STRATEGIC TERMINATION PROCESSES IN SMALL AND MEDIUM BUSINESSES [1]

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ABSTRACT

Evidence suggests that the arbitration framework for termination disputes resolution is generally favourable to small and medium businesses (SME) in Australia.. However, SMEs have long remained more exposed to adverse dismissal disputes than larger organisations. To reduce transaction costs, employers face the option to bargain with dismissed employees over the nature and conditions of the termination. Often, these interactions take a strategic dimension as when relabelling a dismissal a retrenchment in order to save dissipative, stigmatic and reputation costs. Estimates from Australian SMEs suggest independent and arbitrated settlements of this type potentially save about one third of expected court arbitration costs. Recent reforms to statutory dismissal law have undercut the role of these bargaining platforms for SMEs. This will reduce the incidence but increase the long-term volatility of termination processes.

Keywords: Termination processes, dismissal costs, retrenchment, bargaining, Australia

INTRODUCTION

The theory of small and medium firms—SME—industrial relations harmony (Ingham 1967; Ingham 1970; Bolton 1971) has seen steady erosion over time[3]. Termination conflicts constitute a regular feature, particularly at early stages, of employment relationships in SMEs. In Australia, various surveys of workplace and industrial relations have shown that the frequency of employment termination due both to job destruction in economic downturns and unsatisfactory employee performance is higher among SMEs than among larger organisations (Callus et al. 1991; Morehead et al. 1997; Revesz & Lattimore 1997)[4]. This presents a significant challenge, particularly for smaller businesses, which due to HR inexperience, lack of resources and scattered leverage, are particularly vulnerable to costly termination disputes.

Much of the policy debate and recent Australian literature in this area has centred on government regulation of disciplinary termination disputes in SMEs and alleged negative employment impacts (CPA 2002; Harding 2002; Robbins & Voll 2004; EWRE 2005; Freyens & Oslington 2005; Harding 2005; Freyens & Oslington 2007). Although this debate raises important questions and has led to dramatic and controversial reforms in December 2005, it puts too much emphasis on dubious aggregate labour market consequences[5], which are of little relevance and interest to small and medium business owners. Whatever the aggregate employment impact (which most Australian studies indicate must be low) may be,

[1] An ARC Discovery Grant "The Impact of Hiring and Firing Costs on Wages and Employment in Australia" supports this research.

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[3] See (Barrett 1999) for a survey of the literature.

[4] Note however that the AWIRS 1995 survey did not include businesses with less than 20 employees in their sample.

[5] Surveys of the economic literature are generally dismissive of any strong relationship between employment levels and employment protection laws (Bentolila & Bertola 1990; Bertola 1999; Nickell & Layard 1999; Addison & Teixeira 2003).

the main issue for SMEs is to check the cost of terminating wrong hires and reduce overall exposure to excessive and uncertain unfair dismissal claims.

Recent government reforms exempting SMEs from exposure to unfair dismissal claims were partly meant to respond to this concern, but it is unclear that the concern was genuine, or the response appropriate (Howe et al. 2005). The pre-December 2005 dispute resolution framework defined by the *Workplace Relations Act 1996* (*the Act*) responds reasonably well to SMEs' concerns: unfair dismissal claims are relatively rarely lodged (Robbins & Voll 2005), compensation claims are capped to very low levels (AIRC 2005a), reinstatement claims are rarely successful (Chelliah & D'Netto 2006), and most termination disputes are settled prior to arbitration at very low transaction costs (Hagglund & Provis 2005; AIRC 2005b; Freyens & Oslington 2007).

Additionally, employers have also developed systemic and informal responses, operating at the edge of *The Act* to reduce terminations costs and uncertainty. For instance, businesses regularly earmark badly behaving or poorly performing employees for future retrenchments - ie. economic terminations - rather than disciplinary dismissal (Woodger 1992). In fact this is common practice (Carroll & O'Dea 2006) and the reverse mechanism has also been observed in the European context where firms have been known to fire workers—ie. for disciplinary cause - when the underlying motive was in fact of economic nature (Galdon-Sanchez & Guell 2003). In both cases the behaviour is strategic because it consists of negating the nature of the dismissal (and applicable law) in order to derive financial benefits or reduce exposure and opportunity costs. Of course, the law condemns such manipulations when unilaterally designed and imposed by the employer, but this becomes a non-issue if these outcomes are consensual and emerge from negotiations between employer and dismissed employee. This is often the case because under *The Act* SMEs are often not in a position to dictate the terms of these processes and the outcome (separation payment and official termination 'label') therefore requires some degree of bargaining between the parties (Fella 1999).

The key parameters of such dispute resolution processes are the opportunity costs imposed on both parties, both by the dismissal decision and its subsequent challenge. There are various categories of these costs: money, time and efficiency costs, emotional costs, loss of morale, long-term economic consequences. In this article we concentrate on mainstream dispute costs: the first category is common to both parties and consists of the dissipative costs inherent to litigation (lawyers and courts fees, red tape, time costs), the second is employee-specific and consists of the stigma associated to dismissal for cause. Stigma costs brand fired employees as underperforming human resources, which reduces their re-employment chances, whereas retrenchments and quits offer more anonymous exits (Miller & Hoppe 1994; Hagglund & Provis 2005). The third category of costs is employer-specific and consists of the compensatory money transfers claimed by the dismissed employer at either the conciliation or arbitration stage of the dispute. Since just cause for dismissal is a particularly ambiguous concept[6], firm and dismissed employee also face severe information and uncertainty constraints, which are integrated into the bargaining process. The outcome therefore depends critically on the type and size of the expected transaction costs involved. To help quantify these issues, we present detailed survey estimates of termination costs by type of job occupation and industry in Australian SMEs, and discuss implications with respect to recent policy changes affecting SMEs.

[6] For a nomenclature of ambiguous factors undermining the just cause principle, see table 1, p.931 in (Klaas & Dell'omo 1997).

SME EXPOSURE TO TERMINATION DISPUTES

SMEs are usually poorly equipped with human resource management services compared to larger organizations, use more informal procedures and rules, and are therefore both less experienced and more exposed to complex termination conflicts (USSBA 1989; Barrett 1998; Matlay 1999; Wilkinson 1999; Cassell et al. 2002; Newton & Kleiner 2002). These stylised features are usually attributed to lack of personnel expertise, lack of resources to acquire them and task-induced proximity between business owner and employees (Atkinson & Storey 1994; Scase 1995; Moule 1998; Marlowe 2002). As a consequence, Marlowe (2002) notes: "Evidence would indicate that, rather than risk disrupting the team environment, small firms' owners resist using formal policy or practice, preferring instead a negotiated solution to employment-related issues, which avoids overt conflict or workplace dissonance" (Marlowe 2002: 27).

Recent research in Australia suggests that about 60 percent of SMEs do not have formal procedures for termination (Robbins & Voll 2004). Implicitly then, there is a perception that SMEs are more vulnerable to arbitrated termination disputes because they are weak on procedures and this weakness is induced by the nature of the employment environment itself. Although originally conceived to reduce the probability of conflict, this informal approach paradoxically raises SME exposure to legal challenges since unfair dismissal cases can be lodged on reasons of both procedural and substantive fairness (Stone 2005). Claims have been made that too many unfair dismissal applications are lodged and successfully defended by plaintiffs on grounds of procedural unfairness alone (ACCI 2004), which impairs the original purpose of the legislation, but recent research in this area casts doubts on the validity of the claim (Chelliah & D'Netto 2006).

SMEs also feel more exposed to reinstatement claims. The close employment relationship between business owner and employee often implies that when the relationship is severed for employee wrongdoing, the prospect of forced reinstatement by court order is unappealing. There is also a perception among SMEs that legal dispute settlement costs exceed the quality of the service received, leading to a general reluctance to pay much for legal representation and a high rate of self-representation with support from employers' associations (Robbins & Voll 2004; Hagglund & Provis 2005). Additionally, SMEs generally tend to experience higher than average staff rotation[7], of which job destruction and disciplinary dismissals are important components (Morehead et al. 1997; ABS 1999). In particular, the incidence of disciplinary dismissals in Australia has been shown to increase as firm size decreases essentially due to high initial churning in SMEs (Callus et al. 1991; Revesz & Lattimore 1997). Firms employing less than 50 employees experience dismissal rates five to six times higher than in firms employing 500 employees or more. SMEs are therefore much more prone to facing disciplinary dismissals, legal challenges (and induced firing costs) than larger organisations. Furthermore, it is also generally the case that SMEs operate in more competitive product and labour environments than larger firms and that regulatory interference, such as employment protection, is particularly harmful to the "first best" efficiency of small business markets. Competitive product markets require competitive labour markets because margins and profits are thin. This makes it all the more difficult for

[7] (Curran & Stanworth 1981; Buechtemann 1993; Blanchflower & Burgess 1996; Davis et al. 1996; Picot & Dupuy 1996; Revesz & Lattimore 1997; OECD 1999; Juniper et al. 2004)

SMEs to absorb the additional legal and time costs, higher liability insurance premiums and adverse reputation impacts associated with unfair dismissal cases (Gomes & Morgan 1992).

It has recently been argued that, for all these reasons, termination legislation such as unfair dismissal laws disproportionately affects the performance of SMEs in Australia. According to Harding (2002), SME exposure in Australia is characterised by three salient features: (i) the smaller the business the earliest its situation in the business lifecycle, (ii) a high degree of heterogeneity within each SME category (employing 0 to 5 employees, 6 to 10, etc.) and (iii) the smaller the business the higher its reliance on atypical employment contracts. The first two factors increase small business exposure to unfair dismissal regulations through various vectors such as management inexperience with termination processes, tight labour markets, and difficulty for regulators to design legal instruments that adequately take into account the circumstances of the SME community. The third factor is a consequence of SME inexperience in dealing with fluctuating product demand and subsequent inability to redeploy their workforce in adverse economic circumstances. Using these arguments and the results from an employer opinion survey, Harding (2002, 2005) claims that employment protection severely reduces employment creation in Australian SMEs. Although this concern has also been regularly relayed by the Australian Government in the last ten years, and has provided the rationale for recent policy exemptions in this area (which we develop in the next section), the claim remains highly controversial (Barrett 2003; Robbins & Voll 2004; Freyens & Oslington 2005; Robbins & Voll 2005; Freyens & Oslington 2007).

In the light of these vulnerabilities and given a specific set of regulatory constraints, what are available strategies to manage uncertain termination processes? Did recent industrial relation reforms enacted through the *Workplace Relations Amendment (Work Choices) Act 2005* (‘*Work Choices’*) increase or decrease SME exposure to these processes? We first brush the Australian institutional context and the nature of recent reforms to SME termination law. We then proceed to discuss the role of strategic bargaining and its main determinants, which we parameterise with estimates from a survey of termination costs in SMEs.

THE TERMINATION CONTEXT IN AUSTRALIA

Disciplinary Terminations

Disciplinary dismissals, or fires, are involuntary separations for reasons specific to the employee. Such reasons may include unsatisfactory performance, absenteeism or serious misconduct, which are grounds for *fair* dismissal. However, the boundary between fair and unfair dismissal is often hard to establish. *The Act* (1996) distinguishes between *unlawful* and *unfair* dismissal. Unlawful dismissal refers to situations where employees are dismissed without required notice provisions, warnings or explanation (s.170CM), or for discriminatory reasons such as race, creed, temporary absence due to illness or pregnancy, being involved in union-related activities outside working hour, denouncing an employer’s law-breaking activities, etc. (s.170CK). Unfair dismissals are terminations deemed “harsh, unjust of unreasonable” (s.170CG(1)(b)). Whilst *the Act* leaves interpretation of paragraph s.170CG(1)b to industrial relations courts, it stresses the importance of examining whether dismissal reasons are valid, due processes followed, and whether the size of the firm (particularly the absence of human resource functions in the business) has an impact on termination procedures (DEWR 2001; AIRC 2005a)[8]. Compensation, damage awards and

[8] There is survey evidence that arbitration costs are as a consequence smaller for SMEs than for large firms in Australia (Freyens & Oslington 2005; Freyens 2006).

reinstatement orders issued by courts are generally unpredictable and depend on such factors as court attitude towards plaintiffs and the regulatory framework.

Numbers of claims brought in 2003 to Federal and State AIRC courts were 6,954 and 8,299 respectively, down from a total of 21,281 in 1996 (Hansard, Inquiry of the Workplace Relations and Education Legislation Committee, Senate, May 2005). The federal branch of the AIRC is arbitrating fewer and fewer unfair dismissal claims (552 cases in 2001-2, 482 in 2002-3, 429 in 2003-4, 363 in 2004-5). Ruling out cases dismissed on jurisdictional grounds or due to time lapse, the average outcome of such procedures at the Federal level is only slightly favourable to plaintiffs. Over the last ten years, dismissed employees obtained reinstatement and or compensation payments in 53 percent of the cases arbitrated by the AIRC (AIRC 2005a). Assuming similar statistics for States courts, this positions Australia in the middle ground between countries whose courts tend to be employee-friendly (France, Spain, Sweden, Germany) and employer-friendly (UK, Ireland, Austria)[9]. However, for the last three years examined, the AIRC ratio of unfair dismissal cases arbitrated in favour of plaintiffs declined to between 43 and 47 percent (AIRC 2005b). Over the same period, the AIRC reported three quarters of unfair dismissal claims settled by or prior to conciliation, with an ever-increasing settlement rate. Of the claims that remain outstanding after unsuccessful conciliation, 60 percent are withdrawn or settled in the period stretching between conciliation and arbitration. Arbitration by courts is then a relatively rare event averaging about five hundred cases a year[10], only half of which lead to substantive arbitration (the other half being dismissed on jurisdictional grounds or due to time lapse).

There are various jurisdictions competent for arbitrating dismissal disputes in Australia, each covering a specific subset of the Australian labour force (Lawrence 1998; Stone 2005; Chelliah & D'Netto 2006). (i) The Australian Industrial Relations Court (AIRC), which derives its prerogatives from *the Act* (1996), and statutes over claims made by employees of the Australian Public Service (APS), Territories and Victorian employees, federal award employees of incorporated firms and other relatively minor classes of federal award employees, (ii) State industrial tribunals, which rule on applications by non Federal award employees based on State industrial law such as the *Industrial Relations Act 1996 (New South Wales) and 1999 (Queensland)* and (iii) Common law courts, which are competent for wrongful dismissal claims by employees uncovered by either Federal or State law, such as middle or senior managers earning more than $98,200 per year (Commonwealth salary cap, last updated on 1 July 2006). The AIRC and State tribunals are competent for *statutory* action in regard to unfair dismissal claims (as defined above), whilst common law courts arbitrate wrongful dismissal cases, which may not be harsh, unjust or unreasonable but necessarily involve a breach of the employment contract.

There are some differences between Federal and State law: for instance, although the Commonwealth and most States put a salary cap on the capacity to lodge an unfair dismissal claim, Tasmania does not. Western Australia and Tasmania also allow casuals workers to lodge unfair dismissal claims. Overall though, the differences are not large, Victoria and the two Territories follow the same laws as the Commonwealth and all States cap compensation benefits to 6 months. Strikingly though, about 30 percent of Australian SMEs do not know whether they are covered by Federal or State law for termination matters (Harding 2002).

[9] See (Bertola et al. 2000) for evidence on disparate employment protection enforcement across countries.
[10] See (AIRC 2004).

Recent amendments to *the Act*, enacted through *Work Choices*, considerably contracted unfair dismissal legislation by both reducing employee coverage by the AIRC and transferring jurisdiction from State courts to the Commonwealth (Chapman 2006). At the Federal level the relevant legislation remains subsection 170 CE of *the Act*, which now exempts businesses employing less than 100 employees from unfair dismissal claims. The amendments also affect unfair dismissal aspects of economic terminations by prohibiting access to unfair dismissal law for employees subject to unfair selection for redundancy, a now legalised process under 'dismissals for operational reasons' provisions. Many unfairly dismissed employees in SMEs therefore no longer have access to AIRC intermediation. For such employees, the only avenue left to dispute an unfair termination is to appeal to common law (which comes at a much higher cost).

Economic Terminations

Employee retrenchment (or job redundancies) is an involuntary separation by reason of the job becoming redundant (ie. for reasons not specific to the employee: the employer does not want the job performed by *any* employee). Such reasons may include business downturn, technological change or skill obsolescence. The main data source for retrenchment causes, patterns and frequencies are the ABS's Labour Force Mobility survey—LMS—(ABS 2004) and the Retrenchment and Redundancy survey—R&R—(ABS 2002), which unfortunately has been discontinued after 2001. According to these two sources (whose methodology differ considerably), retrenchments yearly affect on average between 2 percent (R&R) and 4 percent (LMS) of total employment. The R&R survey distinguishes retrenchments from fires whereas the LMS does not. However the LMS is methodologically sounder than the R&R (particularly with respect to recall period issues). Whatever the exact numbers are, retrenchments affect a considerably larger portion of the labour force than disciplinary dismissals (by a factor of five, according to the R&R). It is a contention of this article that these statistics are distorted by strategic behaviour about the nature and cause of the termination.

Much of the Australian labour force is regulated by industrial awards and other regulated industrial arrangements such as enterprise agreements or Australian Workplace Agreements (AWAs). The procedures for retrenchment of award-regulated employees depend upon a combination of statute laws and relevant industrial instruments. It is therefore difficult to describe the provisions specific to particular employees and employers, as industrial instruments vary largely even when they deal with a specific aspect of retrenchment.

There are however some established benchmarks which provide minimum severance and notice guidelines to award-regulated employees. These minimum standards depend on whether the award is covered by Federal or State legislation and can be increased by statutory agreements negotiated with workers' representatives. At the Federal level, minimum termination payoffs are set in advance by law. The *Termination, Change and Redundancy Case 1984* defined the standards to be applied with regard to notice, severance, consultation and redeployment (Stone 2005), but kept small firms (under 15 employees) exempt from these requirements. These were recently updated in the AIRC full bench decision referred to as the *Redundancy Test case 2004* (AIRC 2004), which increased the size of minimum severance pay and period of notice and removed the exemption for small firms, albeit keeping a relatively favourable regime for these entities. Table 1a provides an update of the termination awards stipulated by retrenchment law.

TABLE 1a
Federal Severance and Notice Minimum Standards, Relative to Annual Wage

Years of service	Severance		Notice
	Small firms (<15)	Other firms (15+)	All firms
< 1 year	-	-	min. 2%
1 to 2 years	7.7%	7.7%	min. 3.8%
2 to 3 years	11.5%	11.5%	min. 3.8%
3 to 4 years	13.5%	13.5%	min. 5.8%
4 to 5 years	15.4%	15.4%	min. 5.8%
5 to 6 years	15.4%	19.2%	min. 7.7%
6 to 7 years	15.4%	21.2%	min. 7.7%
7 to 8 years	15.4%	25%	min. 7.7%
8 to 9 years	15.4%	27%	min. 7.7%
9 to 10 years	15.4%	30.8%	min. 7.7%
> 10 years	15.4%	23%	min. 7.7%

Source: AIRC Full Bench decision PR032004
(http://www.airc.gov.au/fullbench/PR032004.htm)
Note: the notice period is increased by one week if the employee is over 45 years of age and has at least two years service with the organization.

The reason AIRC standards differ between small and larger businesses is that employees of medium and large organizations are often eligible for either pro-rata long service leave or full long service leave entitlement after 10 years service. However, if the employee is made redundant prior to the attainment of 10 years service, such entitlements become lost to the retrenched employee. In order to deter strategic behaviour by employers, there is therefore additional compensation for employees made redundant just before the 10 years service mark. In table 1b, we contrast the minimum redundancy pay requirements stipulated in table 1a, with an example of State minimum redundancy awards (New South Wales), which are generally stricter but, by contrast to Federal law, do exempt businesses employing less than 15 employees.

TABLE 1b
NSW Severance and Notice Minimum Standards, Relative to Annual Wage

Years of service	Severance Age < 45 years	Age > 45 years
< 1 year	-	-
1 to 2 years	7.7%	9.6%
2 to 3 years	13.5%	17%
3 to 4 years	19.2%	24%
4 to 5 years	23%	29%
5 to 6 years	27%	34%
6 to 7 years	30.7%	38.4%
7 to 8 years	30.7%	38.4%
8 to 9 years	30.7%	38.4%
9 to 10 years	30.7%	38.4%
> 10 years	30.7%	38.4%

Source: (Carroll & O'Dea 2006)
Note: the notice period is increased by one week if the employee is over 45 years of age and has at least two years service with the organization.

It should be noted that regardless of the appropriate award base, payments well over the minimum required by statutory law are common practice in Australia and many OECD countries. In many workplaces there are policies ascribing more generous benefits than required by law. For example, there may be entitlements to severance pay that refer to a formula of three or four weeks pay for each year of service.

Various explanations have been suggested for the phenomenon. Extra statutory redundancy payments (ESRP) may be due to factors such as employer generosity, reputation capital, union agreements above the minimum or the so-called "go-away money" referred to in parliamentary debates (eg. Hansard, House of Representative, 21 February 2002). As with the disciplinary dismissal process, there are also procedural requirements for economic dismissals to be legal. In Australia, employers must notify Centrelink (previously the Commonwealth employment office) if they plan to retrench 15 or more employees. The notice must state the reasons for termination, the number of workers affected and the timeframe for terminations. The procedure is comparable in substance with those adopted by many Western European countries[11]. We do not investigate its potential costs in this study.

DISPUTE SETTLEMENT PARAMETERS

A firing process can be approached as a bargaining game in which the employer makes the first move by communicating the decision to fire to an underperforming employee. The employee then compares the respective payoffs from leaving without challenge or threatening the employer with legal action. In principle, dismissal for poor performance should entail no

[11] For a survey of retrenchment procedures in OECD countries, see (Buechtemann 1993).

cost at all since it is considered "fair dismissal" by the law. In practice, however, the performance and behavioural issues leading to dismissal for cause are often unobservable by third parties and courts may also consider issues that are irrelevant to the firm, such as personal circumstances. A dismissed worker can therefore always lodge a claim for unfair dismissal with some positive probability of winning the case. If the fire is contested, the employer may either settle by accepting to bargain over a termination award or stay the course in which case the employee either proceeds with litigation with the objective of obtaining compensation, or withdraws the challenge. We do not consider here reinstatement objectives as SME research in Australia indicates this outcome is rather rare and undesired by both parties (Hagglund & Provis 2005). Figure 1 presents a simplified decision tree with expected cost and benefits to both parties at each step of the dispute resolution process.

Costs of dismissal for cause are much less predictable than retrenchment costs. They comprise the expected costs of arbitrating an unfair dismissal dispute of which legal, red tape and court costs constitute a dissipative (waste) component since lawyers and courts are not parties in the termination process. Dissipative costs are incurred both by the firm and by the employee.

On the other hand, the expected value of damage awards granted by courts is a pure transfer, ie. of non dissipative nature. Friendlier court attitude towards the plaintiff raises the award's expected value (by increasing the likelihood of receiving the award) [12]. The total expected cost of arbitration to the firm is thus composed of the dissipative legal representation costs and the net expected damage award. Let us assume for simplicity that the utility/disutility derived from a certain benefit/cost is the mere value of the amount considered. If the worker does not contest the fire, she incurs a stigma cost that reduces her probability of finding another job. If the worker contests the fire in courts, the expected benefit from court action is the average expected award net of stigma and the worker's share of arbitration dissipative costs.

[12] Courts are provided with imperfect evidence on the actual cause of the dismissal, which adds an informational problem. The only certainty is that if individual effort, however imperfectly evidenced in court, fails to meet *a critical level*, courts will rule against the plaintiff. There is however no guarantee of success for the plaintiff if effort is above that threshold.

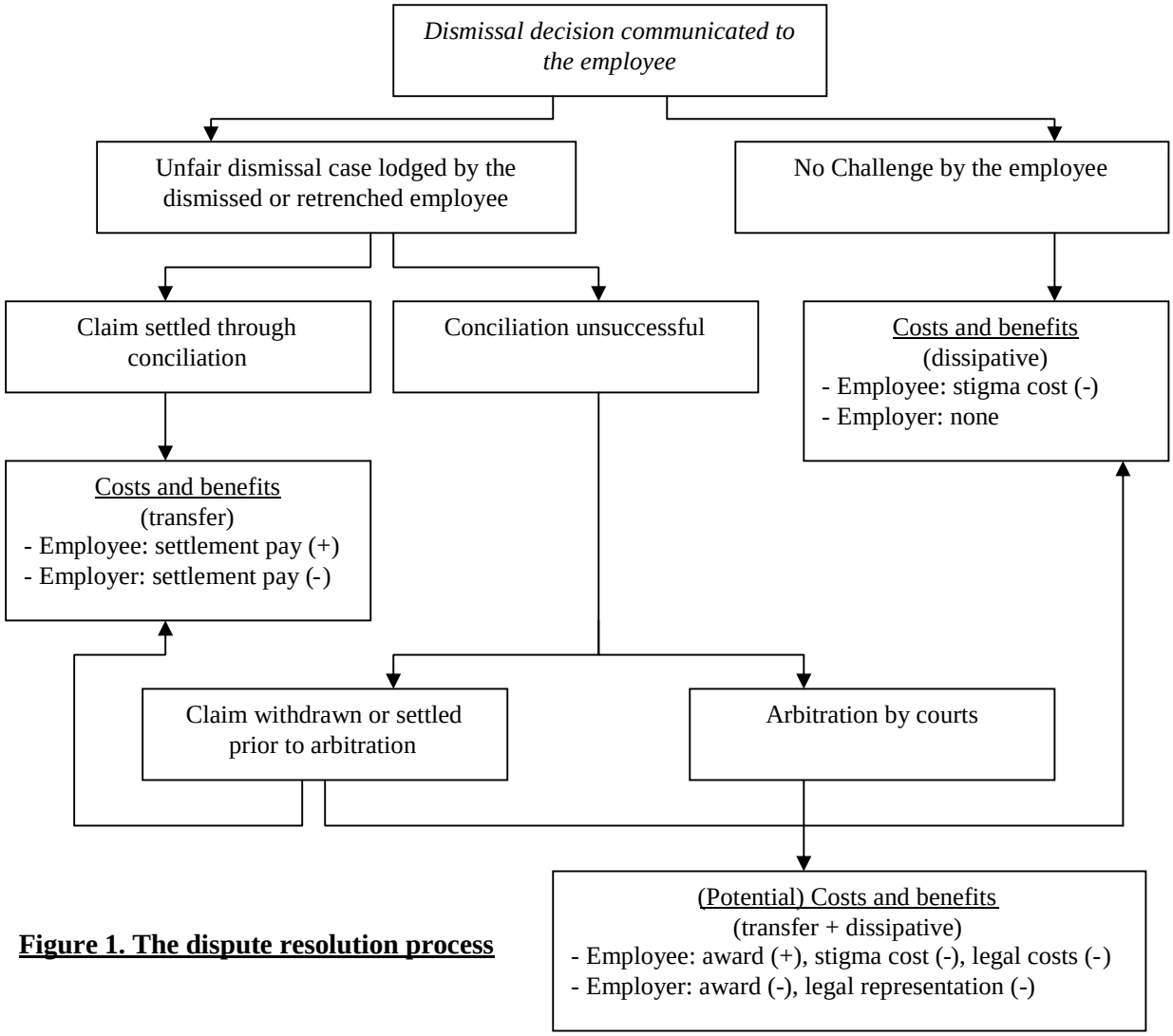

Figure 1. The dispute resolution process

The components of the arbitration process define the bargaining space at the conciliation stage. The worker will not accept a settlement award lower than the expected benefit of challenging the fire, which defines a lower bound in negotiations whereas a higher bound for the bargained award is provided by the amount that makes the firm indifferent between a fire and a settlement (dissipative costs + expected damage award). Bargaining over the separation payoff thus focuses on the partition of conflict waste (dissipative costs *to both parties* and stigma cost).

COST ESTIMATES IN SMEs

Methodology

The survey of termination costs consisted of telephone interviews over an initial sample of 12,279 SMEs conducted in 2004 with the Sensis® Business Index. The response rate of about 22% (RR4) is calculated using CATI methodology (Bates & Dixon 2003). Firms in the sample range in size from very small enterprises with no employees (less than 1% of the sample) or one employee (about 15%), to enterprises with about two hundred employees (about 3%). The size distribution of the sample is however strongly skewed toward small businesses, with three quarters of sampled firms employing less than 15 employees. The sample covers all Australian states with Queensland, Victoria and New South Wales

accounting for about one half of the sample. Three quarters of the sample is based in urban areas.

Since termination costs and their components are relatively elusive concepts, definitions of firing and retrenchment costs were established through a pilot survey, trial interviews with businesses and focus groups with human resource professionals from the Australian Human Resource Institute (AHRI) and Australian Chamber of Commerce and Industry (ACCI) in 2003. Five types of terminations costs were investigated in the survey:

(i) Cost of unchallenged fires: time spent on the process and other administrative costs.
(ii) Cost of conciliated fires: additional time and administrative costs, legal costs and settlement payment if any.
(iii) Arbitration costs: further administrative and legal costs, compensation and reinstatement costs if the unfair dismissal case is lost by the employer.
(iv) Procedural retrenchments costs: time spent consulting with all the parties involved (unions, authorities etc.), outplacement costs, clerical notification work, working out separation packages and cost of industrial action (such as a strike).
(v) Redundancy pay: severance and notice paid in lieu upon retrenchment.

Our interest in this article lies with parameters (ii), (iii) and (v) and we do not report results for costs (i) and (iv). The costs are evaluated for 11 Australian and New Zealand Standard Industrial Classification (ANZSIC) sectors of activity (manufacturing and most services, but not agriculture) and 9 major occupational groups of the second edition of the Australian Standard Classification of Occupations (ASCO). For the purposes of the survey these were grouped into five types of occupation by combining professionals and managers, as in many small and medium enterprises the distinction between professionals and managers is blurred, which was borne out in survey responses. The groups were then ranked by skill, allowing us to consider whether it costs more to fire skilled workers.

The cost estimates are presented relative to the annual wage cost rather than as an absolute dollar cost. Reasons for this are: (i) many separation costs components such as time cost, compensation or severance payments, notice paid in lieu, etc. are actually expressed in terms of wages, (ii) the profit maximizing firm's firing decision hinges on a comparison between firing costs and wage savings, (iii) it is convenient for comparisons, including comparisons across industries and skill groups with different wage levels, and across countries. Wage cost data were obtained from the Australian Bureau of Statistics, (ABS 2002c) and (ABS 2002b), and comprises base pay, payment by measured result and overtime pay. The wage data was weighted by the share of each job occupation and industry in total employment to provide average wage rates by skill and industry, which were then adjusted to reflect the influence of firm size on wages using data on earnings by employer size from (ABS 2002c).

Also, we do not try to read too much from average values for single industries or occupations as conciliation and arbitrations are not routine situations in SMEs and the number of observations collected is therefore relatively limited. Instead, the discussion mainly uses the average estimates aggregated across industries and occupations.

Results

Aggregate conciliation and arbitration costs average 17.1 and 25.3 percent respectively[13]. Settlement and legal counsel payments appear thus to be significantly less expensive than court action. Average retrenchment cost, net of procedural cost, is also 25.3 percent of wage cost, but varies considerably with seniority.

Table 2 presents the skill and industry profile of conciliation costs. There is a pattern of dispute settlements being relatively more costly for white collar than blue collars workers. This is particularly the case for the manufacturing sector.

TABLE 2
Settlement Costs by Skill Group and Industry (% Annual Wage Cost)

Industry/skills *(n=121)*	Managers,	Tradespersons	Advanced and	Machine operators,	Elementary clerks,	*All job occupati*
Manufacturing	33.1%	7.3%	15.3%	9.0%	13.0%	*18.8%*
Construction	8.1%	11.1%	12.6%	:	18.2%	*11.7%*
Wholesale Trade	15.0%	1.9%	9.2%	:	33.0%	*14.6%*
Retail Trade	5.7%	5.3%	6.3%	:	7.1%	*6.1%*
Transport - Storage	19.3%	:	69.2%	12.8%	8.7%	*29.3%*
Communication - Prop.	64.2%	15.9%	13.4%	:	20.6%	*34.1%*
Finance - Insurance	6.5%	:	3.2%	:	:	*5.2%*
Health	6.0%	:	:	:	:	*6.0%*
Culture - Recreation	21.4%	1.5%	19.8%	16.9%	5.8%	*14.3%*
Accommodation	14.5%	:	12.6%	:	4.0%	*11.4%*
All Sectors	*24.0%*	*8.1%*	*17.6%*	*11.4%*	*14.2%*	*17.1%*

The average settlement cost estimate for managers and professionals is distorted by an outlier of 202 percent in manufacturing and 186 percent in the communications sector, whereas an outlier of 689 percent for clerks in transport remains a puzzle. Such values may appear unrealistic and perhaps include other costs than those stipulated in this section of the survey. On the other hand, a conciliation process may sometimes involve considerable time valued by high executive wages. Also, many managers and professionals may not qualify for unfair dismissal procedures due to the salary cap, which may lead to specific and costly dismissal negotiations with management. In the absence of any other information the data was kept. However, reclassifying these outliers elsewhere in our nomenclature would reduce the average settlement cost for transport (down by 12 percent of annual wage cost), manufacturing (down by 7 percent) and communications (down by 13 percent) which in turn substantially reduces total conciliation cost by about 4 percent of average wage cost to 13 percent.

Generally speaking, the table does not portray a tendency for costs to increase in the skill level other than for the white-collar / blue-collar pattern. Labourers appear relatively

[13] These are also the aggregates used by Freyens and Oslington (2007) to derive the employment impact of removing unfair dismissal laws for various categories of firms, including SMEs employing less than 100 employees. The focus here is on the multiple dimensions of these figures.

expensive to settle with, while the opposite holds for tradespersons. Conciliation with professionals appears much more expensive than for any other occupational group. In terms of sectors of activity: manufacturing, communication and property and business services face higher conciliation and settlement costs than other sectors (essentially because of high figures for professionals). Table 3 considers the patterns of arbitration costs by type of job occupation and industry.

TABLE 3
Arbitration Costs by Skill Group and Industry (% Annual Wage Cost)

Industry/skills *(n=38)*	Managers,	Tradespersons	Advanced and	Machine operators,	Elementary clerks,	*All job occupation*
Manufacturing	138.8%	2.9%	7.5%	29.7%	9.9%	*53.2%*
Construction	9.0%	5.9%	:	33.3%	34.7%	*17.0%*
Wholesale Trade	7.6%	:	9.0%	:	9.9%	*8.6%*
Retail Trade	:	:	35.6%	:	:	*35.6%*
Transport - Storage	:	:	27.2%	:	3.7%	*16.6%*
Communication - Prop.	19.1%	1.5%	3.8%	:	34.7%	*10.2%*
Finance - Insurance	:	:	6.5%	:	:	*6.5%*
Health	:	:	:	:	:	*:*
Culture - Recreation	:	:	:	:	:	*:*
Accommodation	10.6%	5.0%	29.9%	:	:	*14.9%*
All Sectors	*44.6%*	*3.4%*	*14.8%*	*31.2%*	*19.3%*	*25.3%*

The average estimate for managers and professionals is distorted by two outliers: one of 202 percent in manufacturing and one of 190 percent in the communications sector. For the reasons outlined above and to preserve consistency, we have kept outlying values.

It would be interesting to test possible correlation between the skill level and the probability of winning an unfair dismissal case through court arbitration. Do the highly skilled (most of whom are highly educated) benefit more from unfair dismissal regulations than others? The survey responses do not have enough information about the cases arbitrated to answer this question, which is left to future research. However, the average data by occupation at the bottom of table 4 suggests that costs, and hence probably compensation, is greater than for professionals and managers for other skill groups. A different question is: what are the types of workers that predominantly go to court? As table 3 indicates, all skill types are represented, but some more than others. Clerks lodged a third of court cases, labourers', machine operators and drivers another third, and tradesman and managers and professionals a sixth. The small number for managers and professionals may indicate that this group is better at picking cases it is likely to win. Alternatively, it may reflect on the higher wage level of this occupational group and its incapacity to lodge claims due to the salary cap. Higher claim rates in other occupations may be related to higher unionization rates, if unions are pushing workers to claim, and to go to court.

Turning our attention to retrenchment costs, we quantify average redundancy pay, which includes severance pay, payments in lieu of notice and any extra payment made to ensure

swift and trouble-free separations. Severance costs were carefully defined to exclude annual leave, long-service leave, sick leave entitlements and accrued bonuses, which are often part of the same separation package offered to the worker made redundant.

Table 4 provides the skill / industry cost profile of redundancy pay together with average years of service at time of retrenchment. Overall, white collar occupations are much more costly to retrench than other types of workers. Focusing on a similar range of seniority, for instance two to four years of service, one does not observe severance payments increasing in the ASCO job occupation hierarchy. A comparison of table 4 with table 1 indicates in some industries and occupations severance payment much larger than could be explained by firms paying the minimum standards set by the AIRC.

TABLE 4
Severance and Notice Payments by Skill Group and Industry (% Annual Wage Cost) (Average years of service indicated between brackets)

Industry/skills *(n=162)*	Managers,	Tradespersons	Advanced and	Machine operators,	Elementary clerks,	*All job occupati*
Manufacturing	6.3% (8)	4.3% (3)	123.5% (9)	10.9% (5)	27.1% (3)	*35.2%*
Construction	18.5% (8)	4.0% (3)	:	4.1% (3)	4.8% (2)	*10.4%*
Wholesale Trade	79.3% (2)	8.7% (6)	29.9% (6)	3.7% (4)	30.0% (12)	*40.2%*
Retail Trade	10.6% (3)	12.8% (3)	6.3% (4)	:	12.0% (6)	*10.3%*
Transport - Storage	87.5% (12)	13.4% (2)	24.6% (3)	:	:	*50.8%*
Communication - Prop.	20.9% (4)	11.3% (3)	19.0% (4)	2.4% (1)	:	*16.2%*
Finance - Insurance	52.0% (4)	:	5.7% (3)	:	:	*33.9%*
Health	24.2% (1)	:	:	:	:	*24.2%*
Culture - Recreation	20.5% (10)	6.8% (2)	8.5% (4)	:	:	*13.6%*
Accommodation	19.1% (4)	:	7.9% (1)	:	:	*14.7%*
All Sectors	*31.6%*	*8.4%*	*41.4%*	*5.7%*	*19.8%*	*25.3%*

ESRP may be due to factors such as employer generosity, reputation capital, union agreements above the minimum, the so-called “go away money” referred to in parliamentary debates (eg. Hansard, House of Representative, 21 February 2002). As we have suggested in this article, fires may also be renegotiated as retrenchment when both parties want to avoid costly litigation, workers avoiding hurting future job prospects, companies avoiding damage to reputations, etc. ESRP may then merely reflect the extent by which expected damage awards incremented by the employee’s negotiated share of dissipative costs exceed statutory redundancy pay.

Mapping the variables of the bargaining process with the average cost estimates for SMEs enables us to parameterize some elements of the bargaining process. First of all average arbitration costs appear to match the magnitude of average retrenchment costs (25.3 percent of wage cost), to both of which should still be added dissipative costs of about 10 percent in the form of administrative or procedural costs. In the light of our discussion, it is realistic to expect the business owner to shun court arbitration, therefore associating firing costs with the expected size of the bargained termination award rather than that of expected arbitration costs.

Settlement costs, which proxy the bargained award emerging from strategic termination negotiations, average 17.1 percent of annual wage cost, which is about two thirds percent of average arbitration and retrenchment costs. Court arbitration of an unfair dismissal case is *ex ante* the worst possible termination outcome for both parties.

We do not have separate estimates for stigma and dissipative costs and therefore cannot determine the average fallback position of the employee (which is the expected benefit from court action after dissipative and stigma costs have been deducted). This also prevents us from measuring by proxy the exact share of the bargaining space that is transferred to the employee in settlement processes. What it does indicate however, is that bargained conciliation on average saves the firm about one third of expected litigation costs. Since court attitudes towards plaintiffs determine a sizeable portion of the employee's fallback position and given this parameter hovers at around 50 percent in Australia, it would not be surprising if the employee were to save as much as the employer from the process, for given macroeconomic parameters.

POLICY IMPLICATIONS FOR SMEs

The results from the previous section indicate that average arbitration costs incurred by SMEs, inclusive of damage awards, amount to about one quarter of annual wage cost (about A$ 11,600), which does not appear particularly prohibitive when compared to average damage awards of $US 480,000 (a tenfold multiple of annual wage cost) and plaintiff success rate of 75 percent reported under common law in California (Chen & Kleiner 2002). Conciliation, inclusive of strategic bargaining processes, brings the cost of the termination process down to 17 percent, saving firms about 30 percent of expected average arbitration costs. Other studies of arbitration and settlement costs in Australian SMEs find even lower orders of magnitude for these costs (Robbins & Voll 2004; Hagglund & Provis 2005)

Human resource management in SMEs is not well equipped to deal with adverse product demand variations (which induces employee retrenchment) and poor employee performance or behaviour (which induces disciplinary dismissal). For these reasons, and because terminations are more regularly experienced by SMEs than larger organisations, SMEs face larger exposure to unfair dismissal and unfair retrenchment claims. Unfortunately, and in sharp contrast to statutory redundancy law, unfair dismissal law does not discriminate between the widely different circumstances of a highly heterogeneous SME population, which added to the informational problems faced by arbitrating courts often leads to wrong arbitration outcomes.

Procedural approach to dismissal

This high degree of uncertainty has led SMEs and dismissed employees to use informal or AIRC-assisted models of negotiation by which a dismissal, fair or not, can be relabelled a

retrenchment or a quit (Hagglund & Provis 2005). These strategic termination processes are highly efficient as they save both agents a significant amount of dissipative costs. They also entail some elements of 'fairness'. The outcome rests essentially on the distribution of bargaining power among the agents, which partially depends on the merit of the case: a dismissed employee with a spurious case or an employer who is particularly weak on procedures cannot expect to obtain a high share of the bargaining space. Procedure weakness is however inherent to the nature of SME HR management, which puts small business owners at a (relative) disadvantage in termination issues, with respect to larger organisations. However, as mentioned in the first section, there is little evidence that this latter issue is particularly harmful to SMEs in practice, but there is a perception among SMEs that failure to address procedural fairness in termination processes will potentially be sanctioned by disastrous outcomes.

As a consequence, there is evidence that procedure and procedural approach to dismissal in SMEs have significantly improved under the constraining influence of unfair dismissal laws, particularly with respect to the formalisation of disciplinary procedures, unambiguous communication and use of progressive disciplinary measures (Goodman et al. 1998; Robbins & Voll 2005) and with respect to identifying factors of failure in termination processes, such as accountable effort monitoring, documentation of the cause of the offence, years of service, etc (Chelliah & D'Netto 2006).

The estimates reported in the previous section and our discussion of bargaining over payments and termination label suggest that procedural improvements probably stem from a need to better position oneself before strategic settlement negotiations begin. A business owner starting negotiations with an immaculate procedural record is likely to capture a much higher share of the bargaining space from the plaintiff. Since (i) the bargaining space is substantial (approximated to between one and two third of total expected arbitration costs), and (ii) most procedural improvements, such as better monitoring and progressive disciplinary measures, are relatively costless to implement in an SME environment where employer and employee work in physical proximity, there are clear incentives for business owners to improve procedures in a regulated context. One should expect these improvements to regress in the wake of the *Workchoice* reforms.

Statutory vs. common law

Whether due to procedural or substantive reasons, issues of exposure have led SME associations to successfully lobby the Federal Government to obtain total exemption from unfair dismissal laws. This policy response is however inadequate. On the one hand, it discriminates in a purely arbitrary manner between SMEs that employ more or less than 100 employees, a policy that typically results in firm size manipulations, reluctance to grow and other undesirable threshold effects (Boeri & Jimeno 2003; Garibaldi et al. 2003). On the other hand, the *Workchoice* reforms, which removed access to unfair dismissal laws for many SME employees, will reduce the incidence of claims lodged against SMEs. While this may appear to reduce SME exposure to the law, it will also in some cases be counterbalanced by increasing usage of common law. Howe et al. (2005) stress that "…there is the distinct possibility that in the absence of a statutory regime, the common law will evolve to meet modern workplace needs, with the emerging doctrine of mutual trust and confidence offering the vehicle for significant change. Yet, this development will proceed on a case-by-case basis, which will often mean significant uncertainty" (Howe et al. 2005: 199). Resolving termination disputes under common law is much more costly for both parties in terms of

dissipative transaction costs and in terms of damage award volatility. The incidence of unfair dismissal claims will probably decrease, but the degree of unpredictability may considerably increase.

Uncertainty has emerged as a huge issue for wrongful discharge litigation under common law in the United States. Gudel (1996) warns that: "In America, it is a given that disaffected employee and former employees will sue. Nothing can keep a company out of court. What matters is what happens when it gets there" (Gudel 1996: 484). Strikingly, Ewing et al. (1995) examine how the 1987 introduction of a 'good cause' discharge standard in a framework that previously severely constrained employees' legal avenues for contested discharge actually boosted employment in the US State of Montana.

By contrast, many dismissals in Australia go uncontested, perhaps because the AIRC-based system of settling disputes prior to and through arbitration has been perceived as detrimental or at least not very favourable to employees (Hagglund & Provis 2005; Chelliah & D'Netto 2006). An arbitration system that caps damage awards at 6 months wage (a limit rarely reached) and yields a 10 percent reinstatement rate would hardly rate as 'employee-friendly', despite a trend plaintiff success rate of about 50 percent. This is also true of AIRC-led conciliation processes. Hagglund and Provis (2005: 83) note: " [conciliation] settlement amounts are inadequate by Australian income standards, and for many aggrieved employees, do little more than cover the cost of hiring someone to represent them". The estimates presented in this article confirm both the findings of previous research and what one would expect from the constraints imposed by the legal provisions of *The Act.*

CONCLUDING REMARKS AND RESEARCH PROSPECTS

This article has shown that the AIRC model of dispute resolution, based on the *Workplace Relations Act 1996*, is relatively inexpensive to use for both parties, offers considerable flexibility to settle disputes in ways that are suitable to both employers and dismissed employees, and its observed outcomes do not appear to be particularly detrimental to small and medium business owners, to say the least. By capping the extent of compensation at a very low level and funnelling claims towards the conciliation and bargaining process, the model significantly reduces SME exposure to unfair dismissal litigation, as opposed to other frameworks inducing systematic use of common law. The low estimates of settlement and arbitration costs presented in this study directly support these observations. Yet, this is precisely the dispute intermediation system that has been removed for many dismissed employees of SMEs in Australia.

By removing recourse to conciliation and strategic bargaining over settlement pay and termination type, the new regime raises the stakes in dispute resolution. It is not clear that moving toward a 'firing at will' doctrine will help reduce overall SME exposure to adverse termination processes. Because this doctrine is evolutionary, it tends to both adapt and erode over time. There is an important and growing literature in the United States on excessive incidence and volatility of wrongful discharge disputes[14] due to a lack of regulation and *ad hoc* States' responses to issues of fairness and 'just cause'. The gains to Australian SMEs of swapping a relatively contained and favourable dispute resolution system for the vagaries of litigation under common law appear to rest critically on Australian employees' future use of

[14] e.g. (Gomes & Morgan 1992; Fisher 1994; Levine 1994; Bingham 1996; Gudel 1996; Chen & Kleiner 2002; Ewing et al. 2005)

common law and the way common law will respond and adapt in the absence of other arbitrating institutions.

There are various avenues to extend research in this area. The future propensity to use common law and its pros and cons in resolving termination disputes need be investigated to inform policy makers. Quantitative research into the measurement of stigma cost and how it varies with the overall socio-economic context would help us to test the exact role it plays in conciliation processes (Bemmels & Foley 1996; Ichino et al. 2003). We also need to know more about the incidence and cause of uncontested dismissals. If, as is suspected, these represent a large proportion of all disciplinary dismissals, we need to know why "Australians don't sue", what are the trends in that area, and whether the recent policy changes will alter this behaviour.

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