

**Judges' "Behavior" Problems:
What Behavioral Economics Says Employment Discrimination Law Is Getting Wrong
(Or: "Yes, Virginia, There Is A Prescriptive Aspect To Behavioral Law & Economics")¹**

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A. Overview: Some Employment Law Prescriptions Based on Behavioral Economics

Courts' thinking about employment discrimination doctrine is stuck in the law-and-economics stone ages. More precisely, it is stuck in the 1980s, before behavioral economics added needed sophistication to the basic free-market rational-actor model of human behavior. While traditional rational-actor economic analyses added a great deal to our understanding of the law, more recent behavioral economic analyses have added still more in a wide range of fields of law.

Curiously, while there has been great debate among economists about whether and to what extent there should be laws against employment discrimination, the devil is in the details of employment discrimination doctrine, and there has been little if any behavioral economic thinking about those details. For example, whether discrimination lawsuits are filed depends heavily on what damages are available, as shown by the dramatic increase in Title VII litigation after Congress increased the available damages in 1991. But exactly what relief is necessary to "make whole" (the Title VII command) a worker who lost a job? How should employment discrimination damages be calculated? Additionally, even egregious cases of discriminatory harassment may not give rise to employer liability, depending on whether the harassed employee complained to management and whether management put sufficient effort into preventing or redressing harassment. But when should employees be compelled to complain to management about harassment as a precondition to filing suit? Relatedly, when should employers' anti-discrimination efforts shield them from liability, or at least from punitive damages?

These damages-and-liability issues are hugely important questions that have drawn Supreme Court decisions and that employment lawyers grapple with regularly – yet the economic thinking on these matters is quite unsophisticated, ignoring the lessons of behavioral economics. Behavioral economics would counsel reform of several such areas of employment discrimination doctrine.

Additionally, behavioral economics can offer insights as to the difficulty of settling employment discrimination cases and the rise of mediation as a solution to that difficulty.

These prescriptions and analyses shed light not only on specific employment law questions, but also on a broader, more theoretical question: When, and under what circumstances, can behavioral economics support prescriptive conclusions? Specifically, this article asserts that behavioral economics does have definite prescriptions to offer, contrary to the views of those who criticize behavioralism as too indeterminate, or who see little hope for prescriptions absent much more data. Yet while behavioral economics can yield helpful prescriptions, those prescriptions may be more modest than paternalistic rejections of market outcomes. Often, the prescriptions supported by behavioralism may be limited to (a) rules encouraging "retail"- or "micro"-level decisionmakers (e.g., judges hearing specific cases) to consider behavioralism in their decisions (e.g., assessing whether it was reasonable to expect an employee to complain to management about harassment), and (b) policies encouraging and subsidizing private market solutions to behavioral problems (e.g., expanding mediation as a solution to parties' information-processing limits).

Despite their utility, behavioral insights have been slow to penetrate into courts' decision-making. A lag between academic insight and real-world implementation is predictable, but it increases the importance of pressing these analyses until the decibel level of the critique is high enough to force courts to listen.

¹ This is just an abstract of a work in progress that I request not be cited in its present bare-bones, citation-lacking form. Please let me know if you would like a copy of the full article draft in late 2005 or early 2006. Also please feel free to offer feedback (or a suggestion for a shorter title) after the conference; it would be much appreciated.

1. Determining Discrimination Damages: The Endowment Effect

When calculating the damages caused by employment discrimination, courts assume that the basic measure of damages is the lost earnings of the discriminated-against employee. Courts draw no distinction between a discriminatory failure to hire and a discriminatory termination of a long-term employee. Yet research findings on the endowment effect indicate that the utility loss typically would be far less for a non-hired employee than for a terminated long-term employee; the latter's sense of endowment in the lost job would be much greater. Indeed, long-term employment features several factors making the endowment effect particularly strong: a feeling that one "earned" the endowment; a lack of substitutability of other goods; and a high amount of nonmonetary/sentimental value.

This article proposes an increase in damages for discriminatory terminations of long-term employees – a change that can be implemented by individual lower-court judges without Congressional or Supreme Court intervention, either by (a) increasing emotional distress damages for such employees, (b) applying a formula to enhance employees' damages based on years of service (e.g., 5% per year of service past the fifth), or (c) adjusting the number of years of post-termination "front pay" the employee receives. Notably, none of these reforms requires further empirical work. Judges already make discretionary damages determinations, pursuant to the Title VII command to "make whole" victims of discrimination. These reforms simply would make those judicial determinations more accurate assessments of discriminated-against employees' utility losses.

Moreover, the question of whether courts should compensate based on higher "endowment values" or lower "economic values" (i.e., willingness-to-accept or willingness-to-pay), a difficult issue in many areas of law, is not a real concern in the discrimination context, where it is a public policy imperative (a) to make victims whole, (b) to deter wrongdoing for the benefit of society, and (c) to construe damages uncertainty against the wrongdoer. Further, while some "endowment values" are inefficient barriers to efficient trade (e.g., homeowners unwilling to accept high prices offered by economic development authorities), it is efficient for employees to feel an "endowment" in long-term employment. Accordingly, recognizing enhanced endowment values in discrimination damages would not risk creating barriers to trade, as they might in the property value context.

2. Diversity/Harassment-Prevention Programs: Prospect Theory

In the past several years, two Supreme Court decisions have incentivized employers (by providing a defense against vicarious liability) to implement diversity/harassment-prevention programs. Employer programs vary widely, however: some are well intended while others are defensive efforts to avoid liability; some are effective while others are amateurish; some are interactive trainings while others are presentations or even just online programs.

The case law is not very well developed as to what employer programs are sufficiently genuine and effective that courts should deem them sufficient to establish the employer's liability shield. Yet much of the guidance and plaintiff-side advocacy to date seems misguided.

Many have argued that employer programs must focus on the positive (e.g., don't discriminate/harass because diversity is wonderful and we should respect each other) rather than on the negative (e.g., don't discriminate/harass because of the risk of lawsuits and workplace disharmony), because employer programs focused on the negative are disingenuous, lawsuit-defensive efforts rather than real efforts to stop discrimination. Prospect theory might indicate that this emerging conventional wisdom is exactly wrong. If people value losses from the status quo reference point more heavily than they value gains, then an employer that wants employees to see the value of not discriminating should focus on how discrimination can cause great loss (e.g., lawsuits and workplace disharmony) rather than how ceasing discrimination could yield great benefit (e.g., enjoyable multicultural sing-alongs in the office lunchroom).

3. Harassed Employees Failing to Complain: Various Behavioral Phenomena

Courts require employees to complain internally, to management, before suing for workplace harassment; an employer may not be liable for even a supervisor's harassment of a subordinate if the harassed subordinate had not complained internally. Courts excuse employees from complaining internally only when those employees show specific evidence of likely retaliation.

Yet a range of behavioral phenomena illustrate why a reasonable person might be unwilling to complain internally about harassment. Loss aversion would make employees especially fearful of facing retaliation if they complain about their supervisors, and other behavioral phenomena would exacerbate this tendency: the endowment effect would make at least some employees especially averse to a risk of losing their jobs; and the salience and availability biases might make employees exaggerate the risk of retaliation (because everyone remembers and spreads rumors about retaliation, but nobody remembers or spreads tales of the person who complained uneventfully). Additionally, prospect theory might make employees hesitant to upset even an unpleasant status quo (i.e., being harassed), because the risk of loss (retaliation) is more fearsome than the risk of gain (stopping the harassment) is appealing.

More generally, when the law assesses the behavior of the "reasonable person," such as in deciding whether an employee reasonably or unreasonably failed to complain about harassment (or in other contexts, such as tort law), it should not conceive of a risk-neutral, perfectly informed decision-maker. Rather, courts should decide cases based on how people actually are capable of behaving. Holding people to unattainable standards is simply a refusal to impose liability whether it is otherwise warranted.

4. Claiming and Denying Discrimination: Optimism and Self-Serving Bias

Economic analyses of settlement long have noted that, at least in the early stages of litigation (or pre-litigation), plaintiffs are too optimistic about the merits of their claims while defendants are too optimistic about their odds of defeating those same claims. Litigation, in this view, is a process of disillusionment: once discovery and court rulings help both sides get past their initial optimism, their estimates of the odds converge, making settlement likely as a way to minimize risk-bearing and litigation costs.

The sources of the parties' initial optimism, however, is a matter of debate. Traditional economic accounts focus on information costs and asymmetries, because initially, plaintiffs know their evidence and arguments but not the defendants', and vice-versa. Principal-agent problems also play a role: while the parties' attorneys could reduce these information problems (because they have more experience and background knowledge than their clients do), their incentive to "sign up" the client, and then their incentive to rack up billable hours, may prevent them from disabusing their clients of their initial optimism.

Behavioral economics supplements these traditional explanations for litigation parties' differing probability estimates. Even given the same information, each party is likely to estimate the odds of victory in his or her own favor, based on self-serving biases and optimistic interpretations of available information.

Yet without empirical data on which parties suffer greater biases, and under what circumstances, we cannot say whether employment discrimination plaintiffs are too quick to claim discrimination or defendants are too quick to deny it. This is an example of how sometimes, to reach prescriptive conclusions based on behavioral economics, we need serious empirical research first. That need for data to go from behavioral theory to prescriptive conclusions has led some to argue that behavioral economics is too indeterminate to yield useful insights.

While the mere presence of optimism/self-serving bias does not let us conclude that more or fewer claims have merit, it does, however, allow us to reach two more neutral diagnoses and prescriptions.

First, optimism/self-serving bias makes even more troubling the widely noted chaos in employment discrimination doctrine. As many have noted, judges possess barely bounded discretion to dismiss or not to dismiss employment cases (usually on motions for summary judgment or judgment as a matter of law). The greater the uncertainty whether a case will be dismissed, the greater the room for optimism/self-serving biases to operate, and therefore the lower the odds the parties will reach an efficient settlement.

Second, the problem of optimism/self-serving bias inhibiting settlement can explain the growth in popularity, and the surprising success rate, of mediation. To many, it is mysterious why a voluntary, non-binding process such as mediation works so well. After all, the mediator has no real authority, and any statements made in mediation are inadmissible in later litigation. The answer is that the forced early disclosure, and the opinion of a respected third party, may diminish the parties' optimism/self-serving biases.

This explanation for mediation's success has been noted outside of economics, but it is instructive to view that explanation in economic terms. It is an excellent example of how behavioralism can supplement

traditional economic explanations (e.g., information costs/asymmetries) to help explain phenomena (like mediation's popularity and success) that are otherwise hard to explain in traditional economic terms.

B. Implications for Prescriptive Behavioral Economics

One of the more interesting criticisms of behavioral economics is that it does not readily yield prescriptions: it sacrifices determinacy for the sake of accurate description; it presents difficult empirical questions that must be answered before allowing definitive prescriptions. This article illustrates several points about the possibility of a meaningful prescriptive aspect to behavioral economic analysis of law.

1. Feasible Prescriptions: "Retail"-Level Decisions on "Micro" Subjects

First, this article illustrates circumstances in which behavioral economics can yield definite prescriptions. Where behavioral economics cannot yield prescriptions, it is usually when the subject matter is too "macro," e.g., assessing whether a minimum wage law or a disability accommodations law is "efficient" for all of society. Most of this article's terrain, however, is more "micro": how should judges decide individual cases? Judges, in focusing on individual cases, can and do consider all of the variables in a behavioral calculus – e.g., in discrimination damages calculations, they can and should consider the employee's length of service, the nature of the job, the other jobs available, and whether the employee excelled at and enjoyed the job. These considerations all affect the extent of an endowment effect, and while they cannot be calculated at a whole-market level (e.g., "is there an endowment effect for employees generally?"), judges can and do make factual determinations like this all the time in employment litigation.

This example illustrates how the efforts to draw prescriptions from behavioralism may have its future in individual-level determinations (e.g., whether a given individual exercised "reasonable care" in a tort case) rather than in society-level analyses (such as whether a statute is socially efficient). The only society-level prescription of behavioralism may be that judges and other "retail"-level decision-makers (e.g., city councils) should consider the realities of human behavior that behavioralism has illuminated, rather than assume the perfectly informed, risk-neutral rational actor who exists only in out-of-date economics texts.

2. Modest Prescriptions: Market-Facilitating, Not Anti-Market

Second, the presence of a behavioral limit on rationality may support a prescription – but sometimes only a modest one falling far short of a paternalistic mandate rejecting market outcomes. Mediators essentially market themselves as experts in helping parties "solve" the problems arising from behavioral limits on their information-processing. This illustrates how private markets may arise to lessen irrationality. This is a phenomenon worth noting, because it bears on whether the mere presence of an inefficient behavioral limitation necessarily supports an anti-market prescription. Often, government may have a more limited role than issuing mandates. Instead, it can supplement, rather than replace or preempt, private market solutions – for example, federal courts and the Equal Employment Opportunity Commission providing mediation services for low-damages cases in which the parties cannot feasibly pay for a private mediator.

3. The Slow Path from Academic Insight to Real-World Implementation

Third, despite the desirability of incorporating behavioral prescriptions into the law, courts have been slow to do so. Courts have remained mired in the pre-behavioral economic paradigm long after behavioral insights have started to penetrate into legal thinking. A particularly striking example is employer mandatory arbitration policies. Courts only began to enforce such policies many years after orthodox free-market economic analysts had been advocating a freedom of contract paradigm; this lag indicates that the free-market orthodoxy was slow to penetrate into judicial decision-making. Today, similarly, a substantial and growing body of behavioral economic analyses has criticized mandatory arbitration policies as insufficiently informed employee "decisions" to merit automatic enforcement as "contracts." Yet courts not only have failed to adopt such views, but even have failed to acknowledge such ideas at all. Perhaps there always is a lag between academic discovery of knowledge and application of that knowledge by real-world decisionmakers. Still, that lag is disappointing to those who believe that behavioral economics does have important prescriptions that could improve the state of the law.