5. Cartels in Labor Markets

Let us now turn to the labor market. To most people, any purported connection between labor and agricultural markets will be dismissed as fanciful. They don't seem to have very much in common. But initial appearances can mislead. First, the two are linked in Section 6 of the Clayton Act, which at the very least suggests that there was an alliance between labor and agricultural movements. Second, that connection is not confined to surface issues. A look at the historical pattern of regulation shows that the movement in labor markets has followed the course of that in agricultural markets. It is important to trace out the parallels.

Freedom of Contract in Labor Markets—Another Easy Case

Our initial question asks, what is the ideal regime with respect to labor contracts? The first point is to note that possible weaknesses of a consistent libertarian position on taxation, infrastructure, collective goods, and the like do not bear very strongly on labor markets. These are bilateral private arrangements that have little to do with the provision of collective goods. Twenty years ago, I wrote an article entitled "In Defense of the Contract at Will," which offered an explanation as to why employers and employees might rationally choose to adopt a form of labor contract that allowed one

side to quit and the other to fire at will, for good reason, bad reason, or no reason at all (Epstein, 1984). The point is that if parties choose this arrangement, then the state ought to second-guess that choice on the ground that it ought to supply workers with some greater measure of protection, which, while beneficial to some workers once a dispute arises, is disruptive to intelligent patterns of business behavior. The acid test is whether an at-will agreement, or indeed any other kind of agreement, gives the best reflection of the joint wishes of the parties. In the overwhelming run of cases, the answer is a resounding yes.

To make this point, my 1984 paper reviewed the standard attack on contract at will: the arrangement had to be inefficient because it allowed for arbitrary and capricious behavior by management unrelated to the needs of the firm, owing to the inequality of bargaining power between the parties. The argument has an inexhaustible appeal for it has been used to justify all sorts of regulation in labor markets, including regulations relating to minimum wages, maximum hours, and employer discrimination. It has also been used to justify labor statutes such as the U.S. National Labor Relations Act. But the argument fails for one decisive reason. It is not plausible to think that just about every employee so misunderstands his interests that he enters into transactions that leave him worse off than before or that do not reflect the value of his production to the firm. Here, as in so many other areas, free entry on the other side of the market affords the most powerful and consistent defense against arbitrary market power. Of course, there is little doubt that someone could point to the exercise of the power to fire that reflects the pettiness and incompetence of management, just as some decisions to quit are borne of jealousy and ill-temper. But the task here is not to examine under a microscope the aberrant behavior of employers and

employees in a few carefully selected individual cases. In a world of millions of transactions, it is always possible to fasten onto the subset of foolish and resentful decisions, which will, it must be remembered, arise under any legal regime. Rather, the task is to find out what set of institutional arrangements will, from the ex-ante perspective, produce the best set of results in the long run. Here the initial presumption that should hold in the absence of harmful subsidies or externalities is that common patterns of behavior persist because they advance the interests of *all* parties to them. Customary practices between ordinary individuals will self-correct if they are inefficient, and the pervasive use of contracts at will at every salary level and in every occupation is strong evidence of the efficiency of the arrangement relative to its next-best alternative. The one serious matter is to identify the source of those gains.

One obvious place is in the administrative costs, both public and private, of running this contractual system. These costs are low because neither side can force the other to continue with the relationship or pay some unspecified damages associated with the breach. In some instances, under a system of freedom of contract, either by custom and practice or by contract, an employer may supply severance pay upon dismissal to give the worker some protection against dislocation. But this financial payment will be calculated by some simple formula. It will not allow courts to impose huge amounts of "consequential damages" for emotional distress and economic dislocation. It involves none of the detailed exploration of the ups and downs of a relationship in the elusive effort to determine whether the dismissal was "for cause."

Another great advantage of the at-will system is that it supplies an informal method of bonding that keeps both sides in line. The employer who tries to take advantage of the

employee by altering working conditions for the worse will be met by the threat to quit, because now the deal is worth less to the employee than the wage received. So long as markets are competitive, the switching costs will be relatively low, lower in fact than they are in a highly regulated world where employers have to think twice before taking on a worker whom they may be unable to fire if things do not work out. Yet on the other side, the employee who takes it easy on the job is faced with dismissal because he is no longer worth his wages. But even here, management will hesitate to dismiss for good reasons. One is the very substantial costs of recruiting and training a replacement who might or might not turn out to be better than the worker who was dismissed. The second is that unjust dismissals could induce other workers to leave while the going is good, thereby compounding the problem of recruitment and retention. (One sign of a well-managed firm is when departing workers are willing, even anxious, to help hire and train their replacements.) The pressures in any competitive market are always intense on both sides, such that the constant monitoring of each places a powerful check against the advantage-taking by the other. Over time, as a relationship emerges, the two parties may well develop some level of trust for each other, which reduces the monitoring costs and allows them to make informal adjustments to preserve their relationship, adjustments that are far more difficult to make in any regulated environment. The at-will regime, which is precarious as a matter of law, often proves quite durable in practice. But where this contract falls short—as when one party has to perform first before the other must perform at all—then some new provision can be introduced to handle the defect. Thus, a salesperson who is paid on commission cannot be fired with impunity after the account is landed but before the commission is paid. The at-will contract

is a viable option, but it is not an obligation. Parties who want periodic or term contracts are free to enter into them.

A full regime of contract requires more than an intelligent law of employment contracts. The second critical piece to any common-law scheme of labor relationships must forthrightly address how competitors and unions must deal with workers under contract with other employees. The usual and correct rule is that any employee who works only under a contract at will is fair game for a rival employer who wishes to bid up his wages. The only way in which an employer can obtain insulation from that competition is to lock in a particular worker under a long-term contract, such that the effort to lure him away becomes a form of "tampering," a tort or civil wrong that goes under the name of inducement of breach (as opposed to termination) of contract. At this point, the employer with a long-term deal has a property right of sorts in the employment contract for its duration, which is protected only against those rival employers who seek to lure away an employee during term *with notice* of the contract arrangement. When that illegal inducement takes place, the current employer has, in addition to a breach-of-contract remedy against his wayward employee, the right to obtain an injunction and damages against the third party, even if he cannot obtain a decree that requires the worker to return to work. To give the famous English example from the 1850s, the worthy Lumley entered into an engagement with the famous opera singer Johanna Wagner for several engagements for the London season. The nefarious Gye came along to bid her away. The court enjoined Wagner from working for Gye, even though it could not compel her to sing for Lumley. The point of the decision was to aver that competition is fine until people enter into specific engagements, but once they do, that person is protected from rivals. All in all, this system strikes

a nice balance between the need for stability in labor relations and the need for competition in labor markets.

The Development of Cartels in Labor Markets

There are, of course, many refinements to the basic pattern that absorb the attention of the professional lawyer. But in line with our theme on the importance of getting the easy cases right, I shall pass by those variations. The central question for our purposes is determining how robust this common-law system is in the face of relentless efforts to cartelize labor markets. These efforts did not start with the large trade unions of the last half of the nineteenth century, but they were much in evidence in the effort of independent contractors (in contrast to employees) to organize guilds under state franchises and charters that would restrict output and raise rates for their members. Often these disputes translated into efforts by the organization to stop the activities of individual members who wished to undercut standard rates. But the rise of mass-production industries demonstrated anew the proposition previously noted about agricultural markets—namely, that those markets that are amenable to competition are equally amenable to cartelization. Now that large numbers of workers are hired to perform similar jobs in the close proximity of the plant floor, the costs of organization are relatively low when set against the anticipated gain. Here again, the fundamental challenge for the labor movement is to find ways to organize its member workers while keeping out new firms seeking entry under the cartel umbrella.

Let's go through some of the steps in the process. First, there is the question of organization itself. Can the labor union find ways to spur the coordinated activities of its members in order to raise wages above the competitive levels? If

so, the question then arises as to whether these kinds of activities should be regarded as contracts in restraint of trade, which expose union organizers and members to private suits for damages, public law enforcement, or both. The late-nineteenth and early-twentieth centuries saw a halting effort to apply the laws of conspiracy and combination against unions and their members. After all, what is the difference to third parties if the increase in the price of goods and services derives from employee, as opposed to employer, efforts to maintain cartels? By the mid-nineteenth century, it became tolerably clear in both England and the United States that the legislatures and courts were reluctant to carry this program to its successful conclusion (see, e.g., *Commonwealth v. Hunt*), but there are some notable exceptions. In the famous Danbury Hatters case (*Loewe v. Lawler*), a union engaged in national secondary boycotts of the products of firms that refused to be unionized was held liable in a treble-damage action under the Sherman Act, which resulted in personal judgments being levied against its individual members (*Lawler v. Loewe*).

The antitrust laws were only one possible source of counterpressure to unionization. On the private side, of equal importance in this period in the United States was the so-called yellow dog contract (anyone who works for the employer outside the union was described as a coward or a yellow dog). This contract stipulated that an employee who agreed to work for the firm had to give that firm his undivided loyalty, so that he could not at the same time be a member of the union, either openly or in secret. These labor contracts were often on an at-will basis, so why, it may be asked, would the employer seek the additional stipulation from a worker who could be fired on the spot once his dual allegiances were discovered? The answer to this question lies in the issue of coordinated worker behavior. Large groups of

organized workers have the power to shut down a mine in an instant by a concerted walkout of the sort that would count as an illegal collective refusal to deal under the antitrust laws. But rather than pursue multiple and costly remedies against this group of workers, the yellow dog contract allowed the firm to bring a single action against any union for inducement of breach of contract before the collective action struck. Injunctive relief against the outsider was a powerful antidote to unionization, but it left the workers the option, if conditions got too bad, to quit the firm and join the union. The English courts were prepared to extend the tort of inducement of breach of contract to the labor situation, and the U.S. courts followed suit. In its defense of standard common-law principles, the U.S. Supreme Court, during this period, took two strong steps to preserve this common-law regime. First, at the constitutional level, it struck down, both at the federal and the state level, efforts to impose regimes of mandatory collective bargaining on firms as a limitation of freedom of contract (see *Adair v. United States* [1908]; *Coppage v. Kansas* [1915]). Second, it held that the tort of inducement of breach of contract applied to employees and unions in the same fashion that it did to opera singers and impresarios: an injunction could be obtained against a union so that it could not engage in covert organizing activities (*Hitchman Coal & Coke Co. v. Mitchell* [1917]). The impressive generalization makes perfectly good sense as a matter of general theory because in both these divergent settings the point of the legal system is to develop a set of institutions that favors and preserves competition in both capital and labor markets. These three cases, which have been commonly and fiercely denounced, should be understood as procompetitive and not as antiunion.

Cartelization and the Political Process in the United Kingdom

The political forces against this procompetitive trend, however, surfaced almost immediately, and manifested themselves in different ways in the United Kingdom and the United States. In the United Kingdom, the decisive movement was the passage of the Trade Disputes Act of 1906, which contained the following key provisions. First, it insulated trade unions, as opposed to their members, from liability for tort. In so doing, it suspended the usual rules of vicarious liability that hold a firm liable for the wrongs of its employees, so long as those wrongs arise out of and in the course of their employment. The effect of this provision was to immunize unions from liability even in the case of an authorized strike. Second, the act made the actions of individual persons done pursuant to an agreement or combination actionable only to the extent that they would have been actionable without such agreement or combination. The point of this somewhat obscure position was to say that the individuals could be responsible for acts of force and violence, which are wrongs when done individually. But they could not be held responsible for any collective refusal to deal or secondary boycott, for in these cases there is no underlying act of force or fraud whose consequences are magnified by collective action. The net effect of this provision was, of course, to remove the antitrust restraint on union conduct that fell short of the use of force. And finally, the act abolished in the context of labor disputes the torts of inducement of breach of contract and other torts relating to interference of trade more generally (as by force between potential trading partners). It also eliminated torts that interfered "with the right of some other person to dispose of his capital or his labor as he wills." The net

effect of these provisions was to withdraw the legal infrastructure that was intended to secure long-term market competition. And just to finish matters off, the instability of markets was further increased by a generalized practice that denied legal enforcement to any labor contract. The long history of tortuous British labor relations was fostered by this legal regime, which had the continued backing of the Labor Party. The economic dislocations that this system inflicts are surely great, even if most difficult to calculate.

Cartelization and Its Implications in the United States

In the United States, the traditional legal order held on a bit longer, given the Supreme Court's defense of the yellow dog contract. But alongside those judicial developments, the political forces of the "progressive" era were pushing hard in the opposite direction to create labor exemptions from the complexity of contract and tort rules needed to secure competitive labor markets.

The first stage of the counterattack was found in the Clayton Act, which exempted all labor organizations from the scope of the antitrust laws on the ground that labor should not be treated as a commodity or an article of commerce. This provision paralleled the British Trade Disputes Act and left labor free to organize for its own self-protection. There is, in this context, an instructive disconnect between the stated rationale contained in the Clayton Act and its particular legislative consequence. The normal consequence of stating that something is not a commodity or article of commerce is to treat it as a *res extra commercium*, or an item that is beyond commerce. That rule would apply to sacred objects, such as gravesites and national monuments, and carries with it the

consequence that they cannot be sold or mortgaged. But clearly no one in the labor movement wanted a rule that prohibited the sale of labor through ordinary employment contracts. What they wanted, and what they were able to get, was an exemption from the requirements of ordinary competition law. They also wanted, and were able to obtain, a general rule that prevented the use of injunctive relief in the course of a labor dispute, from Section 20 of the same statute. The effect of all of this was to undermine the classical legal synthesis as it applied to labor relations.

Yet this system, for all its advantages, did not allow, in and of itself, for the effective cartelization of labor markets because it offered no effective restraint on entry by other firms. Here there were a number of tactics used in manufacturing that were not available in agricultural contexts. One of these was picketing or patrolling, which is an institution devilish to regulate even under the best of circumstances. On the one hand, pickets could be regarded as individuals who supply information to the world about the practices of the employers whom they targeted and thus are protected under any regime that prizes freedom of speech, including the First Amendment to the U.S. Constitution. But by the same token, it is easy to see how speech can become hopelessly entwined with threats, or implied threats, to use force, which is unacceptable under a classical liberal order. Beefy workers standing in mass by a plant gate could use force against the entrants, and just that fear could keep people away from the gates. What makes the matter more difficult is that picketing could also be viewed as a collective effort to obtain a refusal to deal, which carries with it strong antitrust-type implications, especially when used to organize primary and secondary boycotts. But even with all these difficulties, there is no question that picketing is one part of a comprehensive strategy to reduce

entry by rivals that could otherwise prosper under the higher wage umbrella set by union negotiations.

In and of itself, picketing is probably not enough to switch the balance of advantage in labor disputes, for some people could easily treat it as a sign that the picketed firm offers lower prices than those that have the union blessing. In addition, picketing may fail to achieve its stated goals, even when it resorts to illegal activities, because it is expensive to maintain and may not prove effective against rivals who may spring up at multiple sites. So here, as with the agricultural movement, it is possible to add new elements to the mix. For the most part, this was not done in the British Labour movement, but it was done in the American one. The first element of the game was to withdraw the prospect of easy injunctive relief against labor unions, which was done in part by the Clayton Act and, much more systematically, under the Norris-La-Guardia Act of 1932, which also declared the yellow dog contract to be against public policy. In addition, in 1935, the U.S. system adopted the National Labor Relations Act. Importantly, this act instituted a complicated administrative law system that allowed the majority of workers in an appropriate bargaining unit to designate a union as its exclusive bargaining agent. It also established a set of statutory "unfair labor practices" for employers who interfered with union affairs, discriminated against union members, or refused to bargain with the union representatives.

The effect of this system was to abandon the competitive labor market with rapid movements across firms. The intellectual mindset behind both these statutes is easily observed from their statements of public policy. The Norris-LaGuardia Act treats as its public policy the assumption that the "unorganized worker is commonly helpless to exercise actual liberty of contract and to protect his freedom of labor" (29 U.S.C.

§102). The National Labor Relations Act, for its part, starts on the assumption of "[t]he inequality of bargaining power between employees who do not possess full freedom of association or actual liberty of contract" (29 U.S.C. §151). There is a certain irony in both these provisions because of their ostensible acceptance of the ideal of freedom of contract, which is said to be neither "actual" nor "full" for unorganized workers. The new implicit norm for a full and fair contract is the ability to exert monopoly power and the correlative duty of the firm to bargain with workers who have opted by election for the collective bargaining solution. But the principle here is not capable of systematic generalization. The employer, in all cases, has no ability to refuse to deal, but must negotiate in good faith, without having to make any particular concessions to union demands. The system, therefore, creates a bilateral monopoly situation that is calculated to impose high transaction costs on unions and management alike. The law of good-faith bargaining has itself generated an immense amount of complex litigation as to the topics that must be addressed and the pattern of bargaining that must be followed. The firm, for example, that makes a take-it-or-leave-it offer runs the serious risk of being hit with a charge of "unfair labor practices" under the act.

It is important to understand the major inversion of legal rules that is required by the adoption of this scheme. The most obvious change is in the law of contract, for it is no longer possible for an employer to walk away from a transaction. There is now a duty to deal that makes the standard industrial firm resemble a common carrier—with, of course, obvious differences, because there is no rate schedule typical of regulated industries. But once there is a duty to deal, the traditional rules of property have to give way as well. Employees have a right to engage in organizing efforts that take

advantage of the employer's property, at least to the extent that it is not done on the work floor or during working hours. The rules on speech become special as well. While the general American tradition calls for free and robust debate, labor law has its own tradition of speech in which the unilateral promise of benefits or threats amounts to unfair labor practices. These rules create immense difficulties in their application, but it would be a mistake to indicate that they have left employers utterly without resources on their own behalf, for the ceaseless debate over labor legislation before the National Labor Relations Board, and in the courts, has not allowed the union movement to run roughshod over a determined management opposition. But our concern here is not with the question of partisan advantage but with that of social loss. While it is easy to imagine worse paths that U.S. labor law could have taken, I am hard-pressed to believe that this statute could produce any net social gain at all, let alone one that exceeds the extensive administrative costs of its own implementation. When one cuts through the endless details and complexities, what we see is the statutory codification of a preference for monopoly over competition—an easy case wrongly decided.

To understand the full picture, however, it is necessary to understand the limitations as well as the influence of the National Labor Relations Act. This labor statute may create a state monopoly for the individual firm that has been organized, but it does not stop new firms from springing up in competition with them. The issue for the labor movement, therefore, has been how to block these new forms of entry. One strategy is to support various forms of legislation that make it difficult for people outside the union to underbid those in it. That decisive step does not, of course, protect the workers who are thrown out of jobs because they are not

allowed to underbid their union rivals. The point here is to protect the union from competition by setting, for example, the statutory minimum wage above the competitive level that other workers could hope to earn but below that which unions could secure for their workers through collective bargaining. Maximum hour and workers' compensation require a somewhat more complex story, for here these statutes, although apparently neutral, were prepared in a fashion that had a disparate impact on the smaller nonunion firms, which had higher compliance costs than larger unionized establishments. In the United Kingdom, because Parliament was supreme, there was never a constitutional battle as to whether these statutes were consistent with either private property or freedom of contract. But in the United States, it is no accident that maximum hour and minimum wage laws were subject to important constitutional limitations under the older legal order (*Lochner v. New York* [1905]), which also looked with hostility on any system of collective bargaining. But these constitutional limitations were quickly undone under the New Deal (*West Coast Hotel v. Parrish* [1937]).

Questions of individual rights were, however, not the only issues implicated in the U.S. experience. The huge expansion of federal power under the commerce clause that I noted in connection with the agricultural cases was preceded five years earlier by an identical movement in labor cases. The earlier law did not allow for the national regulation of local manufacturing or agriculture (*United States v. E.C. Knight Co.* [1895]), and thus made it difficult for any state to impose a strong system of worker protection in the face of the exit threat. Earlier efforts to impose a national child labor statute had been rebuffed on the grounds that federal government could not assume control over local matters by refusing to allow goods made by firms that had used child labor in their

operations (not necessarily on the goods shipped) to be kept out of interstate commerce (*Hammer v. Dagenhart* [1917]). Local governments did not refuse to enact child labor statutes, but they sometimes allowed children to work at a lower age than any proposed national statute. But with the New Deal, the sharp change in attitude toward labor statutes carried over to matters of federal power. The lower courts all struck down the National Labor Relations Act as beyond the scope of Congress, but the Supreme Court broke with its earlier precedent and allowed the statute to take hold (*National Labor Relations Board v. Jones & Laughlin Steel Corp.* [1937]). The attitude that it was for the federal government to determine whether to support competition or monopoly became the dominant motif in both areas. In the end, the labor movement was able to achieve its two major goals: the ability to organize its own members and the ability to get state assistance in the exclusion of rivals.

Restraints on Union Power

The question is, what was gained by this powerful struggle? What is interesting from a comparative perspective is that the U.S. system, with all its legal requirements and administrative rigidities, probably proved more successful than the British, which withdrew legal protection from labor relations altogether. Within the British system, a determined union could exert enormous economic power without fear of disenfranchisement. Within the American system, a number of powerful factors have tended to blunt the effectiveness of unions. First, the original 1935 New Deal statute was subject to extensive revisions under the Taft-Hartley Act of 1947. That statute was passed in response to the rash of strikes and industrial unrest that followed World War II, and it tended to make the

path of unionization more difficult than it had previously been. A separate set of unfair labor practices directed toward unions were introduced into the statute, including a number that limited their power to engage in secondary boycotts. A widespread set of union corruption issues provoked further regulation under the Landrum-Griffin Act of 1959. The judicial interpretation of these statutes has not been markedly promanagement or prounion, so that the initial legislative compromises have, by and large, remained stable over the past fifty years.

In addition, the secular shift toward smaller firm units, which characterizes modern economies, has complicated the task of organizing workers. Most important, perhaps, the strong, if erratic, free-trade impulse has exposed unionized firms to global competition even in such industries as steel, where the ill-considered tariffs imposed by George W. Bush in 2001 represented a most regrettable error before it was reversed at the end of 2003. The increased foreign competition in such industries as automobiles has effectively taken the strike option off the table for the major U.S. producers because unions well understand that any strike for higher wages is likely to cause a major loss of market share or bankrupt the firm on whose success their own success depends. In general, I think that globalization is the most powerful force at work here. If individual firms within an industry do not sit on a secret cache of monopoly profits, there is little that a union can achieve, no matter how skillful its leadership or aggressive its bargaining strategy. The change in public sentiment toward free trade has had a very market-positive influence on the degree of labor power.