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Labor Law and Entrepreneurial Discovery

by
Charles W. Baird

The labor market is one of the most highly regulated markets in the United States. There are regulations that prescribe such things as minimum wages, maximum hours, workplace safety and health rules, and retirement and pension provisions. In addition there are procedural regulations that specify the allowable processes by which employees and employers interact with each other. The most important of these procedural regulations is the Labor Management Relations Act of 1947 as amended in 1959 (LMRA). This is the law that specifies the rules of "collective bargaining" and union representation in the private sector of the economy. The focus of this essay is on the effects of the LMRA on the crucial role of entrepreneurial discovery in the competitive market process. Specifically, I argue herein that the LMRA severely handicaps American workers' ability to compete effectively in the world market. It does so by drastically reducing innovation in American labor-management relations.

Entrepreneurs and Entrepreneurial Discovery

The central economic actor in the competitive market process is the entrepreneur. An entrepreneur is a person who is alert to hitherto unnoticed opportunities to make pure economic profit through arbitrage, speculation, and innovation.¹ In any economy the plans and actions of millions of people must somehow be coordinated or else those people (or at least many of them) will not be able to execute their plans. In a private property voluntary exchange economy entrepreneurial action is the chief coordinating force. In command economies authority and rules are used in (vain) pursuit of coordination.

Perfect coordination of economic plans and actions is a situation in which all buyers and all sellers can execute their respective plans. Perfect coordination is never achieved, but entrepreneurial action moves markets from situations of less coordination toward situations of more coordination.



Professor Charles W. Baird

Market discoordination shows up in several ways. One such way is the existence of price discrepancies for a given good at a given time. When more than one price exists for good X at a given time some buyers buy units of X at higher prices than those paid by other buyers of X. The reverse side of that coin is that some sellers sell for lower prices than other sellers receive. Some buyers, unaware of market conditions, offer prices that are too low and so do not get all of X they would like to get or may not get any at all. Some sellers, unaware of market conditions, ask prices that are too high, and so do not sell all they would like to sell or may not sell any at all.

Such price discrepancies give rise to opportunities for arbitrage profit. An entrepreneur is one who notices such opportunities and takes advantage of them by buying at the lower prices and reselling at the higher prices. It is the possibility of such pure gains that "switches on" the alertness of the entrepreneur to such opportunities. All the entrepreneur wants to accomplish thereby is to add to his own wealth; but there is another, unintended, result of successful entrepreneurial action. Success breeds imitation, so there is increased competition to buy at the lower prices

and to sell at the higher prices. The price discrepancies narrow, more accurate perceptions of actual market conditions are spread, more plans can be executed, and discoordination diminishes. Any government regulation that reduces the possibility of gaining and/or keeping such arbitrage profits dims entrepreneurial alertness to the states of discoordination that give rise to the profit opportunities. As a result more discoordination will exist and persist than otherwise would.

Opportunities for entrepreneurial profit also exist to be discovered when there is discoordination between market situations at different points in time. Present coffee consumption, for example, could continue unabated at existing prices even though next year's coffee crop has just been drastically reduced by some natural disaster that ruins most of the currently growing beans. An entrepreneur who first notices that the destruction of the currently growing crop implies much higher prices next year than this year can make speculative profits by buying up some of the currently harvested crop, holding it, and reselling it next period. Again such behavior by the more alert will inform the less alert of such possibilities, the actions of the more alert will be imitated, the prospective intertemporal price discrepancies will decrease, present coffee consumption will decrease, and prospective consumption of coffee next year will increase. The unintended result of the successful entrepreneurial action is to make the plans and actions of both buyers and sellers in the coffee market more consistent with actual market conditions than they otherwise would be. Again, it is the possibility of speculative profit that switches on the entrepreneurial alertness to such price discrepancies over time. Any restriction on the possibility for speculative profit will dim that alertness and thus lead to more discoordination than otherwise would exist.

In both of the kinds of discoordination thus far discussed successful entrepreneurial action depends on alertness to situations that exist now or will inevitably exist in the future which hitherto have been unnoticed. Arbitrage profit and speculative profit are gained by entrepreneurial discovery of what is. There is another kind of discoordination which also gives rise to the possibility of entrepreneurial profit—discoordination between what is and what could be. As Kirzner puts it, "Alertness must, importantly, embrace the awareness of the ways in which the human agent can, by imaginative, bold leaps of faith, and determination, in fact *create* the future for which his present acts are designed."² Here the entrepreneurial action that leads to more coordination than otherwise would exist is *innovation*. And, as before, it is the possibility of pure entrepreneurial profit that switches on the necessary alertness to what could be but is as yet unimagined by anyone. Any regulation that makes such innovation more difficult or more costly than it otherwise would be will diminish the

prospective profitability thereof and therefore decrease the amount of innovation that is actually undertaken.

Entrepreneurial discovery of opportunities for profit from arbitrage, speculation, and innovation is not the result of purposive search for knowledge, the need for which is already known. Such purposive search is often carried out by organized research teams and involves decisions based on the comparison of the anticipated costs and benefits of the search. Entrepreneurial discovery, on the other hand, involves knowledge the need for which and the usefulness of which is as yet unnoticed and unknown.³ Entrepreneurs, motivated by the prospect of profit to be tuned in to hitherto unnoticed opportunities, discover what others have overlooked, or ignored, or could not imagine. It is spontaneous discovery that cannot be duplicated by planned search, for all planned search involves an already perceived need. Successful planned search usually causes others to say, "It's about time." Successful entrepreneurial discovery usually causes others to say, "Why didn't I think of that?"

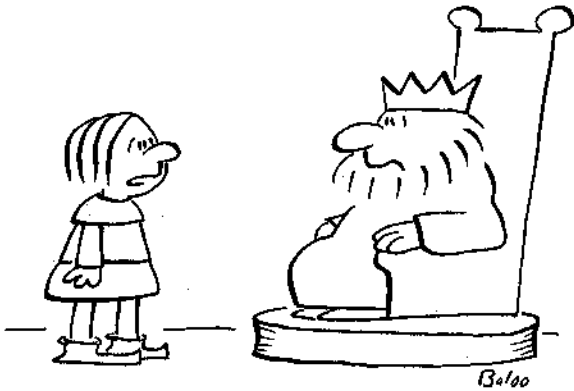
Government Regulation and Entrepreneurial Discovery

Government regulation adversely affects entrepreneurial discovery in four ways. Israel Kirzner labels these effects undiscovered discovery, unstimulated discovery, stifled discovery, and wholly superfluous discovery.⁴

First, government regulation is often undertaken to correct some perceived failure of the private market. In the absence of such regulation, if there were a genuine problem that could be corrected, entrepreneurs would be alert to discover novel and profitable ways of dealing with it. There is a strong tendency for entrepreneurs to discover existing efficient solutions and imagine innovations that make efficient solutions possible in the future. Government regulations imposed as solutions to the perceived problem tend to keep that which is as yet undiscovered permanently undiscovered.

Second, it is impossible for government functionaries to simulate the entrepreneurial discovery process because they cannot capture the profits that result from successful discovery and so will not be alert to such opportunities. Even a bureaucrat who is dedicated to the public interest is unlikely to discover that which is as yet undreamed of by anyone. The best a dedicated bureaucrat can do is engage in purposive search for that which he knows he doesn't know.

Third, government regulation often takes the form of restriction of particular market activities such as market entry by interlopers who may have new ideas about how to do things. A major vehicle for entrepreneurial discovery, in other words, is the freedom of newcomers to innovate. If



"It's worse than the Austrian Army, Sir -- The Austrian economists are invading!"

gains from innovation are foreclosed by blocked entry (government-granted monopoly) there will be less alertness to opportunities to innovate than there otherwise would be.

Finally, government regulation creates its own opportunities for profits from political competition. Alertness is diverted away from market competition and innovation toward political competition for special favors. General benefits through entrepreneurial discovery in the private market are sacrificed in favor of attempts to discover opportunities for political gains by organized interests who pursue narrow benefits for themselves at the expense of all others. The positive sum game of entrepreneurial discovery in the private market is gradually replaced by the zero sum game of entrepreneurial discovery in the political market.

The Labor Management Relations Act

This law was originally enacted in 1935, and it was then

the Wagner Act. The NLRA was amended in 1947 and renamed the LMRA or the Taft-Hartley Act. The LMRA was again amended in 1959, but those amendments in no way affected the features of the law that are of concern here. While the current law is often called the NLRA, its actual name is the LMRA, and that is the name I use in this essay.

There are three features of the LMRA that have particularly adverse effects on entrepreneurial discovery in the labor market: exclusive representation, union security, and the proscription of employer-sponsored unions.

Section 9(a) of the LMRA states that a union that is selected by a majority of employees of a firm in a union representation election shall be the exclusive bargaining agent for all the employees of that firm.⁵ The winning

union not only gets to represent those employees who freely choose such representation, it also gets to represent those employees who want to be represented by some other union as well as those employees who do not want to be represented by any union. The winning union gets to be a monopolist in the provision of representation services to the employees. Competition from other unions and from nonunion modes of representation is blocked by force of law. Those who argue in favor of this monopoly unionism do so by analogy with the principle of exclusive representation in Congress. The winning congressional candidate in a congressional district is the exclusive representative of all the citizens in that district, and that monopoly representative is picked by majority vote. If it is all right to do this in the case of Congress, these proponents of monopoly unionism argue, it is also proper to do so in the case of

Of course, this is an entirely inappropriate analogy because what is proper in the case of government, which by definition has a monopoly in the legal use of force, is not necessarily proper in the case of a private association of private people such as a labor union.

Section 8(a)3 of the LMRA empowers labor unions that are exclusive bargaining agents to agree with employers that all employees either must join the union thirty days after being hired (a union shop) or, in other cases, may refrain from joining the union but still must pay union dues (an agency shop). Not only must employees who do not want to be represented by the union acquiesce to such representation "services," where there is a union shop or an agency shop they must pay for what they don't want or be fired. Not only is the union granted a government protected monopoly, it is empowered to force people to pay for what it monopolistically provides no matter how poorly it performs. These two forms of union security are designed to protect the unions against dissatisfied employees who would otherwise withhold support from unions that perform poorly. One of the most important mechanisms of the competitive market process—escape from poor performance—is blocked. Those who argue in favor of such union security arrangements do so by claiming that since a union by law represents all the employees of a firm, all those employees gain from the representation. An employee who did not have to pay union dues would be a free rider—i.e., he would get union-generated benefits for free. Of course, these same proponents of union security are not willing to advocate that the law be changed so that a union would represent only those employees who want such representation. If the law were changed in that way there could be no free riders.

Section 8(a)2 of the LMRA forbids employers to be involved in the "formation or administration" of any labor union or to contribute either financial or nonfinancial support to any labor union. This feature of the law is ad-

dressed to the alleged role of company-sponsored unions in the years prior to the passage of the original Wagner Act. It was widely asserted that such "company unions" acted merely as fronts for the employer who would use them to exploit his workers. According to union folklore, company unions were formed merely to meet the requirements of Section 7(a) of the 1933 National Industrial Recovery Act so that the "real" unions, such as the American Federation of Labor, could be kept out. The truth of the matter is that most company-sponsored unions were formed in an effort by both employees and employers to discover effective modes of labor management relations. Many of them could reasonably be regarded as early forms of what today are called "quality circle" arrangements whereby employees participate in the formation of management decisions regarding production arrangements. Company unions stressed the fact that labor and management are complementary members of the production team. The independent unions, on the other hand, tried to sell the spurious idea that management and labor are natural enemies. The massive recognition strikes of 1933-1935 were, by and large, not strikes by a majority of employees of the involved firms. More often than not an outside union got a few employees of a firm to go on strike and then the union would send in "flying squadrons" of nonemployees to act as pickets and to intimidate the majority of the employees, members of company unions, who wanted to continue to work.⁶ The role of company unions was nicely stated by Judge John P. Nields in his decision in the 1934 *Wierton Steel* case which involved a fight between a *Wierton*-sponsored and an independent union:

It is said that this relation (between management and workers) involves the problem of an economic balance of the power of labor against the power of capital. The theory of a balance of power is based upon the assumption of an inevitable and necessary diversity of interest. This is the traditional old-world theory. It is not the 20th century American theory of that relation as dependent upon mutual interest, understanding, and goodwill. The modern theory is embodied in the *Wierton* plan of employee organization.⁷

The LMRA and Entrepreneurial Discovery

It is no secret that many basic industries in the United States such as autos and steel are in trouble. They are unable to compete effectively with foreign producers, notably the Japanese, and so they are declining. In response to this decline both management and unions have appealed to the federal government for protection against foreign competition and for taxpayer subsidies. I contend that it is no accident that the industries that are most imperiled by competition from the Japanese are precisely those industries that are most heavily unionized according to the strictures of the LMRA. The principles of exclusive representa-

tion and union security together with the proscription of alternative forms of unionism involving active employer participation have blocked the discovery of superior forms of labor management relations that would have permitted these industries better to adapt to changing market conditions.

Because of the principle of exclusive representation there cannot be active competition between two or more labor unions at the same firm at the same time. Neither can there be competition between union and nonunion providers of representation services. Individuals cannot even represent themselves. Protected by its government-granted monopoly, an exclusive bargaining agent has less incentive than it otherwise would have to be alert to possible innovations which would benefit both managers and workers by lowering costs and thereby allowing the firm to be a better competitor. Indeed, the exclusive bargaining agent has little incentive to improve its own services to employees. It does not have to fear that dissatisfied employees will seek representation services elsewhere or decide to represent themselves. The only way individual employees can escape from union abuse is to organize a majority in favor of undertaking a lengthy and costly decertification procedure which is purposefully structured to make success difficult. If more than one union were permitted to function at the same time, and if individual employees always had the ability immediately to opt out of the services provided by an unsatisfactory union, every union would have a keen incentive to remain alert to opportunities to improve its services to employees.

The principle of union security makes it even easier for exclusive bargaining agents to survive without being alert to opportunities to discover how better to serve the common interests of employees and employers. If employees cannot even withdraw financial support from union officers who perform unsatisfactorily, those officers can tune their alertness to ways to better serve themselves rather than their members. Protected by forced union dues they are free to undertake what, from the point of view of employees and employers, are wholly superfluous discovery processes. A symptom of this is the current enthusiasm of labor union leaders for laws enforcing the spurious doctrine called "comparable worth." If such laws were passed wages would no longer be determined by collective bargaining; they would be determined by political wage boards. Apparently union officers now think they are better at political manipulation than collective bargaining.⁸

The proscription of employer involvement in labor unions cuts off an obvious avenue of entrepreneurial discovery in labor relations. Since workers and the owners of capital are complementary participants in production it seems likely that if workers and management were free

explicitly to cooperate in experimenting with alternatives to the existing structure of unionism, significant innovations would be discovered and implemented. The Japanese model of labor-management relations is often held up as the one we ought to emulate. That model is squarely based on employer participation in labor unions. It is striking to realize that the infamous company unions of the 1930s could have evolved into labor management institutions similar to those so highly regarded and recommended today. If it hadn't been for the adoption of the LMRA they might have done just that. Or some altogether different and superior forms of unionism might have emerged. The tragedy is that we can never know what might have been discovered in the absence of these government-imposed blocks to entrepreneurial discovery. All we know is that we are the victims of undiscovered discovery.

Deregulation is in style. It has been undertaken in various degrees in several industries such as airlines, banking, trucking, and telecommunications. It is time to add the labor relations industry to that list. Only by deregulation of the labor market can the benefits of entrepreneurial discovery be realized. The only way we can discover what we don't know about improving unionism is to set up the necessary conditions for that discovery process to occur. Deregulation is the most necessary of all those necessary conditions.

Footnotes

1. Israel M. Kirzner, "Uncertainty, Discovery, and Human Action," in Israel M. Kirzner, ed., *Method, Process, and Austrian Economics*, (Lexington, MA: D. C. Heath and Co., 1982), Chapter 12.
2. *Ibid.*, p. 150, emphasis in the original.
3. Israel M. Kirzner, *The Perils of Regulation: A Market-Process Approach*, (Lexington, MA: D. C. Heath and Co., 1982), Chapter 12.
4. *Ibid.*, pp. 13-19.
5. For a thorough description and discussion of each of the major features of the LMRA see Charles W. Baird, *Opportunity or Privilege: Labor Legislation in America*, (Bowling Green, OH: Social Philosophy and Policy Center, Bowling Green State University, 1984).
6. *Ibid.*, pp. 42-44.
7. *Ibid.*, p. 43.
8. See Charles W. Baird, "Comparable Worth: The Labor Theory of Value and Worse," *Government Union Review*, forthcoming.

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"Rational Expectations" Offers Nothing That's Both New and True

by
Roger W. Garrison

When John Maynard Keynes' *General Theory* was published in 1936, it ignited a revolution in the teaching of economic theory and the prescription of economic policy. But Ludwig von Mises was not inclined to abandon the then-emerging Austrian theory of the business cycle and join the revolution. Instead, he reminded the profession of some Old Economic Truths, and he demonstrated that Keynes' "revolutionary ideas" were nothing but crankish and shop-worn inflationist schemes cloaked in new economic jargon. Henry Hazlitt, who based his own critique of Keynes on the teachings of Mises, concluded that there was not a single proposition in the *General Theory* that is both new and true.

Today, Mises would be amused if he could witness the newest revolution in economics. The New Classicists, with their notion of "rational expectations," may create as much of a stir in the closing decades of the twentieth century as Keynes created in the middle decades. But Hazlitt's assessment of Keynesianism applies equally well to the New Classicism: They have nothing to offer that is both new and true.

There is a kernel of truth in their mathematical description of the reactions of market participants to the policy moves of government. But this truth is Old Truth. Adam Smith explained over 200 years ago that the "man of system" (Smith's term for the economic planner), failed to realize that market participants would act in ways that tended to conform to their own individual plans rather than those of the central planner:

~~[The man of system] seems to imagine that he can~~ arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board; he does not consider that the different pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislator might choose to impress upon it.

—from the *Theory of Moral Sentiments*

In the 1953 edition of *Theory of Money and Credit*, Mises, in effect, made use of this insight to explain the fallacy in the Keynesian policy of inflationary finance. At the same time his explanation anticipated by decades the insights that have been newly discovered by the New Classicists:

Let us leave the problem of whether or not it is advisable to base a system of government finance upon the intentional deception of the immense majority of the citizenry. It is enough to stress the point that such a policy of deceit is self-defeating. Here the famous dictum of Lincoln holds true: You can't fool all the people all the time. Eventually the masses come to understand the schemes of their rulers. Then the cleverly concocted plans of inflation collapse. Whatever complaint government economists may have said, inflation is not a monetary policy that can be considered as an alternative to sound-money policy. It is at best a temporary makeshift. The main problem of an inflationary policy is how to stop it before the masses have seen through their rulers' artifices. It is a display of considerable naivete to recommend openly a monetary system that can work only if its essential features are ignored by the public.

These are the Old Truths that lie at the heart of the New Classicists' web of equations which incorporate the interplay between government policy and market activity.

For sure, the New Classicism involves something more than the insights of Smith and Mises. But the new ideas of New Classicism turn out to be untrue ideas. Formally, their equations stretch Lincoln's dictum to the point of claiming: You can't fool any of the people any of the time. This idea is pushed to such an extreme that some of the most basic principles of economics are contradicted. F. A. Hayek, one of Mises' most renowned students, identified the price system as a "communications network": Prices communicate essential information about consumer demands, resource availabilities, and profit opportunities. And both Mises and Hayek saw as one of the market's virtues the fact that it could serve its function without the market participants having any theoretical understanding of its principles. They also saw as one of the market's vulnerabilities the fact that monetary manipulation could falsify price signals; it could "jam" the "communications network" causing the discoordination of economic activity and the misallocation of resources on an economy-wide basis.

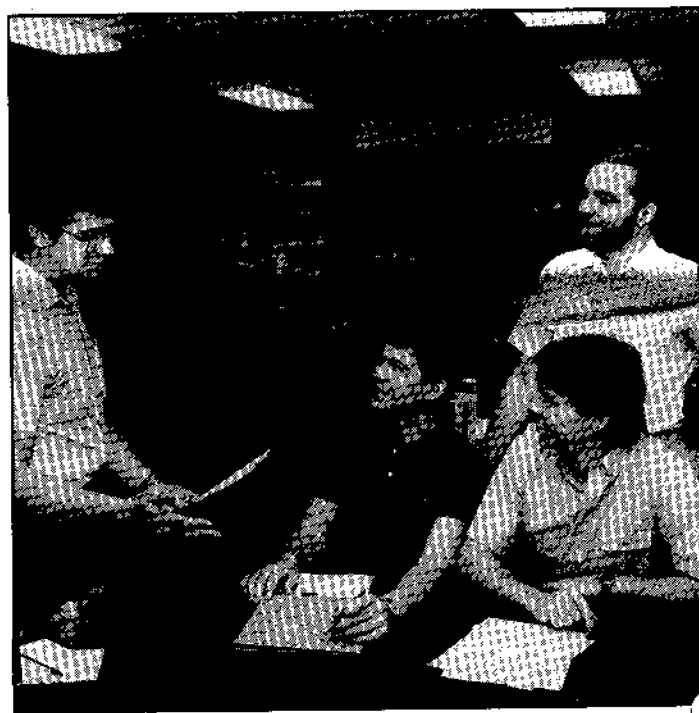
These important ideas have no place in the New Classicism. The "rationality" imbedded in "rational expectations" requires the market participant to know—or to act "as if" he knows—how the economy works, to anticipate government policy moves, and to anticipate their specific effects upon the economy. The "rational" market participant has information—or acts "as if" he has information—about consumer demands and resource availabilities independent of the prices that convey this information. This is the information, in fact, that allows the market participant to sort out "real" price movements from the effects of monetary disturbances and thus to avoid being misled by a

monetary stimulant. In this view, the "rationality" of market participants translates directly into a "rational" allocation of the economy's resources. A boom-bust cycle anticipated is boom-bust cycle avoided, and the fully anticipated price inflation, which is the only effect of the attempted monetary stimulant, is perfectly harmless.

If the rational-expectations view were correct, the New Classicism would have raised more troublesome questions than it seeks to answer. How do the market participants acquire their information independent of the price system? If they actually have this information, what function does the price system serve? And how is it that the market participants understand the workings of the economy and the economy's response to various government policies when professional economists have been debating these unsettled questions for well over two centuries?

Dating from its beginnings in Vienna over a hundred years ago, the Austrian school has recognized the importance of "expectations" in any theory of economic activity. And market participants are always taken to be "rational" in the sense that they, in their own judgment, make the best use of the means available to them to achieve their chosen ends. But while Austrian economists today can applaud the on-going retreat from Keynesianism, they have little to learn from the "rational expectations" of the New Classicism.

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(left to right) Professor Roger W. Garrison and Mises Institute Fellows Mark Thornton, Sven Thommesen, and Don Boudreaux at the Institute offices on the Auburn campus.

any constraints on inflationary policies. So would loans by the International Monetary Fund to countries in balance-of-payments difficulties. Countries with relatively strong currencies would be required to subsidize those with weak ones. The provision of the IMF charter allowing uniform devaluation of currencies against gold also was ominous.

tracts denominated in it; he would expect gold to become a nongovernmental international money.

A reviewer is expected to assess a book, not just describe it. Hazlitt was prescient in seeing, from the beginning, the inflationary implications of the Bretton Woods system. In