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The Law and Economics of Identity

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THE LAW AND ECONOMICS OF IDENTITY

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I. INTRODUCTION

A growing number of legal scholars have written about the demands that society and particular employers have placed on non-traditional employees to perform their identities,[1] "or make themselves palatable" to their employers, by comporting with the criteria that the institution values.[2] These authors have forcefully made the argument that some of these requirements are actually a form of class subordination; as a response, they argue for various forms of legal intervention.[3]

Kenji Yoshino provides a particularly useful scheme for conceptualizing this situation. At one extreme are situations where employers ask employees to actually "convert" or alter their identities.[4] A requirement that employees change their religion is an example of such an extreme practice, and under existing law, such a practice would be deemed clearly illegal.[5] At the other extreme, there are practices such as demands by an employer that employees "cover" their identities.[6] "Covering" is the demand for an individual to play down those disfavored characteristics of her identity which make the favored group uncomfortable, even while the group remains fully aware of that underlying identity.[7] These practices have not been found to be illegal, and there is disagreement among scholars as to whether there should be any condemnation for such demands on employees with regard to their identities. In between these two extremes, Yoshino observes two intermediate cases: passing (pretending that one is a member of the favored group, even though the

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1. *See* Devon W. Carbado & Mitu Gulati, *Working Identity*, 85 CORNELL L. REV. 1259, 1262, 1293–98 (2000); Camille Gera Rich, *Performing Racial and Ethnic Identity: Discrimination by Proxy and the Future of Title VII*, 79 N.Y.U. L. REV. 1134, 1200–02 (2004); Kenji Yoshino, *Covering*, 111 YALE L.J. 769, 781 (2002); Gowri Ramachandran, *Intersectionality as "Catch 22": Why Identity Performance Demands are Neither Harmless nor Reasonable*, 69 ALB. L. REV. 299, 304 (2005–06).
2. *See* Carbado & Gulati, *supra* note 1, at 1307.
3. *See* Ramachandran, *supra* note 1, at 305.
4. *See* Yoshino, *supra* note 1, at 772.
5. *See* Ramachandran, *supra* note 1, at 305.
6. *See* Yoshino, *supra* note 1, at 772.
7. *Id.* A good example of a covering demand is the pressure frequently placed upon homosexual employees to "act straight" at work, even though their sexual orientation is known and tolerated by their employers.

underlying identity remains unchanged) and reverse covering (performing one's identity to conform to a stereotype held by the favored group).[8]

The types of responses that Yoshino identifies suggest both that employees and employers alike are constantly negotiating issues of identity[9] and that identity is an important part of the employment relationship. Yet, labor economists have been traditionally silent about the concept of identity.[10] In a series of recent articles, Nobel Prize-winning economist Professor George Akerlof and his colleague, Rachel Kranton, fill this gap.[11] Borrowing constructs from the fields of sociology and psychology, Akerlof and Kranton demonstrate how identity influences the behavior of both individuals[12] and organizations.[13] This Essay explores the insights that Akerlof and Kranton's conceptual model has for the various legal issues that are beginning to arise as courts struggle with questions surrounding grooming and dress-code discrimination.[14]

II. THE AKERLOF AND KRANTON MODEL

In the traditional neoclassical economic model, the preferences of an individual are both fixed[15] and dependent upon pecuniary factors such as income and effort.[16] So at a very simple level, the modeling of the decision to work is characterized as a choice between work and leisure. Characterized in that way, one could then divide into three groups the set of factors affecting the choice to work: (1) the opportunity cost of the work (i.e., leisure); (2) the individual's level of wealth, and (3) the individual's set of preferences. Under this basic model, the individual's preferences are taken as given and are not subject to immediate change. The opportunity cost of leisure is directly proportional to the wage rate, and the measure of wealth is a function of the individual's income. Absent from the traditional model is any mention of identity.[17]

Akerlof and Kranton start by including identity in the individual's utility.[18] They define identity not only as what economists traditionally refer to as "tastes" but also as "norms"—"how people think that they and others *should*

8. *Id.*

9. *See* Carbado & Gulati, *supra* note 1, at 1263–66.

10. *See infra* notes 15–17 and accompanying text.

11. George A. Akerlof & Rachel E. Kranton, *Economics and Identity*, 115 Q. J. ECON. 715 (2000) [hereinafter *Economics and Identity*]; George A. Akerlof & Rachel E. Kranton, *Identity and Schooling: Some Lessons for the Economics of Education*, 40 J. ECON. LIT. 1167 (2002) [hereinafter *Identity and Schooling*]; George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9 (2005) [hereinafter *Identity in Organizations*].

12. *See Economics and Identity*, *supra* note 11, at 716.

13. *See Identity in Organizations*, *supra* note 11, at 10.

14. *See* Catherine L. Fisk, *Privacy, Power, and Humiliation at Work: Re-Examining Appearance Regulation as an Invasion of Privacy*, 66 LA. L. REV. 1111 (2006) (discussing the key legal issues surrounding identity discrimination).

15. *See Identity in Organizations*, *supra* note 11, at 9.

16. *Id.* at 13.

17. *Id.* at 9.

18. Utility refers to preference-ranking of choices. *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 23 (1988).

behave."[19] Social norms are, in essence, "social regularities" or behaviors that are widely adopted in society.[20] They are activities that "society holds that people should do."[21] As Professor Lawrence Lessig notes, social norms "frown on the racist's joke; they tell the stranger to tip a waiter at a highway diner; they are unsure about whether a man should hold a door open for a woman." [22] Social norms differ among different cultures and within given cultures during different periods of time.[23]

Professor Jon Elster has observed that the "workplace is a hotbed for norm-guided action."[24] Social norms, for example, have long had an important impact on gender roles in employment specifically with respect to work/family concerns.[25] Moreover, one of the central conclusions of the famous Hawthorne experiments of the 1930s[26] was that employee work effort is significantly influenced by the norms of the employee's workgroup with respect to what constitutes an appropriate work level or output.[27] Applying this analysis, employees are deemed not "irrational" when they don't increase output in response to increased employer incentive pay; they are simply responding to workplace social norms—i.e., they don't want to be ostracized by fellow employees as "ratebusters."[28] Moreover, other observers have pointed out that in the workplace, breaching norms can sometimes have more "serious consequences" than breaching the law.[29]

The concept of norms, while necessary, is not sufficient to fully incorporate the concept of identity. Rather, Akerlof and Kranton argue that the critical component is that norms "depend upon the particular *situation*—that is, when, where, how, and between whom a transaction takes place."[30] Every situation, they claim, will define how individuals think they need to behave in that particular situation. Those expectations are defined, not only by the way

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19. *Id.* at 12.

20. *See* C.A. Harwell Wells, Note, *The End of an Affair? Anti-Dueling Laws and Social Norms in Antebellum America*, 54 VAND. L. REV. 1805, 1809 (2001).

21. *Id.*

22. *See* Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 662 (1998).

23. For example, in many countries today, and even historically in some parts of the United States, social norms favored the use of mass transit as a way to get to work. Today in the United States, however, there is a fairly strong social norm favoring solo commuting in one's own car. *See* Lior Strahilevtz, *How Changes in Property Regimes Influences Social Norms: Commodifying California's Carpool Lanes*, 79 IND. L. J. 1231 (2000).

24. *See* Jon Elster, *Social Norm and Economic Theory*, J. ECON. PERSP., Fall 1989, at 99, 100.

25. *See, e.g.*, Belinda M. Smith, *Time Norms In the Workplace: Their Exclusionary Effect and Potential for Change*, 11 COLUM. J. GENDER & L. 271 (2002).

26. The experiments were conducted at the Hawthorne plant of the Western Electric company in the late 1920s and early 1930s. They involved "illumination experiments" (testing a relationship between intensity of workplace illumination and efficiency) and "Relay Assembly Test Room" studies (involving changes in working conditions in a work group consisting of five women producing electrical delays). *See* Stephen R.G. Jones, 98 AM. J. SOC. 451, 454–55 (1992).

27. *See* Bruce E. Kaufman, *Expanding the Behavioral Foundations of Labor Economics*, 52 INDUS. & LAB. REL. REV. 361, 370 (1999).

28. *Id.*

29. *See* Smith, *supra* note 25, at 349.

30. *See Identity in Organizations*, *supra* note 11, at 12.

individuals feel about themselves, but also by the expectations of those around them. Akerlof and Kranton argue that "[i]n a model of utility . . . a person's identity describes gains and losses in utility from behavior that conforms or departs from the norms for particular social categories in particular situations."[31]

In the Akerlof and Kranton model, each person's utility function is in part based upon what sociologists and psychologists call "social categories." Each person knows his or her own category and that of other people with whom the person interacts.[32] Additionally, identity is based upon the person's assigned social category and the extent to which that person's own characteristics match the ideal of his or her assigned category. A person's identity is further dependent upon his or her own actions and the action of others; specifically, the extent to which such actions correspond to the behavior prescribed by society's expectations as to how that person should fit into the ideal of the social category to which that person belongs.[33] Thus, a person's utility is dependent upon that person identity and his or her assigned social category. Akerlof and Kranton refer to increases or decreases in utility that derive from changes in the identity component of the utility function, as gains or losses in identity.

III. IMPLICATIONS

There are various implications of modeling utility in this way—that is, endogenously—and including identity. First, Akerlof and Kranton note that identity "may be the most important 'economic' decision people make."[34] To the extent that individuals choose who they want to be, any social limits that are imposed on this choice are limits that affect their utility.[35]

Second, decisions about identity produce both direct and indirect externalities. A direct externality occurs where "[o]ne person's actions can have meaning for and evoke responses in others."[36] The authors provide the example of a man wearing a dress thereby threatening the identity of other men, since a dress is a symbol of femininity.[37] On the other hand, an indirect externality occurs, where the identities of individuals are in part shaped by their environment. That is, individuals clearly bring who they are to their workplaces, but it is plausible that part of what we are, or what we become as individuals, is shaped by our work environments. Therefore, we develop identities that to some extent are shaped by the places and the people with whom we interact.

Third, unlike the neoclassical assumption that preferences are fixed, the inclusion of identity into the utility function illustrates how preferences can be changed.[38] This finding is important for two reasons. First, it raises the

31. *Id.* at 12.

32. *See Economics and Identity*, *supra* note 11, at 718.

33. *Id.* at 719.

34. *Id.* at 717.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

controversial issue that identity is a mutable trait.[39] Second, to the extent that identity is mutable, incentives are thus created for others in society to manipulate those changes. In the context of the employment relationship, employers could see this as an opportunity to affect the behavior of employees and their productive effort.

A. Identity As The Most Important Economic Decision People Make

Akerlof and Kranton argue that identity might very well be the most important decision individuals make.[40] If that is the case, courts should recognize the importance of claims regarding disruptions of a person's identity. Various scholars have noted that early in the development of sex-discrimination law under Title VII, dress-code and grooming cases were rejected by courts based in part on the inconsequential nature of the claims.[41] These courts rejected the claims based on the argument that Title VII was meant to protect biological sex and not the mutable characteristic of a choice of dress or grooming characteristic.[42] The Akerlof and Kranton model suggests that the choice of identity, while mutable, is a significant choice that individuals make. The model also suggests that the choice is of critical importance to a number of various other economic outcomes that both individual and organizations make in arranging their economic affairs.[43] This choice is far from trivial. Thus, the argument could be made that, given the importance of identity to the economic ordering of affairs in the employment relationship, courts should be somewhat cognizant of a person's choice of identity when evaluating legal doctrines that involve such a choice. This will be the case in disputes involving Title VII, but it might also apply to disputes challenging terminations under some of the common law exceptions to the employment-at-will doctrine.

Most private-sector employees in the United States today are employees "at-will" and can be fired or disciplined by employers for virtually any reason. As the Tennessee Supreme Court stated in *Payne v. Western & Atlantic Railroad*,[44] employers are free to "discharge or retain employees at-will for good cause or for no cause, or for even bad cause without thereby being guilty of an unlawful act."[45] Mr. Jerry Greenfield, the founder of Ben and Jerry's Ice Cream Company, in an interview with *Rolling Stone Magazine* expressed the doctrine somewhat more colloquially by stating, "If I can fire someone for making shitty ice cream, then I can fire them for being a shitty person."[46]

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39. *But see* Jennifer L. Levi, *Clothes Don't Make the Man (Or Woman), but Gender Identity Might*, 15 COLUM. J. GENDER & L. 90, 112 (2006).

40. *See Economics and Identity*, *supra* note 11, at 717.

41. *See* Franklin H. Romeo, *Beyond A Medical Model: Advocating for a New Conception of Gender Identity in the Law*, 36 COLUM. HUM. RTS. L. REV. 713 (2005); Devon Carbado, G. Mitu Gulati & Gowri Ramachandran, *Makeup and Women at Work*, HARV. C.R.-C.L. L. REV. (forthcoming 2006).

42. *See* Carbado, Gulati & Ramachandran, *supra* note 41, at 14.

43. *See Economics and Identity*, *supra* note 11, at 716 (arguing that identity influences employment outcomes).

44. 81 Tenn. 507, 523, 526–27 (1884).

45. *See* Jay M. Feinman, *The Development of the Employment at Will Rule*, 20 AM. J. LEGAL HIST. 118 (1976) (providing a historical discussion of the development of the doctrine).

46. *See* Robert E. Sullivan, *Just Desserts*, ROLLING STONE, July 9–23, 1992, at 79.

Over the years courts have carved out a number of exceptions to the basic at-will presumption. For example, under the implied-contract exception, representations made by employers regarding job security, disciplinary procedures, and other employee privileges have been treated by state courts as enforceable provisions even in the absence of an express employment contract.[47] Employees raising this exception have relied on employee manuals/handbooks and oral statements made by supervisory personnel as the contractual basis for such implied promises.[48]

A second exception stems from policy considerations and involves situations in which the termination of the employee contravenes some explicit, well-established public policy.[49] Initially, the public policy exception focused on protecting employees who were fired for engaging in behavior which directly benefited the public welfare. For example, courts protected employees who had been fired for serving on jury duty[50] or refusing to follow orders to commit an illegal act.[51] Recently, however, plaintiffs' lawyers have attempted to expand the reach of the public policy exception. In particular, this exception, it has been argued, should apply not only in those narrow situations in which an employee is fired for performing a civic duty, but also in cases in which employers were engaging in actions that encroached on an employee's personal autonomy. This argument has often been raised when employers attempt to limit the off-duty activities of an employee with regard to that employees' political activities,[52] personal relationships,[53] and behavior or lifestyle outside of work.[54] The

47. *See* MARK A. ROTHSTEIN ET AL., EMPLOYMENT LAW 671–94 (2d ed. 1999). The implied contract exception includes both cases based on written or oral communications, see, e.g., *Chiodo v. General Waterworks Corp.*, 413 P.2d 891 (Utah 1966) (finding that a contract for a specific time period included implied terms that employee would conform to the usual standards of performance), *Woolley v. Hoffman-La Roche, Inc.*, 491 A.2d 1257 (N.J. 1985), *modified*, 499 A.2d 515 (N.J. 1985) (finding that absent a clear and prominent disclaimer, an implied promise contained in an employment manual that an employee will be fired only for cause may be enforceable against an employer even when the employment is for an indefinite term), and cases based on conduct, see, e.g., *Grouse v. Group Health Plan Inc.*, 306 N.W.2d 114 (Minn. 1981) (holding that the doctrine of promissory estoppel allows a plaintiff to sue employer who withdrew job offer after plaintiff had accepted, but before plaintiff had began job).

48. *See, e.g.*, Small v. Spring Indus., 357 S.E.2d 452, 454–55 (S.C. 1987) (noting that it would be unfair to allow employers to treat statements of this kind as gratuitous or nonbinding).

49. *See, e.g.*, Nees v. Hocks, 536 P.2d 512 (Or. 1975) (finding a violation of public policy in a case involving an employee who was discharged for jury service).

50. *See, e.g.*, Hodges v. S.C. Toof & Co., 833 S.W.2d 896, 899 (Tenn. 1992) (reinstating a compensatory damage award for employee who was fired for jury service).

51. *See, e.g.*, Tameny v. Atl. Richfield Co., 610 P.2d 1330 (1980) (finding in favor of an employee who was dismissed for refusing to participate in an illegal scheme to fix retail gasoline prices); Delaney v. Taco Time Int'l, Inc., 681 P.2d 114 (1984) (reinstating a jury verdict in favor of employee who was fired for refusing to sign a false and arguably defamatory statement regarding a sexual proposition he allegedly had made to a subordinate).

52. *See generally* ROTHSTEIN ET AL., *supra* note 47. *See also* Bell v. Faulkner, 75 S.W.2d 612 (Mo. Ct. App. 1934) (finding against an employee who was discharged for refusing to vote or campaign for certain candidates favored by the employer).

53. Rulon-Miller v. IBM Corp., 162 Cal. App. 3d 241 (1984) (finding in favor of plaintiff on various grounds where the employer fired the plaintiff for her off-duty dating activities).

approaches the courts have developed in each of these areas provide some insight into how courts might look at similar types of challenges by employees who are terminated because of their dress and grooming choices.

In any event, the Akerlof and Kranton model provides some support to the argument that the choice of identity is a serious economic choice and that employees and employers are seriously affected by the consequences of this choice. Courts should not dismiss this choice as trivial but rather should treat the legal consequences of this choice with the seriousness that it deserves.

B. The Externalities of Identity

Akerlof and Kranton note that identities have externalities. The identity of one person can have meaning not only to him or herself, but also evoke reactions from others. Professors Carbado, Gulati, and Ramachandran adopt a similar understanding of identity when they ask these questions: "Does the female employee appropriately 'wear' her sex? Does she appropriately 'dress up' her identity?"[55] "Figuratively," the authors continue, "the terms 'wear' and 'dress up' help to convey that, in a variety of ways, women can exercise agency to signal their willingness or refusal to comply with gender normative standards of behavior."[56]

To the extent that identity has externalities, the reverse is also possible—namely, that the environment and individuals within that environment could influence each other's identities. For example, employers could use workplaces both as sources of identity and as one of the instruments to motivate employees to be more productive.

Traditional models of compensation include monetary rewards and supervision as the only two ingredients used to motivate employees.[57] If it were possible for employers to observe at zero costs the quality and quantity of the labor inputs provided by employees, traditional economic theory would dictate that employees would be paid according to the value of their marginal products.[58] Under such conditions, there would be no monitoring costs and the only incentive aspect of concern to the employer would be that of paying employees enough to motivate them to enter the labor force.[59] In the presence of informational asymmetries and positive monitoring costs, employers are not able to perfectly observe labor input effort.[60] Therefore, the need arises to create two proxies of the actual labor input effort. The two proxies translate into the

54. Brunner v. Al Attar, 786 S.W.2d 784 (Tex. Ct. App. 1990) (upholding lower court decision against employee who was terminated for her volunteering off-duty work with an AIDS foundation).

55. *See* Carbado, Gulati & Ramachandran, *supra* note 41, at 15.

56. *Id.*

57. *See* Sheldon E. Haber & Robert S. Goldfarb, *Does Salaried Status Affect Human Capital Accumulation?*, 48 INDUS. & LAB. REL. REV. 322, 326 (1995).

58. *See* Robert Drago & John S. Heywood, *The Choice of Payment Schemes: Australian Establishment Data*, 34 INDUS. REL. 507, 509 (1995).

59. *See* Haig R. Nalbantian, *Incentive Compensation in Perspective*, *in* INCENTIVES, COOPERATION, AND RISK SHARING 3, 10 (Haig R. Nalbantian ed., 1987).

60. *Id.*

types of compensation arrangements entered into as part of the employment contract. In general, two types of compensation arrangements exist: employers can pay individuals for the time they worked or by the result (i.e., outcome) of their work.[61] In either case, notice that since the employer is not observing labor input directly, the employer needs to rely on a combination of rewards and imperfect monitoring.

This is where identity comes into play. Akerlof and Kranton suggest that employees can be categorized as "insiders" and "outsiders."[62] Insiders share a norm which relates their interests to those of the firm.[63] Akerlof and Kranton argue that a firm could include identity as a factor to increase higher effort just the same way that a higher wage or increased monitoring will increase effort.[64] The key, then, is to create the incentives necessary to help the employee see herself as an "insider" to the organization as opposed to an "outsider":[65] The norms for insiders are to act in the interests of the organization. Therefore, such an identity reduces the wage differential required to generate high effort from the employee.[66] The rationale, as Akerlof and Kranton point out, is straightforward: Insiders to the organizations derive utility from their positions as such, and thus do not need as large a difference in monetary rewards to induce them to work hard (i.e., to exercise high-level efforts)—their interests are aligned with those of the firm.[67] Outsiders, on the other hand, need a higher monetary reward to compensate them for the utility they lose when forced to identify with the interest of the firm, since those interests are not the interest which match their identity.[68]

Akerlof and Kranton point out that there could be a set of conditions under which it could be profitable for firms to invest in order to change a worker's identity from an outsider to an insider since they could be reducing their wage bill over the long run. According to them, [i]f inculcating identity is cheap, if there is much uncertainty, if workers' effort is hard to observe, if revenues/output depend upon special exertion at peak times, if workers are especially risk averse, [and] if high effort is critical to the organization's output," it would be beneficial for the firm to invest in identity.[69]

C. Exploring the Decision to Adopt Identity-Shaping Policies

A major implication of the Akerlof and Kranton model, thus is that as part of their compensation practices, firms might adopt policies to shape the identities of employees. It is interesting to explore the factors (the cost of inculcating identity; the cost of monitoring employees; and, the level of worker's

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61. *See* Eugene F. Fama, *Time, Salary, and Iincentive Payoffs in Labor Contracts*, 9 J. LAB. ECON. 25, 42 (1991).

62. *See Identity in Organizations*, *supra* note 11, at 14.

63. *Id.* at 15.

64. *Id.*

65. *Id.*

66. *Id.* at 14.

67. *Id.* at 15.

68. *Id.*

69. *Id.*

risk aversion) under which firms might be more likely to adopt such policies. These policies, in turn, might result in legal claims, such as the *Jespersen* case,[70] in which employees claim some violation of a statutory or common-law right.

1. *Cost of Inculcating Identity*

Organizations will be more likely to invest in policies designed to change workers' identity, as it is cheaper to do so. For example, Akerlof and Kranton note that it should be relatively cheap to inculcate identity in soldiers in a voluntary army since they self-select into the military and thus are more open to the information and approaches the military presents.[71] It is also very difficult for individuals to leave the military, which again reduces the cost of the government to inculcate identity.[72]

Probably no private organization enjoys these same advantages and cannot match the military in terms of inculcating identity. However, among private firms there exists some variance in terms of the costs they face in this regard. Any conditions that make the individual more receptive to the interests of the firm and thus more open to an identity transformation should make it less costly for the organization to inculcate identity. The key thus becomes identifying the organizations in which the interests of employees and employers are more likely to coalesce.

This distinction has been explored through the theory of Internal Labor Markets. The employment relationship can take a variety of forms.[73] Employers and employees can enter discrete contracts of fairly short duration and with no expectation of continuing employment.[74] These types of arrangements have been described as encompassing what economists call the external labor market ("ELM").[75] ELMs are characterized by large numbers of workers and large numbers of employers.[76] In general, ELMs are considered relatively competitive due to the mobility of workers and the competition among firms for these new workers.[77]

ELMs operate on two basic assumptions. First, the tasks performed by employees are of a general kind, in the sense that there is very little of the task

70. Jespersen v. Harrah's Operating Co., Inc., 444 F.3d 1104 (9th Cir. 2006) (en banc).

71. *Identity in Organizations*, *supra* note 11, at 16.

72. *Id.*

73. *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 57–81 (1975).

74. *Id.*

75. *See* Michael L. Wachter, *Labor Law Reform: One Step Forward and Two Steps Back*, 34 INDUS. REL. 385 (1995) [hereinafter Wachter, *Reform*]; *see also* Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. PA. L. REV. 1349, 1353 (1988) [hereinafter Wachter & Cohen, *Collective Bargaining*].

76. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1357.

77. *Id.* This "ideal" view of the external labor market is realized only under a very detailed and specific set of assumptions (e.g., perfect information, workers mobility, profit maximization). Where these conditions are not met, market distortions can arise. *See* DOUGLAS L. LESLIE, CASES AND MATERIALS ON LABOR LAW: PROCESS AND POLICY 25–28 (1992).

that is specific to the particular organization.[78] "General skills" are learned by the employee at his or her own expense and thus require no training from the particular firm.[79] "General skills" are equally valuable to any other firm in the search for the same type of knowledge.[80] Second, there is no expectation of a long term employment relationship within the ELM context.[81] Both parties to employment contracts within the ELM can terminate the contractual relationship without incurring any substantial loss.[82]

Not all employment transactions, however, are of this form. Some jobs require the learning of skills that are somewhat specific to the particular contracting firm.[83] These "specific skills" are valuable only to the particular firm and thus there are no incentives to acquire them within the ELM context.[84] Employees will be reluctant to invest in skills that are only valuable to a particular employer in the absence of some expectation of a long-term employment relationship.[85] Employers will be equally reluctant to train employees in these more specific skills, since there is no guarantee that employees will stay with the firm or will perform in a way that allows the employer to recover the costs associated with the training of employees.[86] Thus, the need arises to devise a mechanism that will create the right kind of incentives for the acquisition of firm-specific skills.[87]

Internal Labor Markets ("ILMs") provide such a mechanism and thus constitute an alternative to exclusive reliance on the use of ELMs.[88] ILMs arise because of ELMs' inability to deal with employment transactions where there is a need for skills that are specific to a firm.[89] Implementation of an ILM requires the employers and employees to agree to an understanding of a long-term employment relationship.

By internalizing parts of the employment relationship, firms potentially can encourage workers to make long-term investments with them, which in turn produce technological and cost efficiencies for the firm.[90] The "internalizing"

78. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1358–64 (distinguishing between firm-specific skills that are not easily transferable to other firms and general skills that are easily transferable across firms within the same industry).

79. *Id.*

80. *Id.*

81. *See* Wachter, *Reform*, *supra* note 75, at 385.

82. *Id.*

83. *See* Douglas L. Leslie, *Labor Bargaining Units*, 70 VA. L. REV. 353, 366–67 (1984) (describing the relationship between internal labor markets and specific job skills).

84. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1358.

85. *Id.*

86. *Id.*

87. *See* Ramona L. Paetzold & Rafael Gely, *Through the Looking Glass: Can Title VII Help Women and Minorities Shatter the Glass Ceiling?*, 31 HOUSTON L. REV. 1517, 1521–24 (1995) (discussing the development of internal labor markets and its application to employment discrimination problems).

88. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1358 (asserting that ILMs arise because of the costs of job- or company-specific skills). *See also* Wachter, *Reform*, supra note 75, at 385–86.

89. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1358–64.

90. *Id.* at 1360–61.

involves undertaking certain types of investments in human capital.[91] Employees make firm-specific investments early in their career, learning skills required to perform firm jobs and agreeing to a wage rate lower than what they could potentially get elsewhere (i.e., the employee's opportunity wage).[92] Employees then recover their return on this investment at a later point in their career when their actual or inside wages are higher than their opportunity or outside wages.[93] Employers, on the other hand, invest at the earlier stages of the employee's career by paying a wage that is higher than that employee's marginal productivity.[94] The employer recovers her investment during the employees' mid career years.[95] At that stage the employee's marginal productivity is believed to exceed the wage paid by the employer.[96]

Central to the ILM's functioning is the expectation that employees will be attached to the firm for a long period of time and that they will be adequately compensated for their investments in the case of a breach.[97] The employer arguably would not want to lose an employee with specialized training because this would require the training of another employee and result in a corresponding loss in productivity during the training period.[98] The employee, on the other hand, will possess skills that are not readily transferable and will therefore be reluctant to leave employment voluntarily until after she has recovered all of her investment.[99] Thus, to the extent that the parties to the ILM arrangement continue their relationship, their agreement will be fully realized.[100]

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91. *See* Wachter, *Reform*, *supra* note 75, at 385.

92. *See* Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause And Employment At Will*, 92 MICH. L. REV. 8, 12–19 (1993). Professor Schwab provides an excellent analysis of the Internal Labor Markets concept from two different perspectives: the "specific human capital" story and the "efficiency wage" story. Under the "specific human capital" story, investments in firm-specific skills occur under an incentive system in which both parties share the cost and benefits associated with the learning of those skills throughout the employee's work life. Schwab points out that a critical aspect of the "specific human capital" story is the self-enforcing nature of the employment relationship. Since the "specific human capital" story assumes that the employee's productivity is higher than the employee's inside wage at later stages in the employment relationship, and at the same time, the employee's inside wage is higher than the employee's opportunity wage, there is no incentive by either party to terminate the employment relationship. Employees have no incentive to leave the firm since they are being paid more than what they could made in the outside market; employers have no incentive to fire the employees since their productivity exceeds their wages. Under the "efficiency-wage" story, while employees' productivity later in their careers is higher than their outside or opportunity wage, their inside wage, at that stage, is even higher. Consequently, there is an incentive for the employer to terminate late-career employees since their wages exceed their productivity.

93. *Id.* at 18; *see also* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1363.

94. *Id.* at 1361.

95. *Id.*

96. *Id.*

97. *See* Paetzold & Gely, *supra* note 87, at 1522.

98. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1361.

99. *Id.* at 1363.

100. *See* Paetzold & Gely, *supra* note 87, at 1523; Wachter, *Reform*, *supra* note 75, at 385. Opportunistic or strategic behavior, however, becomes a problem within ILMs. Opportunistic behavior appears when either party attempts to breach implicit or explicit contracts. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1360–64. In such situations one party can be seen as trying to expropriate the returns or "rents" that the other party expects out of her investments.

The discussion so far suggests that the cost of inculcating identity will be lower in organizations which rely on ILMs as opposed to ELMs, since employees become attached to the organization for long periods of time, and thus are more likely to internalize the values of the organization. The costs of inculcating identity will also be lower to the extent that employees find it more difficult to leave the organization, and thus, as in the context of ILMs, tie their futures to that of the organization. Akerlof and Kranton point to the military as an example of an organization with a cost advantage in this regard. They note that it is relatively inexpensive for the military to impart identity given the difficulty that recruits face in leaving the service.[101] Once they commit, recruits are in a very real sense a captive audience. The more difficult it is for an individual to leave an organization, the lower the cost to an organization to inculcate identity since the organization has less competition for the individual's interests.[102] In the case of the military, the difficulty of leaving service means that the cost probably approaches zero.

For private-sector firms, the cost is significantly higher than zero, but we should still expect to see some variance among firms. Some employees make significant amounts of human capital investments that are more specific to a profession, and sometimes even to a firm. For these individuals leaving the firm will be much more difficult (i.e., costly) and thus they will be in a position not unlike that of a military recruit. Firms that employ primarily employees who make this type of investment will find it less expensive to inculcate identity.

2. *Cost of Monitoring Employees*

Three of the next factors mentioned by Akerlof and Kranton (uncertainty, difficulty in observing worker's work effort, and extent to which revenues depend upon special exertion at peak times) can be grouped together under the broader category of monitoring costs. The basic principle is that it will be more profitable for a firm to use identity as an incentive scheme when the firm operates in an environment in which, for example, it is harder to monitor

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Workers generally make firm-specific investments early in their careers and then recoup such investments as they age. The employee may invest by agreeing to a below-market wage early in her career, with the expectation that later on she will receive above-market compensation. *Id.* For example, an employee may, early in her career, learn a skill that is specific to a particular employer. While doing this, she will likely agree to receive a below-market wage with the expectation that later on she will be permitted to stay in the firm and recover her investment in the form of above-market compensation. However, if the employer terminates the employment relationship after the employee has learned the skill and the employer's investment has been recovered (but before the employee is able to recover her investment), the employee's investment will be lost. Similarly, an employer may invest in an employee's career by paying her more than her marginal productivity at an early and/or later stage in her career, with the expectation that the employer will recover its investment during the employee's mid-career years. During this middle period, the employee could behave opportunistically and make it difficult for her employer to recover its investment. For ILMs to work it is necessary to adopt some mechanisms to minimize the ability of employers and employees to engage in opportunistic behavior. Arguably, individuals can always enter contracts to protect against possible opportunistic behavior. Several scholars, however, have noted that the contract option to guard opportunistic behavior is often unsatisfactory. *See* Christine Jolls, *Hands-Tying and the Age Discrimination in Employment Act*, 74 TEX. L. REV.1813, 1829–30 (1996).

101. *See Identity in Organizations, supra* note 11, at 16.

102. *Id.*

employees either by other individuals (supervisors, peers, or customers) or by equipment (cameras, computers, or other technology).[103] The rationale is that using identity can transform these individuals from outsiders into insiders because their identity is tied to the success of the firm.[104] Once the transformation from outsider to insider is complete, the need for monitoring is reduced.[105] Similarly, the use of identity and the corresponding transformation from outsider to insider should help the firm deal with the uncertainty and fluctuations in revenue and output caused by peak times.

3. *Workers' Risk Aversion*

Risk-management theory suggests that it is efficient to allocate risk to the party better able to bear the cost associated with a specific risk.[106] In the employment context, since employees have a fairly limited ability to diversify their human capital portfolio,[107] employers are generally believed to be risk-neutral and employees risk-averse.[108] Thus we should generally expect employers to use identity as an incentive scheme. Yet once again this is not what one observes in practice. What might explain the discrepancy?

The ILM model provides an explanation. Firms that rely on the ILM model are more likely to operate under a system in which most employees are more likely to have made investments within the firm (in terms of their human capital) and thus are much more risk-averse than perhaps the average employee, or at least as compared to employees in firms operating under the ELM model.[109] Employees in firms using the ELM are more mobile, and have made less of an investment in one particular firm, and thus are less risk-averse.[110] Those employees will be less willing to identify with the firm, making it in turn more expensive for the firm to turn them into "insiders."

The point is that firms which operate within the ILM model might be more likely to invest in identity than firms that rely on ELMs. Similarly, at different points in the employee's career, a firm might be more or less willing to invest in identity than at others. Finally, as forces in the economy, such as globalization and increased competition compel some firms to change business strategies, some tension could arise as firms that used to operate in an ILM model abandon that model in favor of an ELM model.

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103. *Id.* at 19–22. *See also Identity and Schooling*, *supra* note 11, at 1189–92 (discussing the role of identity and discipline in the school context).

104. *See Identity in Organizations*, *supra* note 11, at 19–22.

105. *Id.*

106. Joseph E. Stiglitz, *The Design of Labor Contracts: The Economics of Incentives and Risk Sharing*, *in* INCENTIVES, COOPERATION, AND RISK SHARING, *supra* note 59, at 47, 50.

107. GARY S. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION 15–17 (3d ed. 1993) (human capital refers to the investments individuals have made in education).

108. *See* Stiglitz, *supra* note 106, at 50.

109. *See* Wachter & Cohen, *Collective Bargaining*, *supra* note 75, at 1363.

110. *Id.* at 1357.

IV. CONCLUSION

Legal scholars have explored the concept of identity in great detail in recent years. The recent work by Professors Akerlof and Kranton provides additional insights as to how identity affects the employer-employee relationship. For example, Akerlof and Kranton argue that identity is part of an employee utility function and thus is subject endogenously to environmental forces.

Consistent with prior work in this area, the Akerlof and Kranton model also suggests that employers' efforts to modify or inculcate identity could be seen as affecting an employee's utility. Alerlof and Kranton, however, help to identify the conditions under which employers are more likely to engage in that kind of behavior. Whether empirically that is the case is a question left for future research.