts a tacit obligation that consists of complying with all of the rules, orders and reasonable instructions emanating from the employer. Masten identified the aspects of authority distinguishing a firm from the market by comparing employment law and commercial contract law. He investigated whether an employer's rights or authority might be replicated in commercial contracts. The law does not consistently treat commercial transactions and employment relationships: 'the investigation reveals that the law does in fact recognize substantial differences in obligations, sanctions and procedures governing the two types of exchange' (ibid.: 196). The courts establish the nature of a particular economic relationship based on these criteria. Masten concluded that 'the traditional emphasis in economics on the authority of management to direct the efforts of employees is at least nominally supported by the law governing employment transactions' (ibid.: 186).

It is also important to underline that the employment contract itself does not fully prejudge the type of relations engaged – an employee/employer relationship or an independent contractor relationship – in the sense that the parties cannot by contract alone determine it. Legislators and judges can legally qualify the situation according to the 'salient facts' and to the abusive contract terms. Therefore, the notion of the contract appears to be 'confused' in the United States. The employee is hence defined as 'a person who works in the service of another person under an express or implied contract of hire, under which the employer has the right to control the details of work performance' (in Black's Law Dictionary).[11] The right to control tests constitutes a criterion used by judges for observing the power of the employer. Judges also use the criterion of economic dependence to observe this top-down form of power. In the case of American courts, authority in the employment relationship and the control associated with it are based on both the outcome of work and the way in which the work is conducted. In contrast – and this is a

[11] This is unlike French labor Law.

fundamental difference – in a commercial transaction, control cannot be based on the outcome of work (Masten, 1988).[12]

Thus, when work conditions are not specified in the contract, they are written in the employee handbook, which is distributed at the time of hiring and discusses all questions of discipline, dismissal and salaries, among others (Blanc-Jouvan, 2005). In other words, the employee handbook defines all the norms that come under the organized firm of the collective negotiation and constitutes the 'law of the firm', that is, the normative rules of the intra-firm game. The commanding power consists of making all decisions linked to the work of employees, and its main expression is found in the so-called theory of 'employment at will'. According to this theory, the employer maintains the ability to dissolve the individual employment relationship at any time without explanation[13] when it is with unlimited duration. Therefore, without collective conventions and trade unions, the employer has full freedom in the use of the workforce. Stone (2004) explains that 'the bulk of American nonunion workers remained subject to the at-will doctrine and basically unprotected for their job-related grievances' (2004: 123). How do contract economists influenced by American doctrine include this labor law of the non-organized firm?

First, it is essential to note that NCT and MTPR do not make reference to the labor law based on the collectively organized firm. Therefore, the only possible connection between economics and law relates to the non-organized firm. However, in the Unites States (in contrast to France), the work relationship has been understood since the 19th century to be ordinary merchandise by law. In the United States, the dominant form of employment contract is at will; 'the doctrine at will says that an employment contract of indefinite duration can be terminated by either party at any time for any reason' (Stone, 2007: 84). The work relationship currently remains 'an ordinary object' for the law. For American lawyers, work is thus the object of a simple economic exchange. Furthermore, the at-will rule is a *de jure* employment contract,

[12] This is clearly the definition of employment relationship proposed by Coase in his 1937 article.
[13] It is important to note that this measure does not result in notices of the termination of employment contracts or in compensation. The United States is the only industrialized country to have such a rule.

but implicit contracts for job security seem to be the norm for most workers. In this view, it becomes clear that the outsiders remain subject to the unmediated at-will rule, lacking job security and job-related benefits (ibid.).

The NCT appears to belong to the at-will doctrine. The canonical paper of Alchian and Demsetz (1972), which prefigures the NCT, can be reread in this perspective. Indeed, these two economists treat the employment relationship as a simple trading relationship (such as a relationship between a grocer and his customers). For them, in the same way that a manager gives order to his secretary to type a specific letter, a customer gives his grocer the order to sell him a specific brand of tuna. A passage of the paper of Alchian and Demsetz shows the close relationship between the NCT and the at-will doctrine:

> 'It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. I can punish you only by withholding future business or by seeking redress in the courts for any failure to honor our exchange agreement. That is exactly all that any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products. […]. To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. […]. I have no contract to continue to purchase from the grocer and neither the employer nor the employee is bound by any contractual obligations to continue their relationship' (ibid.: 777).

The contractual freedom of individuals completes the pure economic exchange: employers and employees are free to define the terms of the economic exchange in the view of the NCT. There is no

authority in the firm but only different forms of market power. The at-will theory constitutes a strong application of this contractual freedom. From this point of view, we can also see the specificity of modern property rights theory in the analysis of the nature of authority.

Following Alchian and Demsetz, Hart (1995) raises the question of the origins of authority without considering the legal specificity of the employment contract. Contrary to the TCE (and to the work of Masten, 1988), the MTPR argues that a firm can also give orders to another firm. Therefore, the interesting question for this theory is why an employee pays attention, whereas an independent contractor does not. To answer this question, Hart (1995: 58) affirms that 'in the former case, if the relationship breaks down, the employer walks away with all the nonhuman assets, whereas in the latter case, each independent contractor walks away with some nonhuman assets. This difference gives the employer leverage. Individual *i* is more likely to do what individual *j* wants, if *j* can exclude *i* from assets that *i* needs to be productive. This theory defines the firm as a collection of nonhuman assets such that 'control over nonhuman assets leads to control over human assets' (ibid.). Why does an employee obey his employer? The answer is because the latter can deprive the former of production assets. Consequently, the origins of authority come from ownership; ownership is a source of power (this argument is similar to the Marxist approach to power relationships in the capitalist firm). Authority is not linked to the particular nature of the employment relationship, and command power is not specific to the firm; the commanding role within a firm is not different from the commanding role between firms. In the MTPR, power is dependent on ownership and is exclusively dedicated to palliate contractual failures when contingencies occur (Hart, 1995); if contracts were complete, power would not exist. This theory reduces authority to a *de jure* form of power that results from the ownership (and the associated 'residual control rights') of non-human (physical) assets. In other words, according to this incomplete contract approach, 'control over a physical asset in this line can lead indirectly to control over human assets' (Hart and Moore,

1990: 1121). The conception of authority proposed by the MTPR is significantly different from the conception of authority successively proposed by Coase (1937), Simon (1951) and Williamson (1985).

The last argument seems to imply that employees have few alternatives to the specific relationship between them and their employer to give value to their productive efforts. There is no symmetry between the employer and the employee since the latter is economically dependent on the former. For the employer, the dependence relationship is very different. The employer is not dependent on his employees because if the economic relationship is broken, he does not lose all of his residual income (in contrast to employees). Furthermore, the employer can also organize the production to replace the employees with lower-cost factors of production. Therefore, the authority of employers is indirect in MTPR because it results from the power conferred by property rights (Baudry and Chassagnon, 2010). In other words, MTPR, which characterizes the employment relationship from the lens of power relationships, seems to be 'realistic' regarding the law of non-organized firms. Indeed, this theory focuses on the unevenness between employers and employees, from which employers have the capacity to unilaterally fix the work conditions. The MTPR sheds light on the importance of bargaining power resulting from the ownership of capital assets in the market regulation of the relation between employee and employer, which is indirectly a way to adhere to the at-will doctrine.

To conclude this section, we have shown in a positive point of view that contract approaches to the firm are not 'decontextualized' and seem to be largely complementary. Having said that, we must raise the following question: what judgment can contract approaches make about labor law? In other words, it is crucial to deal with the normative dimension of contract economic theories. To assess this, we propose to compare these theories with the French labor law.

3. THE NORMATIVE CONCLUSIONS OF CONTRACT THEORIES OF THE FIRM: THE UNAVOIDABLE TENSION WITH THE FRENCH MODEL OF LABOR LAW.

Despite some important differences regarding the recognition of law in analyses of employment relationship, contract economic theories are in agreement on some crucial elements if we consider the normative consequences of their approaches in terms of labor law. Among these elements are the uselessness of protective rules of employees in terms of efficiency,[14] the incompleteness of formal employment contracts, which give way to relational contracts (MacNeil, 1974, 1978; Williamson, 1985; Baker, Gibbons et Murphy, 2002), the critical appreciation of the role of courts, and (notably concerning TCE) the superiority of the model of governance based on private ordering. However, these conclusions conflict with a large part of the French labor law that tends to be based on 'legal pluralism'. Indeed, three sources of law coexist in France in terms of labor[15] (Pélissier, Supiot and Jeammaud, 2006): State sources, professional sources and employment contracts. However, contract economic theories do not deal with the role of the State and French law courts in the regulation of employment relationships and seem to fail in analyzing the political dimension of the firm.

3.1. A partial compatibility between contract economic theories and French labor law

Regarding the analysis of French labor law, it appears that this law is in line with contract economic theories on two points: (1) contractual freedom and power of the employer and (2) collective conventions and negotiations.

3.1.1. Contractual freedom and employers' power

In the United States, the employment relationship is mediated by the employment contract between an employer and an employee. In France, the jurisprudence defines this contract as a convention by which a

[14] According to contract approaches, the employment at will leads to economic efficiency. In this view, the crucial question of the effectiveness of rules is obscured. However, protective rules of employees can also be considered as a way of economizing transaction costs (see Collins, 1993).

[15] In this paper, we do not discuss the international sources, which are within the competences of international labor law and community law.

physical person signs on making herself available to another person – physically or morally – under the subordination of whom (which) she places in return for remuneration. From these three elements, which are indispensable for characterizing an employment contract, a work activity, a remuneration, and a subordination relationship, it is evident that the last one is the more important. The France's Court of Cassation reaffirmed in 1996 in the ruling '*Société Générale*' that the employment relationship is *characterized by the execution of a work activity under the authority of an employer who has the power to give orders and directives, to control its execution and to punish the failures of the subordinated*. Consequently, any typical convention related to an employment contract confers to the employer authority over his employees. Regarding this point of view, there are no crucial differences between the American labor law and the French labor law[16] (even though the NCT and the MTPR do not take into account this crucial real-world fact).

Regarding the last argument, contract economic theories seem to propose a coherent analytical framework for studying the legal contractual aspect of the employment relationship. For example, at the moment of the conclusion of the employment contract, there is a negotiation between the employer and the employee and an agreement on numerous elements of the employment relationship. This negotiation process is strictly contractual such that there are no contradictions between economists and lawyers on this point. As Pelissier, Supiot and Jeammaud (2006) argue, the agreement governing the employment can be assimilated to a 'specification zone', where the ability to expressly determine the qualification and the remuneration of the employee, the place and other conditions of his work, the clauses providing advantages and guarantees for the employee (job vehicle and accommodations, experience advantages, clauses of ensuring employment during a precise time and so on) and other specific subjections (working test period, clause of mobility, result clause or non-competition clause) is stipulated. Similarly, the

[16] Nevertheless, we will show that the constraining structure of the exercise of the commanding power of the employer differs strongly between France and the United States, even regarding the definition of subordination. Associated with contractual power relationships in the United States, the subordination relationship is based on the institution of the authority relationship in France. See infra.

contractual dimension is important when the employer decides to change or modify certain employment and work conditions. These changes or modifications constitute a revision of the employment contract, which thus requires the agreement of the employer.

If, in a contractual perspective, the employment contract seems to be an instrument of negotiation between the different parties, we must note that it is also the first principle for determining the work and employment conditions. From this contract, the employee becomes the creditor of the job provision and of the work tasks corresponding to the accepted qualification. TCE focuses on obedience and acceptance, and other contract economic theories do not mention this fundamental aspect of the employment relationship, which suggests that the employer has an unlimited ability to fix the work conditions. According to TCE, this acceptance zone does not result strictly from positive law but instead results from private ordering. In this view, Simon (1951) proposes 'a theory of the employment relationship' (1951: 293) in which authority plays a central role; authority is the nature of the employment relationship. For Simon (1951), the employment contract is strongly different from the ordinary marketing contract. Indeed, '*W* enters into an employment contract with *B* when the former agrees to pay the former a stated wage (*w*)' (ibid.: 294). Hence, *W* accepts authority in a specific area of acceptance. Simon (1951) thus writes:

> 'We will say that *B* exercises authority over *W* if *W* permits *B* to select *x [an element of the set of all possible behavior patterns]*. That is, *W* accepts authority when his behavior is determined by *B*'s decision. In general, *W* will accept authority only if *x0*, the *x* chosen by *B*, is restricted to some given subset (*W*'s area of acceptance) of all the possible value. This is the definition of authority that is most generally employed in modern administrative theory' (ibid.).

However, only the obligatory legal content allows the analysis of the area of this zone by fixing it in law (Ray, 2000). This is why an employer cannot demand employees to work and provide productive tasks beyond the initial employment contract (notably because the criterion of employee qualifications and performances is central in French employment contract). Because the area of the acceptance zone depends on this qualification, the employer cannot modify it without the consent of the employee. The judicial law concerning the procedure of modifications of the employment contract – which has remained the explicit approbation of the employee since 1987 – is consistent with Williamson's perspective (see Williamson, 1985, 1991, 2002).

Furthermore, the employee must submit – as he is in the United States – to the judicial power of the employer. The employer has the ability to impose the rules on the employee, as he is the instigator. Labor laws thus recognize a form of implicit contract and of 'auto-administration of the firm' (Pélissier, Supiot and Jeammaud, 2006). More specifically, we can observe three forms of power in employers, namely, the direction power, the normative power and the sanctioning power (Jeammaud, 2008).

The direction power refers to the power of economic (and management) direction, which confers to the employer the right to make choices of creation, suppression and transformation of productive activities and of implementation and organization of production processes. The direction power is also related to the power of directing individuals, which gives the employer the right to recruit an employee, to assign him to a precise task or work station, to fix his remuneration, to manage and control the execution of his work and to unseat the employee from the productive activity. This prerogative is one aspect of the power that each owner obtains from article 544 of the French civil code (*Code Civil*), which governs the access conditions of the owner to his asset and the conditions of its use by others. The French civil code affirms that *ownership is the right to enjoy and dispose of things in the most absolute manner, provided they are not used in a way prohibited by statutes or regulations*. In this view, the treatment of ownership is not fundamentally different in the sense that ownership may also give *de jure* power in the French legal

system. The normative power refers to the rules implemented by the employer himself. These rules are called 'the employers' untitled rules' and concern, for example, the awarding of primes, the modes and the criteria of the evaluation and promotion of the workforce, among other factors. Finally, the sanctioning power is linked to the right of the employer to take sanctions toward employees making professional faults. Among these sanctions are official warnings, punitive layoffs, and dismissals, among others.

From this perspective, the analysis of power proposed by MTPR appears to be coherent with French law. However, if the legal order confers to the employer the power of making decisions aiming to or influencing the employee who must accept them, we note that the French labor code (*Code du Travail*) does not formally recognize this form of authority. The legal prerogatives constituted by the employers' powers result from the combination of different rights by which the control of production methods and the undisputable rule of the employee-employer subordination relationship are ensured. The French notion of *contrat de travail* is directly related to the notion of subordination in which the duty of obedience is accepted in return for the absorption by the firm of a range of social risks.

The combination of the contractual freedom with the employers' powers resulting from the ownership of non-human assets (the *de jure* power of Rajan and Zingales, 2000), which is the main characteristic of the non-organized firm, is central for the contract economists of the firm in terms of the efficiency of the employment relationship. Indeed, the employer is thus able to implement via contracts the incentive devices previously mentioned. The objectives of these contracts are to force the employee to achieve the highest level of effort (see supra). Although the power of the employer is taken into account by contract economists, it appears that, according to these economic approaches, the protection of employees should not come from law but from market mechanisms. Indeed, some market mechanisms are able to reduce the potential opportunistic behavior of the employer, who would be tempted to exploit the employees by not respecting his (ex ante) commitments.

Several market mechanisms have been analyzed by contract economic theories to address this problem of the non-enforcement of the contract. The more important mechanism is reputation (see Williamson, 1985; Baker, Gibbons and Murphy, 2001; Hart and Holmström, 2010). The reputation of a firm is derived from the way in which it pays employees and constitutes an incentive to behave honestly with the employees. As a result, a firm that exhibits opportunistic behavior (such as underpaying workers) will face difficulties in the long term in recruiting new employees and/or will see the more efficient employees leave (which is costly). A second important market mechanism underlined by Williamson is based on the potential actions used by the employees to thwart the opportunistic employer. In fact, employees are not really without recourse and can act in a way that penalizes their employer by choosing perfunctory cooperation to the detriment of the consummate productive cooperation. Therefore, employees also have power within the organization. In his 1985 book, Williamson notes that 'incumbent employees who are forced to accept inferior terms can adjust quality to the disadvantage of a predatory employer' (1985: 262). Beyond the market mechanisms, unions' actions and the process of collective negotiation can be used to combat employers' opportunism.

3.1.2. Collective negotiation and convention: the efficiency of the labor collective relationships in the organized firm

Beyond individual employment contracts and the *de jure* power, the sources of the French labor law include collective negotiation. This is a procedure likely to be used with agreements endowed with normative effects, called collective agreements or conventions. The particularity of these agreements is that they apply in a systematic way to individual contracts and employment relationships and thus without mediation because the wills of the concerned parties do not matter.

The procedures of collective agreements refer to the collective conventions of the organized American firm. Therefore, we also observe the double nature of the employment contract as both an authentic

contract and an institutional act (*un acte condition*) in both French and American labor law. The latter refers to the non-contractual situation of the employee in the institutional context of work (as in the Williamsonian analysis), whereas the former refers to the contractual dimension of the employment relationship between an employer and an employee. In these conditions, for the lawyer, the employee is both the co-contracting party of the employer and the member of the workforce. In other words, beyond the 'will agreement', the employment contract (and thus the 'access' to a new firm) allocates a particular position to the employee by prompting the application of a set of arrangements independently of the express will of the contract parties. This is the case for the institutional arrangements emanating from State regulations such as hygiene and safety and also for the arrangements resulting from collective conventions (see Supiot, 2009). These conventions state the minimum amount of remuneration, the classification grid and the work time. Furthermore, collective conventions are both an automatic effect and an imperative effect such that they are imposed on all individual employment contracts. In addition to employment contracts and employers' powers, collective conventions constitute an integrated part of the governance of employment relationships.[17]

In other words, the normative dimension of the Williamsonian analysis of the internal organization of the firm and of private ordering appears to be in line with the French case. On different occasions, Williamson focused on the superiority of the legal model of industrial pluralism (see Shulman, 1955; Cox, 1958; Summers, 1969) – and notably the process of collective negotiation between employers and unions – compared with the model of legal centralism.

First, Williamson suggests that giving unions the control of conflicts between individuals promotes the group's interests to the detriment of individual interests. This argument is complementary to those he uses to justify the efficiency of the process of arbitration in comparison with the legal procedure (see infra

[17] Two other elements of the governance of the employment relationship are the processes of the defense of interests (unions' actions, workforce representation) and public intervention (the rules of hygiene and safety mentioned supra).

the discussion on disputes). In this view, Williamson (1975) quotes the work of the lawyer Cox (1958), for whom allowing an individual to engage in the procedure of arbitration would discourage the on-going cooperation between the employer and the employee. For Williamson (1985), collective negotiation with unions is a strong condition of 'efficiency' (1985: 254) in two ways. On one hand, unions have a role as 'agents' in terms of information on employees' preferences. On the other hand, unions have the objective of governance. That is, they must ensure the continuity of the relationship between the employer and his employees when specific human capital is engaged in the relationship. Unions are also important in the moderation of increasing the wages of employees, which could penalize the economic durability of the firm. Finally, by means of collective negotiation, the firm implements a real internal market of labor endowed with institutionalized and explicit rules, notably in terms of the wage grid[18] and with a promotion system that contributes to efficiency by encouraging cooperative behavior from both employees and employers, who have the common interest of continuing the relationship.

In summary, the model of industrial pluralism is considered a good system of labor relationship insofar as it is a 'proposed' model and not an 'imposed' model that establishes the autonomy of the firm, which is in accordance with the contractual tradition of the United States (Blanc-Jouvan, 2005: 156).[19] More generally, contract economic analysis, which is strongly influenced by British and American classical-liberal philosophy, analyzes individual or collective contracts as the expression of the contractual will of the free, equal and responsible contractors in the case of the organized firm. Because the contract is the result of individual freedoms, legislators and judges do not interfere with its formation or its content. However, not all the arrangements of the French labor law adhere to this model. On the

[18] Williamson (1975) notes that 'the internal labor market achieves a fundamental transformation by shifting to a system where wage rates are attached mainly to jobs rather than to workers' (1975: 74).

[19] We should add that because it is an agreement that is freely made between two distinct rational individuals, a contract does not strictly (a priori) contravene the interests of the involved parties. Therefore, contracts represent a basic form of justice, as they cannot damage the initial well-being of the contractors.

contrary, it seems that contract economic theories are clearly incompatible with the positive labor law of the French legal system.

3.2. The importance of both the State and law courts (judges) in the French legal structure of labor relationships: a major inconsistency with contract economic theories

As Supiot (2010a) writes, 'a contract only makes sense if the parties it binds have concluded it under the auspices of some higher authority that can guarantee they will keep their word (e.g., the gods, the king or the State). In the absence of such a guarantor, the contract will be no more than an expression of the will of the strongest party' (2010a: 152). In terms of employment protection law, this higher authority plays a central role in France. In this view, contract economic theories cannot be expressly applied to the French system of employment relationship regulation because of two major differences with the American labor law: (1) the supervision of employers' powers by the State and law courts (judges) and (2) the legal settlement of conflicts and disputes.

American labor law is a law *of* the firm and *for* the firm, but the labor law in France is significantly different. Supiot (2009) explains that the French model of labor law is based on a 'political conception' of employment relationships, which are 'dominated' by State intervention. We believe that two characteristics of the French model are incompatible with a strictly contractual analysis. These two characteristics, which result from the crucial role of the State, are the State's fixing of a set of individual rights that concern all the employees and the role of the judge in the administration of employment relationships.

French labor law was and still is dominated by the intervention of the State, whose laws and rules aim to impose a 'balance' in the employment relationship. Among these laws and rules, we find the implementation of a legal structure supervising the exercise of employers' powers. Although they are

considered contractual relationships of private law, the employment relationships are submitted to rules emanating from the public order aiming to protect the weaker party of the contract. The role of the State is also important in the settlement of disputes. More generally, the role of the judge is essential in the French labor law (in contrast to the American labor law). Although employer – notably in the non-organized firms – has a large latitude in the management of 'his' firm in the United States, this is not the case in France, where the conception of the employer as a 'judge' does not correspond to the reality of the law courts (Waquet, 1996).

In contrast to the at-will doctrine, French labor law has traditionally used the unfair contract terms and the abuse of right doctrine, in particular with regard to the regulation of alternative employment contracts. French law is characterized by a high level of aggregate protection compared to the USA. Similarly, breaking an employment contract comes under the strict control of the judge (notably in accordance with a law passed on July 13th 1973 that invites the judge to verify the reality and the seriousness of the grounds used by the employers in the dismissal letter, see Glendon 1984). The role of the judge is also imperative in terms of the control of the disciplinary, regulatory and management powers of the employer. Indeed, the judge must control social plans and avoid or limit dismissals. Dismissal for economic reasons is thus under the judicial field and the control of the judge – notably the French Cassation Court. Furthermore, some clauses of the employment contract are subjects of particular attention for judges. This is the case for the clauses that give the employer the ability to blame the employees whose productive 'results' do not strictly respect the contractual conditions in order to avoid cases in which the employer transfers economic risks to the employees. The failure of employees to achieve contractual objectives can be a cause of dismissal only if the two following conditions are met: (1) the objectives must be realistic and suitable with the professional skills and competences of the employee and (2) the employee who has not achieved his objectives has made a specified fault.

From another perspective, we want to underline the fact that the fixing and the evolution of the remuneration, which represent an important subject of attention for the economists interested in incentive mechanisms, are not based on a pure contractual procedure of the (free) contractors. French jurisprudence has been interested in the variation clauses that allow the employer to substantially and unilaterally modify some elements of the employment contract. The main risk is thus that the employer obtains, due to the contract, the unilateral power to modify these fundamental elements. However, the Cassation Court has deemed some of the clauses of the employment contract to be void; an example of such a clause is one that allows the employer to modify the contractual remuneration of the employee. Similarly, the procedure of wage individualization depends on justification requirements. If the employer can pay employees differently, he must be able to justify these differences (Pélissier, Supiot and Jeammaud, 2006). Judges can even intervene to validate (or not) the lawful nature of the remuneration systems based on the classification of employees in terms of their relative performance.

Finally, the discretionary power of the employer is strictly supervised and circumscribed such that if the employer maintains a form of *de jure* power and some extended prerogatives in the French labor law, he cannot act only in his own interest. In France, jurisprudence has proclaimed the so-called 'standard of the interest of the firm' as the main evaluation criterion of employers' decisions. In other words, we observe a real and important gap between the French labor law and the contract theories of the firm. The same conclusion can be made regarding the regulation of disputes.

In terms of disputes and conflicts, in contrast to the American law that encourages a procedure of 'professional settlement' of disputes, the French law advocates the legal settlement of disputes, notably concerning individual disputes, through the *prud'hommes* council (*conseil des prud'hommes*), which is an elective and joint court. This legal procedure is explicitly opposed to the point of view of Williamson (1985), who justifies in different occasions the superiority of arbitration and grievance procedures over the legal system of judges and courts for settling disputes.

In this perspective, Williamson (2002, 2005) uses the work of the law theorist Galanter (1981), for whom 'in many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute' (1981: 4). In other words, in the case of economic transactions based on a perfectly identified good – the pure exchange model – a court can be efficient for settling disputes and conflicts. However, in the case of the employment relationship, courts are not efficient, according to Williamson (1991), who thus justifies the economic interest of the contractual regime of the 'forbearance law' (1991: 276). On the one hand, the parties concerned by an internal dispute have superior knowledge of the circumstances of the dispute. On the other hand, settling these disputes through courts would reduce the efficiency and the integrity of the hierarchy. Arguably, courts even refuse to judge certain intra-firm disputes that concern, for example, transfer prices between divisions, delay questions or quality failure.

In summary, for questions of contractual freedom, employers' powers and collective negotiation, the normative conclusions emanating from the contract economists are a priori consistent with the legal regime of French employment relationships. However, the roles of the State and judges in their regulation constitute important differences. As a consequence, the evaluation of the French labor law regarding the firm using a contract-based approach amounts to an a priori 'disqualification' and disregards all the elements that are not consistent with the American legal system. In other words, from a normative point of view, it would be preferable to abolish all that goes beyond the contractual structure in the case of NCT and MTPR and all that stems from the internal settlement processes used to resolve disputes and conflicts in the case of TCE.

4. CONCLUSION

In conclusion, two main results arise from this analytical paper. On one hand, the contract economic theories of the firm and the employment relationship are explicitly or implicitly similar to the institutional

and legal environment regulating the employment contracts in the United States. On the other hand – and this argument is complementary to the first – these theories can only partially account for the central characteristics of the administration of the employment relationship in France, which is very specific under the country's labor law. It is thus fundamental to 'contextualize' the national institutions to avoid hasty generalizations.

Additionally, the distinction between a political model (the French case) and an economic model (the United States case) has broader theoretical implications. Contract economic theories develop a view of the firm that is closely linked to the definition of the firm as an autonomous legal entity governed by its own internal rules – and not by external norms (see Courtois-Champenois, 2002). Similarly, the powers and the rights of the employer are stronger in the United States as compared to France and the professional legal order is clearly distinct from the State public order in the United States. All these elements seem to be in line with the cultural and intellectual roots of contract economic theories, which are clearly based on the specific institutional and legal environment of the US. In contrast, the incompleteness of contracts is clearly admitted by legislators in France and different external norms and provisions aim at reducing this incompleteness. Similarly, French legislators usually try to reduce the asymmetry of power between employer and employee and to limit the discretionary decisions made by employers. Contract economic theories do not seem to consider this balancing of power as important in the regulation of the employment relationship as compared notably to the benefits of employment at-will and pure private ordering.

A salient implication of this paper is that contract economic theories do not have all the analytical and conceptual 'tools' necessary to include the political dimension of capitalist firms and to reconsider the effectiveness of law. The law and economics of the firm cannot be reduced to a question of economic efficiency. Additionally, as Supiot (2010a) argues, 'the rule of law must be reinstated to end human subordination to economic efficiency' (2010a: 151). Thus, we agree with him when he writes that 'the

drive for depoliticization led most economists to abandon the learned tradition of political economy in favor of economic science' (ibid.: 158). Such an assessment sheds a new light on the real-world power relationships and places political economy at the centre of the theory of the firm, notably because economic theories of the firm tend to 'dominate' corporate law and corporate governance regulation and appear to be responsible for introducing the economic efficiency paradigm (for a complementary view see Iacobucci and Triantis, 2007).

It does not mean that the economics of the firm is hopelessly compromised by this assessment. However, we think that these contract approaches should be 'recontextualized' in order to include institutional changes. Regulatory frameworks have been constructed and have evolved at the national level. Hence, the context of globalization has clearly dismantled these frameworks. Finally, the new institutional theories based on the assumption of incomplete contracts – notably TCE – have not evolved in parallel with international institutional changes, whereas their analytical frameworks are supposed to be based on the role of institutional environment in determining firm governance structures (see Furubotn and Richter, 2005 [2000]).

Furthermore, one can question the current relevance of contract economic theories, as for two decades some large transformations have substantially modified the economic and legal characteristics of the employment relationship in both the United States and France (Stone, 2009; Supiot, 2009). The main changes in the employment relationship are related to the reappraisal of the internal labor markets, the decreasing weight of unions (and thus the reducing number of collective agreements in the United States), the decentralization of negotiations in France (agreements taken at the level of the firm), the blurring of the boundaries between the work of employees and that of independent contractors (see Morin, 2005), the increase in insecure jobs, new socioeconomic issues (e.g., corporate social responsibility, struggles against discriminations and the search for men/women equality) and human resource management

practices (e.g., the management by competencies model, the individualization of wages and the merit-based remuneration).

In view of these transformations, the law has evolved differently in the two countries analyzed. For Stone (2009), changes in the nature of the law in the United States represent a major shift in the role of employment regulation away from collective bargaining and toward the State. In France, the evolution has been opposite. Indeed, the law seems to step aside in favor of a stronger contractualization of the employment relationship (Supiot, 2010a). Under these conditions, we can conclude that there exists a certain 'convergence' between the two national institutional and legal environments, which requires new economic analyses of the employment relationship. Indeed, the economic theories previously analyzed do not seem to be able to include or deal with these fundamental transformations in institutional environments.

In summary, we note that the majority of the economic works we have presented in this paper date from the 70s, 80s and 90s and since then have not been the object of new analyses. For example, the seminal works of Williamson on the employment relationship have never been 'updated' and seem to be effective only in the context of the Ford-era business. Thus, we should question the 'normative' dimension largely advocated by contract economists and, notably, by TCE. How can we explain the reappraisal of the internal labor market and thus the industrial model of the employment relationship considered by Williamson as an efficient model of internal organization? New developments need to be proposed both in economics and in law to reconsider the positive dimension of the employment relationship and to analyze it from the new international institutional environment. In this positive view, it is also necessary to analyze the politico-legal implications of the emergence of complex organizational forms (which are not correctly explained by contract approaches) that allow employers to exploit possibilities for the fragmentation of the legal form of the firm, notably in terms of employment and collective legal responsibilities (see Chassagnon, 2011). This is also one of the theoretical implications

resulting from this work; we leave this question for future studies but it seems clear that it shows that the Declaration of Philadelphia, which affirmed that ‘labor is not a commodity’ and called for ‘the extension of social security measures to provide a basic income to all in need of such protection’, is still topical (see Supiot, 2010b).

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