

Equality for the labour market: An appreciation of WH Hutt

Charles W Baird

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Foreword

The purpose of FMF *Monographs* is to use the analytic method of political economy to shed light on how best the promotion of free markets will improve the workings of the South African economy. In particular, authors are urged to apply the microeconomic approach of studying how individuals, firms and households behave in response to either naturally occurring or regulatory induced incentives. This requires that they display a sound, institutional knowledge and understanding of their theme. Where macroeconomic aggregates are introduced into the discussion, FMF authors analyse them from the market perspective, namely from the foundation stones of economics itself, supply and demand, the interactions of countless individuals with differing preferences and intentions. This approach also requires that authors pursue their analysis in a logical fashion to policy proposals unencumbered by preoccupations as to what is or is not politically practicable at any given time. They should not be tailored simply to gain the approval of pre-existing (but from a historical perspective transient and ephemeral) vested interests or political groupings.

The author of this *Monograph*, Charles Baird, writes within this framework. Baird is a labour economist with a strong training in micro theory and a lengthy professional interest in Austrian economics. He sees markets as dynamic processes. His subject matter – the writings of the University of Cape Town scholar William Hutt on trade unions – could not be a more appropriate topic for his attention. Nor would it be easy to find a more relevant topic for end-of-century South Africa.

Successful trade unions, according to conventional wisdom, mean that workers will no longer be “unorganised and exploited”. Successful trade union activity counters “low wages” which in turn “translate into low labour productivity”. Successful trade union activity provides workers with “voice regulation” or “participation in public policy making”. Each of these is strongly argued for by the NIEP¹ (National Institute for Economic Policy), a body with close links to the African National Congress.

Dr Baird, drawing on the writings of South Africa’s most influential labour economist, Professor Hutt, disagrees with each of these propositions. Exploitation of one input (labour) by another (capital) can occur in two ways – it depends whether the inputs are complements or substitutes. If they are complements (capital and labour need each other in the production process), the only way exploitation can occur is if employers shut in workers to a low wage. But how can employers *deny* alternative job opportunities to their workers? If they offer less than workers are willing to accept, workers can offer their services to other employers. The likelihood of all employers forming a cartel and agreeing not to bid against each other is low – and even if it occurred, like any cartel, the chances of it succeeding are even slimmer. Some entrepreneur will soon notice the opportunity to hire “exploited” under-priced labour.

If the inputs are substitutes, the only way for capital to exploit labour is to shut-it-out. But shutting-out is just as difficult as shutting-in. There is no way (without government intervention) a business person can employ capital at the expense of labour, causing wages to fall, and then prevent other profit-seeking entrepreneurs from hiring the lower-priced labour (at the expense of capital).

These arguments are not only persuasive in making the case against “exploitation”, they also counter the view that trade unions improve both wage levels and productivity. It is because entrepreneurial activity occurs that exploitation fails. It is because entrepreneurial activity occurs that labour (and all other resources) are shifted – or “displaced by economising” in Hutt’s words – from where they are less valued to where are more valued by all consumers. As a consequence of these shifts, total economic welfare is increased and labour’s rewards rise simultaneously. Entrepreneurship has a productivity-enhancing effect in all markets including the labour market.

Certainly for labour (or capital) to be “displaced by economising” can be uncomfortable in the short run even if it is wealth-enhancing in the longer term. Here Professor Baird does not refute the conventional wisdom that trade unions provide political power. He simply disapproves of how that

power is exercised. Like Hutt, he argues for “consumer sovereignty” not worker, capitalist, landowner or technocratic rule. Since consumer sovereignty makes all of us better off (an assertion supported theoretically and empirically), and trade union political power makes everyone (including non-unionised workers) poorer, it is not difficult to understand Baird’s stance.

Some readers might find it less easy to agree with Professor Baird’s critique of Hutt’s views on the right to strike. Baird is essentially a contractarian, and argues that unless a contract exists to the contrary, and provided strikers do not prevent other workers accepting job offers they themselves refuse (i.e. do not prevent voluntary exchange), then strikes should not be proscribed. That is all very well, but the existence of an employment relationship is itself a tacit contract. Certainly there should be a right to terminate contract. But if Baird’s view that labour markets are no different from any other market is correct, then it is difficult to see how he can argue for a temporary suspension of contract pending renegotiation. Hutt may not merit Baird’s disagreement on this issue.

Baird writes as an academic expert. His views are not those of the FMF (which has no corporate view), nor of its Council Members or Directors. But his knowledge of Hutt’s work is profound. The influence Hutt has had on labour and union legislation in both the USA and the UK over the last twenty years make Baird’s current analysis particularly relevant for South Africa in the 1990s. As such the FMF believes this is an important contribution to the debate on how to avoid abuse of power in the labour market.

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1 National Institute for Economic Policy (1996) *From the RDP to GEAR: The Gradual Embracing of Neo Liberalism in Economic Policy*, Johannesburg, pg.20

The author

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Professor Baird is a contributing editor of *The Freeman*, published by the Foundation for Economic Education, Irvington-on-Hudson, NY. He is also on the editorial boards of three other academic journals and is affiliated with both the Heritage Foundation and the CATO Institute in Washington, DC.

Professor Baird has published four textbooks, four public policy monographs, and over sixty articles in the professional journals and in magazines. His research speciality is in the law and economics of labour relations. He has also written topics including environmentalism, the economics of politics, the tax system, and the Austrian school.

Acknowledgement

I thank my colleague, James Ahiakpor, for several useful criticisms of an early draft of this paper, but exonerate him from any blame for remaining faults.

Charles W Baird

1

Introduction

Throughout his entire professional life, W. H. Hutt attacked conventional wisdom. In his first professional article (Hutt, 1926), he defended the British factory system of the early nineteenth century against the muckraking attacks of socialists, journalists and politicians. According to Hutt, that system did not exploit workers, it gradually liberated them from the “abject poverty” to which the working classes had long been consigned. Moreover, he continued, the legislation passed by Parliament supposedly to ameliorate the excesses of the system, were actually passed at the behest of elite interests whose status was threatened by the entrepreneurship driving the factory system. As we would say today, the British Factory Acts were egregious examples of rent-seeking at the expense of the general welfare.

Hutt’s first major publication was *The Theory of Collective Bargaining* (1930). Here he began his life-long quest to obtain analytical equality for the labour market. His principal theme was that the labour market is just like any other market. Economists ought not, as they were then and still are wont to do, treat labour differently from, say, apples or cars. While it is appropriate for economists to study the economics of labour, the economics of apples and the economics of cars, the economic way of thinking should be applied rigorously in every case. He had nothing but scorn for most “labour economists” who, in his mind, were simply apologists for coercive, predatory labour cartels called trade unions. The 2nd edition of *The Theory of Collective Bargaining*, which consisted of the original 1930 text plus a new chapter to update the analysis, was published in 1975 by the Institute for Economic Affairs. In 1980 the Cato Institute reissued the 2nd edition with a foreword written by the present author.¹

Hutt’s most extensive work on unionism was *The Strike-Threat System* (1973), in which he extended the arguments of *The Theory of Collective Bargaining* and completely destroyed the myth that trade unions have benefited labour as a class at the expense of capitalists as a class. To the contrary, Hutt argued, unions have made workers in general worse off than they otherwise would be, and, along the way, have hurt consumers and impaired the flow of national income. To promote the *general* welfare, rather than the particular interests of professional union leaders and academics that live off the strike-threat system, it is necessary, Hutt says, to abolish unionism as we know it.

Apart from the conclusions of his analyses, Hutt’s antipathy toward labour unions can be traced back at least to the influence of his father, who was a working class compositor. In an interview of Hutt by Morgan Reynolds for the *Journal of Labour Research* (reprinted in Reynolds, 1986), he asserted that his father thought “that the unions were tyrannical.” He continued, “My father had to accept that he must join the union or the firm would certainly dismiss him; he had to support a union movement that he did not believe in ” (Reynolds, 1986, p. 21). According to Hutt’s former student, Brian Kantor, professor of economics at the University of Cape Town, South Africa, where Hutt taught from 1928 to 1965, another source of this antipathy was the role of racist, white trade unions in putting down blacks in South Africa.² For example, in 1922 the white trade unions undertook a long, violent, bitter strike which the press labeled a “Red Revolt.” The slogan most frequently used by the strikers was “Workers of the world fight and unite for a white South Africa” (Williams, 1989, pp. 56-58).

My theme and plan

My task in this paper is to explicate Hutt’s analyses of unionism in *The Theory of Collective Bargaining* (TCB) and *The Strike Threat System* (STS). To do this I will first explain the connection between the two books, and then I will discuss the three pillars of Hutt’s economic way of thinking – Austrian market process theory, the nature of voluntary exchange, and Say’s law of markets. Although Hutt was not a strict adherent of the Austrian school of economics, the best way

to understand his work is in the context of the Austrian analysis of the entrepreneurial market process, as first spelled out by Mises (1949) and then greatly elaborated by Kirzner (1973, 1979, 1985 and 1989). Say's law of markets, which is nothing other than a logical implication of the process of voluntary exchange, was always in the back of Hutt's mind. He referred to it frequently in both books. In fact, the year after he published STS he published a book trying to show that, notwithstanding the conventional wisdom that Keynes had refuted it, Say's law is vital to a proper understanding of the market process (Hutt, 1974). Next, I will show how Hutt weaves these tools together into what I call his labour market process theory. Then I will discuss four additional interesting points in the two books that are not part of Hutt's market process theory but which are important in their own right. In both books Hutt was very critical of the ways that famous early economists – e.g., Adam Smith, John Stuart Mill and Alfred Marshall – treated labour. He took all three, and several others, to task for treating labour as a special case, not subject to regular economic analysis. In the penultimate section I will report what Hutt had to say about those three on this issue to demonstrate his frustration with economists over labour issues. My colleague, James Ahiakpor, who specialises in the history of economic theory, argues that Hutt was not fair in his criticisms of the three because, notwithstanding the passages quoted by Hutt, whole chapters of their works demonstrate that they did apply standard analysis to labour. I will not address the fairness issue here. That is a subject for another paper. In conclusion, I will express my views on the future of labour economics and Hutt's role therein.

The relationship between the two books

Hutt was nothing if he wasn't consistent. In his mind the two books are parts of one analysis. When he wrote TCB in 1930, he hoped that it would be sufficient to get his fellow economists to take a hard look at what labour economics had become – an autonomous, *ad hoc* body of logical contradictions and propositions based on sentimentality – and set about the task of reconstructing the field into a legitimate economics of labour. In the event, the book was almost totally ignored. Perhaps one reason for this was that it was written in South Africa. Few economists in the northern hemisphere paid any attention to anything done outside Europe and the United States. Whatever the reason, by 1971 Hutt resolved to try again by writing a more extensive book, STS, on the same subject. Of course, by then the fallacies of conventional labour economics were much more deeply ingrained, and labour economists were even more resistant to Hutt's message. In 1975, when the 2nd edition of TCB was published, he added a new chapter most of which was a brief summary of the main points in STS that were not covered in the first edition of TCB. Still, most labour economists ignored his arguments.

Hutt's mind on the relationship of the two books is best stated in his own words:

In 1930 I published a small book entitled, *The Theory of Collective Bargaining* This early contribution of mine argued that, while the power to strike can redistribute income in favor of the members of particular unions, it cannot redistribute income in favor of labour in general at the expense of capital in general. Despite so clear a thesis, it has yet to be successfully refuted. Yet if the argument is valid, its importance for the contemporary world can scarcely be exaggerated.

The present work [STS] advances a wholly new exposition in which the same conclusion is reached via a somewhat different route. Its purpose is to analyse the nature, distributive consequences, policy implications and ethical significance of the strike-threat in modern societies. During this analysis, it examines typical arguments which are used by 'labour economists', to justify notions of the kind that I challenged in 1930...

I expected that the obvious challenge of my book [TCB] would prompt a major contribution, from economists better qualified than myself, to deal with the questions I

raised. During my entire academic life I have been expecting an authoritative book. But although there have been many splendid contributions ... they have had hardly any policy impact. ... [Here he acknowledges contributions from such people as Mises, Hayek, Machlup, Friedman and Alchian.] ... Yet these economists have not succeeded in making their convictions on the strike-threat issue influential. They have failed, particularly, to win the sympathy even of those of their academic colleagues whose minds are not closed (which, unfortunately, I often think today is a small proportion).

It seems almost arrogant of me to attempt to achieve what I feel economists of such eminence have failed to achieve. Yet try I must. I speak to those who do not refuse 'dialogue' (STS, pp. vii-viii).

Conventional wisdom among economists and laymen concerning trade unionism is still tragically misinformed. It may be arrogant of me, but I hope my exposition of Hutt's ideas will make them better known.

2

Market process theory

Austrian market process analysis begins with one axiom and two observations. The action axiom (Mises, 1949) states that every person tries to make the best of every situation he confronts. This does not mean that all agents try to maximise wealth, for what is “best” in the mind of one person may be very different from what is best in the mind of another. The axiom merely says that people, to the best of their abilities, apply means at their disposal to achieve ends they value.

The first observation is that human action – the purposeful application of means in pursuit of ends – takes place in an environment of scarcity. There are insufficient means for any person to achieve all the ends he seeks.

The second observation is that the knowledge necessary to have all individuals make mutually consistent production and exchange plans and successfully carry them out “exists nowhere in its entirety” (Hayek, 1945). Rather, there is a natural division of such knowledge. No one knows the tastes and preferences and the productive and exchange abilities and limitations of all economic agents in an economy. That knowledge is broken into small bits and pieces and widely dispersed among those agents. Each one knows most about himself and perhaps a little about a few others. Moreover, much of the knowledge is subjective and it is frequently changing. If we define a successful economy as one in which there is at least a rough coordination of the production and exchange plans and actions of all economic agents, central planning and regulation must fail. The planners and regulators must make their decisions in ignorance of most of the relevant knowledge.

The only way that a coordination of economic activities can be achieved is by the competitive market process which generates input and output prices that reflect actual scarcity values in the economy. Briefly, each person makes his production and exchange plans on the basis of bid and ask prices he expects to encounter when he bargains with others. A bid price is the price a buyer offers to pay to acquire something, and an ask price is the price at which a seller offers to sell. If a seller expects to encounter high (low) bids, he will plan to supply more (less) than otherwise. If a buyer expects to encounter high (low) asks, he will plan to buy less (more) than otherwise. People discover actual bid and ask prices when they attempt to carry out their production and exchange plans. An overly optimistic buyer, who expected to find low asks, will, when he discovers his error, decrease his planned purchases. An overly optimistic seller, who expected to encounter high bids, will, when he discovers his error, decrease his planned sales. Overly pessimistic buyers and sellers, if they have chosen to enter the market at all, will also have their price expectations falsified and will change their plans accordingly. If their pessimism keeps them out of the market altogether, they will not have their expectations falsified directly, but alert entrepreneurs (discussed below) will coordinate their plans with market realities. At the same time that agents alter their production and exchange plans in response to actual bid and ask prices they discover in the market, they will adjust their own bid and ask prices according to what seems in their best interest.

Equilibrium bid and ask prices are not given to anyone. They are discovered in the market process (Hayek, 1978; Kirzner, 1979, Chapter 2) as agents, by trial and error, seek out the best terms of trade they can. In disequilibrium, some buyers will be buying for higher prices than other buyers have discovered. Some sellers will be selling for lower prices than other sellers have successfully asked. Either the agents themselves, or, more importantly, entrepreneurs, will notice these price discrepancies and attempt to gain from them by buying low and selling high. This, through arbitrage, will push prices of inputs and outputs closer and closer to their equilibrium values. Equilibrium is achieved, if ever, when expected and actual bid and ask prices correspond in each case. Equilibrium prices are those which cause all economic agents to make mutually consistent plans and carry out mutually consistent activities. Equilibrium prices of inputs and outputs are the “natural scarcity values” of those inputs and outputs (Hutt, 1973, Chapter 7).

In Austrian market process theory a market for a particular product or service is divided into two sub-markets – the input market and the output market. In each, there are sellers and buyers. Sellers in an input market are resource owners – people who own non-human capital (capitalists), people who own land, and people who own labour. Land consists of all gifts of nature – natural resources and unimproved real estate. Labour is the services that human beings perform as they use their mental and physical abilities (their human capital). Each worker, from janitors to CEOs, owns himself and therefore owns his own labour. Non-human capital goods – which consist of plant & equipment and tools – are, originally, the result of mixing of labour with gifts of nature. Subsequent capital goods are produced by mixing land, labour and the services of earlier capital goods. Resources – land, labour and capital – are those things which are physically necessary for production. They are the inputs in neoclassical production functions.

Buyers in an input market are entrepreneurs. While a capitalist, a worker or a landowner can *also* be an entrepreneur, a pure entrepreneur is not a resource owner. Entrepreneurship in the Austrian sense is not a factor of production. It is not physically necessary for production (as an engineering input). However, before any engineer can put a production function into action there must first have been the entrepreneurial insight that would be worthwhile to do so. The role of a pure entrepreneur is to be alert to, and to grasp, what he thinks are profit opportunities. He is the profit-seeking, loss avoiding residual claimant. A pure entrepreneur has no “how-to” knowledge. That knowledge is part of the labour he assembles from resource owners. A pure entrepreneur’s knowledge (“insight” is a better word) is that it would be worthwhile (profitable, in terms defined by the entrepreneur) to get something done. The actual doing of it is accomplished by the resources assembled.

Unlike the factors of production in neoclassical production functions, alertness cannot be increased or decreased by hiring more or less of it. Alertness is the motivated propensity to notice profit opportunities. Either an entrepreneur notices such an opportunity, or he does not. If an entrepreneur hired out his alertness to someone else he would be contradicting himself. If he really notices opportunities that others miss, why doesn’t he grab them for himself rather than allow his employer to be the residual claimant? If he doesn’t realise the significance of what he notices, he really isn’t the entrepreneur; the person who hires him is.

There are three types of entrepreneurial activities – arbitrage, speculation, and innovation. Arbitrage is the attempt to make profit from two or more prices existing for the same thing at the same time. Speculation is the attempt to make profit from intertemporal price discrepancies. Innovation is the attempt to make profit from a new product, a new production technique, a new deployment of resources, a new marketing strategy, etc.

As I suggested above, a resource owner can also be an entrepreneur. Henry Ford was a capitalist who also noticed that it would be profitable to assemble land and labour (from others) as well as capital (from himself as well as others) to undertake mass production of the Model T. As the entrepreneur, he was the residual claimant in the enterprise. He got to keep what was left over after all the bills had been paid, including the bills he owed to himself. The capitalists, including himself, who made capital available for the enterprise, were contractual claimants. They received contractual interest and their opportunity costs in the form of sacrificed (normal) dividends and capital gains from investing elsewhere. The workers were also contractual claimants. They received the wages and salaries they and the entrepreneur agreed to in their employment contracts. Land owners were also contractual claimants. They were paid the rents and fees they and the entrepreneur agreed to in their hiring contracts.

The founders of Apple Computer, Steve Jobs and Steve Wozniak, were entrepreneurs as well as workers. They assembled their own labour services, as well as the labour services of others, along with capital and land from others. As entrepreneurs they had a contractual claim contract with themselves equal to their labour opportunity costs, and they had contractual claim contracts with capitalists and land owners. They were the residual claimants on the other side of those contractual claim contracts.

Consider the pessimistic buyers and sellers discussed above. Their pessimism could keep them out of the market altogether, so they will not discover their errors by noticing bid and ask prices of other people. But there is a profit opportunity, through arbitrage, for an entrepreneur who notices the errors. When an entrepreneur recognises that buyers are bidding more than pessimistic sellers expected was possible, he can act as a middleman and buy at a price that pleases the pessimistic seller and then sell at a price that pleases a pessimistic buyer. So long as the difference between his buy price and his sell price is greater than his transaction costs, all three parties will be better off, and the market is nudged toward coordination.

When an entrepreneur assembles, by voluntary exchange contract, all the resources, *including time*, necessary to produce a new product, the sum of the input prices due to resource owners is the price of the product in its inchoate form. The entrepreneur's vision of the highest price that he can successfully ask buyers of the product to pay is a different price of the same product (remember, we are including in resources *all* the resources necessary, including time). If the imagined final product price is greater than the sum of the prices of all the necessary resources there is, in the entrepreneur's mind, a profit opportunity. If the entrepreneur is right he will make profit; if he is wrong he will incur losses. The entrepreneur, as residual claimant, is the risk bearer. If he cannot meet his contractual obligations, he goes bankrupt.

The key operational insight of Austrian market process theory is that every case of discoordination of plans (or disequilibrium) contains *profit opportunities* for entrepreneurs who are alert enough to observe the spot or intertemporal price discrepancies, or the discrepancies between the current way of doing things and an imagined better way of doing the same things or imagined better things. If the entrepreneurship is successful (i.e., profitable), it will be imitated by entrepreneurs who were not alert enough to be first to notice the profit opportunities but are alert enough to mimic success. As the process of imitation proceeds, the price discrepancies will narrow, and/or the innovations will spread. If the initial entrepreneurship is unsuccessful (i.e., it results in losses), it will not be imitated. The entrepreneurial activities that resulted in losses will be shunned. This is how situations of disequilibrium are resolved. This is how problems are solved. This is how progress is made. This is the source of economic growth and improving standards of living. What is discovered to work will be adopted, what is discovered not to work will be discarded. This process effectively copes with the natural division of knowledge, because all the relevant knowledge is brought to bear in the process. Every person uses his own knowledge, perceptions and dreams to the best of his ability, to pursue his own ends. The diverse plans and actions of countless people are coordinated by countless price signals that emerge from this competitive discovery procedure.

An example

An example of this process in action, taken, with some elaboration, from STS (p. 15), is helpful. Suppose that some workers are being under-paid in their current employment. That is, the workers are paid less than they could be paid (net of the costs of relocation) if they worked for another employer who is seeking to hire the sort of labour these workers provide. Even if the workers themselves are totally unaware of the alternative employment alternative, it would be profitable for an employer who notices the price discrepancy to bid these workers away from their current employment. If the alternative employer doesn't notice the price discrepancy, it would be profitable for a middleman to notice it and offer the workers more than they are currently getting but less than the middleman charges the alternative employer. (This is just an entrepreneur, acting in his own interest, helping overly pessimistic buyers and sellers as discussed above.) In a system of voluntary exchange, the workers won't relocate unless they perceive they will gain by doing so, the alternative employer won't hire the workers unless the amount he has to pay (either directly or to a middleman) is less than the amount that he considers to be his break-even cost for the workers, and the middleman won't arrange the transaction unless he perceives that the difference between what he pays the workers and what the employer pays him is more than his cost of providing the service. Successful entrepreneurship on the first round will alert other entrepreneurs to the existence of under-priced labour, competition for that labour will intensify, payments to workers will increase,

middlemen will be squeezed out, and employers will eventually have to pay each worker almost exactly the revenue (net of any other incremental costs saved) an employer would lose if any one worker quit.

A neoclassical economist would say that each worker would, in the limit (Austrians don't find this concept very helpful), be paid his marginal revenue product. There was disequilibrium – under-priced labour. Therefore, there was misallocated labour. Scarce labour was not deployed to its most highly valued use. This disequilibrium created a profit opportunity for anyone who noticed it, whether the alternative employer, a middleman, or even the under-priced workers themselves. Mutually profitable voluntary exchanges were made, and the disequilibrium was gradually whittled away.

Some normative observations

Austrian market process theory regards the entrepreneur as the creator of value. Normatively, entrepreneurs deserve any residue above the costs they have contracted to pay, because it is their entrepreneurial insight that makes all value-creation possible (Kirzner, 1989). Before any production function can be put in operation in any enterprise, the idea that it would be worthwhile to do so had to occur to the entrepreneur. Entrepreneurial insight is the original creative act. Entrepreneurs need resources to create value, but they acquire resources to carry out the process of value-creation. Resource owners, as resource owners, merely hire out their resources to entrepreneurs by voluntary exchange contracts. Once assembled by such contracts, the resources (in the case of purchase of capital goods and land), or their use (in the case of hire of capital goods, land and labour), belong to the entrepreneur. The only just claim that resource owners can have against the enterprise are those stipulated in their hiring contracts. It is true that, in equilibrium, as a result of the competitive market process, resources owners will come to be paid the marginal revenue products of their resources. But the normative case for distributive justice in Austrian theory rests on the voluntary exchange nature of the hiring contracts, not on equilibrium marginal productivity theory.

Note that in the example above the word “exploitation” does not appear. If “exploitation” means that person A harms person B in order to further his own interests, there is no place in the example above where the word could appropriately be applied. Hutt defined exploitation as follows:

I define “exploitation” as any action taken, whether or not through discernible private coercion (collusion) or governmental coercion, which reduces the value of the property or income of another person, or prevents that value from rising as rapidly as it otherwise would, unless this effect is brought about through: (a) dissolving some privilege; or (b) substituting some cheaper method ... of achieving any objective; or (c) expressing a change in consumers' preference; or (d) democratically authorised taxation (STS, p. 3).

“Coercion” implies involuntary exchange. (Hutt is willing to overlook the coercion of taxes, providing they are for legitimate government purposes.) Dissolving privilege, substituting less costly for more costly production techniques, and responding to consumer preferences are all part of the competitive market process. An entrepreneur can reduce the value of the property or the income of less alert agents by offering better deals to the people who do business with the less alert. This is not involuntary exchange, it is competition. In short, A exploits B when A engages B in any kind of involuntary exchange.

Specifically, when an employer B pays a worker less than the full value of the worker's labour to B, but more than what that worker could receive from his next best employment alternative, that is not exploitation unless B somehow prevents the worker from seeking better paid employment opportunities and accepting them when they are discovered. In fact, even if B paid the worker less than what he could get in his next best employment, it would not be exploitation unless B somehow prevented the worker from discovering or accepting that alternative. Hutt calls this

captive worker case “shut-in” labour (STS, Chapter 7) and opines that it is next to impossible for an employer to do this, especially when, with the automobile, most labour is very mobile.

The criteria for voluntary exchange

Voluntary exchange contracts meet four criteria (Baird, 1995):

- a) *Entitlement*. All parties to the contract must either own that which they offer to exchange, or they must be acting as the authorised agent of the owner(s). In employment contracts, workers own their labour and entrepreneurs own the job (in the sense that they have created the job and have bought or hired the complementary resources needed to carry it out). Workers and entrepreneurs are free to hire or not hire agents to represent them in the labour market.
- b) *Consent*. All parties to the contract must agree to (i) enter into the contracting relationship – i.e., to bargain with each other – and (ii) the terms at which any actual exchange takes place – i.e., the final outcome of the bargaining. No forced bargaining can result in a voluntary exchange contract.
- c) *Escape*. All negotiating parties must be able to turn down any offers they do not like and walk away from the bargaining process without losing anything to which they are entitled. There is no requirement that bargaining continue until a satisfactory deal is made or that either side must make concessions.
- d) *No misrepresentation*. No party to the contracting may defraud any other parties. That is, no one can tell a lie. This leaves room for honest error. I can make any claim that I believe to be true when I make it, even if it turns out later to be incorrect.

Moreover, no misrepresentation does not require the parties to tell all they know. It merely proscribes any person saying something he knows to be false. This must be so because if it were not there could never be any successful entrepreneurship. An entrepreneur makes profit by assembling resources for a total cost that is less than what he thinks he will receive from customers when they buy the finished product. If he were morally or legally obliged to tell the resource owners the full value of their resources as he sees it, he could never make a profit. But if entrepreneurs could not make profit they would have no reason to be alert to situations of discoordination that need to be corrected. Their hope for profit, and their knowledge that if successful they may keep their profits, is what causes entrepreneurs to be entrepreneurial. Without entrepreneurship, the whole market process would shut down. We would be at the mercy of central planners and regulators who, even if they were benevolent and well-intentioned, could not possibly know enough to coordinate any one market, much less all markets together.

Say's Law of Markets

In the process of voluntary exchange, goods and services are produced so that they may be used by their producers to obtain non-competing goods and services that are produced by others. The people who produce cars do so to sell them to car buyers. The revenue they receive from car buyers, less the amounts paid to buy intermediate goods and services from other producers, becomes wages and salaries, rents, interest and profit. All are incomes received by someone. The recipients of those income flows then spend them on non-competing goods and services, like food, computers and entertainment. In other words, the production of cars is the source of demand for non-competing goods and services. Production of one thing gives rise to incomes which are then used to demand other things. Put another way, supplying one thing *is* demanding other things. Say's law was misleadingly stated by Keynes as “supply creates its own demand,” implying that the supply of computers automatically gives rise to an equal demand for computers. Jean Baptiste Say never said anything like that. He merely observed that the act of supplying A is also the act of demanding goods and services other than A which aren't, in buyers' mind, substitutes for (in competition with) A. In Hutt's words, “the *source of demand* for any particular input or output produced is the flow of inputs and outputs of all the things which do not compete with it; for some part of that flow is destined to be exchanged for it ” (Hutt, 1974, pp. 5-6). In general, production *is* the source of demands.

Although production gives rise to the ability to demand the things that are produced, there can be discoordination between the supply and demand for particular goods and services. It is the job of the market process to generate prices of inputs and outputs such that the quantity supplied by some people equals the quantity demanded by other people for every good and service. Mismatches that persist, that are not corrected by the competitive market process, are due to failures of pricing, which according to Hutt, are always the result of the private or governmental use of coercive force. For example, when a labour union is able to sustain above market wage rates for some workers it can do so only by preventing other workers from adding their services to production flows. The union “shuts-out” competing labour. This contracts the flow of production of real goods and services, which diminishes the sources of demands for other, non-competing, goods and services, and thus diminishes the wages flow in particular, and the incomes flow in general. When the shut-out workers and other entrepreneurs discover each other and enter into hiring contracts, new production will add to the source of demands, but it will be lower-valued production, and thus it will not add as much to the source of demands as the shutting-out took away from the source of demands. The highest valued employment of the shut-out workers is in the production from which they are excluded. They would have accepted employment there at the market rate because that was the best wage offer available to them. However, the union displaced them into lower wage jobs where their labour services added less to the source of real demands.

3

Hutt's labour market process theory

Hutt clearly recognised the centrality of entrepreneurship in the labour market process:

The most vital economic decisions are 'entrepreneurial' decisions: They are made within an institutional framework of custom, law and knowledge.... These decisions which are being continuously made, are in every case concerned with retaining, replacing, accumulating, or decumulating the physical resources employed in various possible combinations, in certain specific activities, together with the retraining, recruiting or displacing of labour in accordance with this process. Now, the use of capital equipment, materials and labour in any activity will not occur unless some entrepreneurial remuneration is deemed possible for every increment of resources invested in that activity (STS, pp. 3-4).

He also recognised the importance of alertness and uncertainty to entrepreneurship:

[I]t is realistic to regard entrepreneurs as *continuously vigilant* ... in their efforts to observe and interpret the facts about current changes in the composition of consumer preferences and the availability of different kinds of means for their satisfaction. These facts, which are the data of business prediction, are frequently in the form of probabilities. They are used to determine both the prospective profitable prices for outputs and the costs which it is prospectively profitable to incur (STS, p. 127, emphasis added).

Like Kirzner, he thought of entrepreneurship as the ultimate source of all productivity. In a section entitled "'Labour productivity' is often a misnomer," in the second edition of TCB, he wrote:

Excluding managerial ingenuity and acumen, it is doubtful whether human skills relevant to the goods and services which contribute to the well-being of mankind have improved one iota since the beginning of the industrial age (TCB, p. 91).

Hutt categorised the economic agents in his labour market process theory in Chapter 15 of STS, where he discussed the impossibility of "bringing the categories and concepts which economists have found useful into close correspondence with the cruder categories and concepts with which the statistician must be content" (STS, p. 218). His concern here and in the next chapter was to explain the determinants of labour's absolute and relative shares of national income. Empirical studies done over many years, by many economists, many of whom would have dearly loved to demonstrate that unions have raised both labour's absolute and relative shares, uniformly have shown that labour's relative share has remained almost constant for the last 150 years or more. While labour's absolute income has increased, so too have the incomes of all economic agents, and there is no empirical proof that unions are responsible for any of it (Chapter 16).

Hutt agreed with "earlier economists" who classified 'agents of production' as 'land, labour, capital and enterprise'" (STS, p. 219). He used "enterprise" and "entrepreneurship" as synonyms. He then said that contemporary economists, in trying to measure returns to the various agents of production, put land together with capital and treat the return to enterprise as part of the return to capital. This is all right, he said, because "asset owners" (owners of land and capital) are usually the entrepreneurial risk bearers because, unlike workers, they are better able to diversify risks. He went on to say:

But properly visualised, entrepreneurial remuneration is neither remuneration of capital nor remuneration of labour. It may accrue to either (positively as profits or negatively as losses) according to which assumes the risk of the entrepreneurial decision turning out to have been wise or lucky (or unwise or unlucky). Those earlier economists showed real insight who classified entrepreneurship separately, as ‘enterprise,’ an agent of production distinct from the other three agents – land, labour, and capital. For the yield to ‘enterprise,’ namely ‘profit,’ is payment by results [the residual claim] for the most important function that is performed on behalf of the community – prediction and responsible action to determine the composition of the stock of assets and/or valuable skills. Through this function, entrepreneurs determine the form of economic activity (STS, p. 219).

It is the entrepreneur – whether capitalist, landowner or worker – who directs the deployment of resources in accordance with profit opportunities arising from perceived consumer demands. Kirzner would say that the entrepreneur is “alert” to those profit opportunities, but it is the same idea. Kirzner would also say that entrepreneurship cannot be an agent (factor) of production in the same sense as land, labour and capital are because it is impossible to hire more or less entrepreneurship. In this respect Hutt treated entrepreneurship like T. W. Schultz does (Schultz, 1975). Kirzner was very critical of Schultz on this point (Kirzner, 1985, Chapter 1), but it is not crucial for my thesis. What is important is that Hutt clearly saw the profit-seeking, loss avoiding activities of entrepreneurs as the spark plugs that make the market process work.

Moreover, his picture of the entrepreneur was very close to that of Kirzner. In the quote immediately above, Hutt tied residual claimancy to entrepreneurship. As we saw earlier in the “continuously vigilant” quote, Hutt appreciated the importance of alertness. Hutt also recognised the subjective nature of entrepreneurial expectations:

[T]he residual claimant must try to determine [discover] the market price of inputs and to offer or accept that price. In the case of his offer for labour, he will have an *interpretive discretion*, exactly as he will in charging output prices. But ... it will be just as much beyond his powers to influence the labour prices determined by the workers’ alternative employment opportunities as it will be for him to influence the prices it will be most profitable for him to charge in the market for outputs (STS, p. 14).

“Interpretive discretion” means that it is the entrepreneur’s subjective perceptions of those prices that will determine whether or not he thinks there is a profit opportunity. He has no control over what those prices will actually be, but he acts entirely on his own judgement.

Hutt understood that entrepreneurship is always a trial and error process of discovery, and he had a good grasp of decision-making in the (disequilibrium) market process.

In groping at profit maximisation and loss minimisation during the course of ordering different input-mixes of different magnitudes, entrepreneurs cannot avoid aiming at (however wide of the mark their achievement may fall) the point at which further increments of inputs of a particular kind will bring lower yields than could be obtained if the resources needed to produce those further increments were used in some other way. There is inevitably an element of hit and miss in their predictions; but if the contemplated output of a certain commodity at a provisionally envisaged price is 500, the sole reason why the figure is not 550 or 450 is that the responsible decision-maker guesses that 500 is more likely to be the most profitable... [J]udgements on such matters are under continuous or spasmodic revision (STS, pp. 129-130).

In response to the common assertion by unionists that increased labour costs can be passed forward onto consumers by higher prices without any loss of employment, Hutt showed that he understood the process of groping toward equilibrium prices:

It is true ... that there will often be a range of possible product prices which can be asked without demand for the output being felt likely to fall away *immediately*, or *entirely*, or *disastrously*. But the interpretive discretion so created does not alter the fact that there can be only one product price for management to fix which will ultimately *turn out to be* to the investors' maximum advantage. ... *[I]t is expected that judgement about what this price is ... will change over any 'budgetary' period*, as buying and selling markets are observed; and adjustments from time to time in prices and inputs, in the light of the observations, will tend to reduce but not eliminate the inevitable risks. Hence while 'entrepreneurs' discretion in pricing' remains, that word 'discretion' simply covers all the imponderables which have to be taken into account (STS, p. 160).

The economising-displacement process

Hutt called the feature of the labour market process that is responsible for continuous improvements in the standard of living of the working classes "the economising-displacement process."

The improving real income of the wage-earning and salaried classes has been the consequence of (a) what I shall be calling the 'economising-displacement' process, namely managerial, technological, and scientific ingenuities [innovations] which progressively displaced labour and assets [capital and land] from their existing employments, *thereby releasing effort and resources for providing additional – usually different – outputs*, and (b) thrift – *the net accumulation of output-yielding assets – resources which magnify the real yield to human effort* (STS, p. 19).

It is this process, not unionism, that accounts for labour's growing absolute level of income. In fact, the economising-displacement process has overcome "union-caused impoverishment"

The offsetting factor to union-caused impoverishment has been chiefly what I like to call 'the economising-displacement process'. Through this process, it has become possible to produce given outputs with fewer workers (the labour-economising case) or with assets of reduced real value (the capital-economising case). Costs of production and marketing have been drastically reduced for the common advantage. Indeed, ever since the invention of the wheel, 'the economising-displacement process' has been releasing labour and other assets for the production of additional objects In so displacing labour and cheapening assets in one activity, this process has been continuously raising the real value of labour in other activities generally, that is, raising the real wage rates at which 'full employment' of labour as a whole can be achieved, as well as raising prospective and realised yields to noncompeting investment (TCB, 1980, p. 92).

There was no long and bitter struggle, led by unionism, by which the labouring classes obtained decent standards of living. It was the result of profit seeking, loss-avoiding entrepreneurs effectively coping with scarcity by constantly being alert to how to do what is done with fewer resources so the released resources could be deployed to producing outputs that hitherto could not be produced. This added to the sources of real demands and higher wages. The role of unions was to impede this wealth-creating, wage-enhancing process.

A pattern prediction

Hayek said that while economics is incapable of making useful quantitative predictions, it is capable of producing pattern predictions (Hayek, 1952). Pattern predictions are qualitative. They describe the directions of relationships and the general characteristics of causes and effects. Because economic outcomes are the result of human action, and human action is driven by subjective, therefore unmeasurable, costs and benefits, economics, unlike the natural sciences, cannot quantify its predictions.

One pattern prediction that falls out of Hutt's economising-displacement process is that technological unemployment cannot be a long run problem. It cannot build up a reserve army of the unemployed. Why not? Because when some labour is made redundant by technological innovation, that idle labour becomes a profit opportunity for an entrepreneur who can figure out how profitably to re-employ it producing other things. We have confidence that this will happen because potential profits attract entrepreneurs like honey attracts bears. We count on self interest to make it happen.

Exploitation and the composition of capital

A crucial part of Hutt's labour market process theory concerns the effects of strike-threat coercion on the composition of the capital stock. First, it is quintessentially Austrian to recognise the heterogeneity of capital goods and the importance of changes in the capital structure. Neoclassical capital theory usually assumes a homogeneous capital good and investigates its equilibrium flow rate. Austrian capital theory is built on the recognition that there is a wide variety of capital goods, and different types of capital are appropriate for different kinds of production. The Austrian theory of the business cycle says that inflation causes distortions of relative prices, which, in turn, causes entrepreneurs to make erroneous investments (investments that are inconsistent with the actual pattern of consumer demand). When inflation ceases or becomes anticipated, the investment mistakes will be recognised, and the structure of capital goods will be corrected. This correction period is a recession, for the mistaken investments will have to be terminated and written off. In the second edition of TCB, Hutt added an interesting twist to Austrian cycle theory which I will discuss later.

Hutt's analysis of the effects of strike-threat on the composition of the stock of capital goods is based on his theory of exploitation which he first explained in the first edition of TCB and greatly elaborated in STS. I have already quoted Hutt's definition of exploitation. In my own words, A exploits B by imposing involuntary exchange on B in order to transfer income or wealth from B to A. Hutt asks whether it is possible for capitalists to exploit workers or for workers to exploit capitalists (STS, Chapter 7). Capital goods and labour are related in two ways. Most often they are complementary inputs. They need each other; they add to each other's productivity. Sometimes, as when a technological innovation allows computers to substitute for workers in carrying out certain tasks, capital goods and labour are substitutes. If they are complements, the only way that capitalists could exploit workers would be to shut-in those workers – i.e., somehow deny those workers any alternative employment opportunities. Similarly, if their inputs are complements, the only way that workers could exploit capitalists would be to shut-in their capital – i.e., somehow to deny those capitalists any alternative employments of their capital goods. On the other hand, if their inputs are substitutes, the only way that capitalists could exploit workers would be to shut-out the workers – i.e., somehow prevent entrepreneurs, who could use either capital or labour in production, from choosing labour over capital. Similarly, if their inputs are substitutes, the only way workers could exploit capitalists would be for workers to shut-out the capital – i.e., prevent entrepreneurs, who could use either capital or labour in production, from choosing capital over labour.

The general principle is that owners of substitute inputs can exploit each other only by shutting-out, and owners of complementary inputs can exploit each other by shutting-in. In the case of complementarity, does it seem likely that capital can shut-in labour? When workers have only one employer for whom they can work, the employer is called a monopsonist. In the nineteenth century there may have been some cases of local monopsonies. Labour, after all, was not very mobile. The transaction costs of relocation were very high. Information costs about alternative

employment opportunities were high. But even if all this were true, how could the monopsonist *deny* alternative employment opportunities to his workers. According to Hutt, cartels of employers who agreed not to poach each other's workers were very rare, and when they existed their monopsonistic power was eroded by prisoners' dilemma problems and by interloper entrepreneurs who were constantly alert to the possibility of under-priced labour (STS, Chapter 8; see also Fishback, 1992).

There is another way that capitalists could shut-in workers. They could get workers to invest in firm-specific skills – i.e., skills that have no value to other employers. To do this employers would have to trick workers into thinking the investment was worthwhile; and then, after the fact, refuse to pay the workers any more than the workers' best employment alternative would pay them. But employers who gain a reputation for such exploitation will not find any future victims. “[E]xploitation forecast is exploitation evaded” (STS, p. 5).

Could workers exploit capitalists by shutting-in capital? Yes. If investors invested in specific capital, “sunk in concrete,” not expecting that it would be subject to strike-threat coercion, and then the workers who worked with the capital unionised, they could extort confiscatory wage rates from the capitalists. The capital costs of specific capital, since there would be no alternative uses for it, would be sunk. The capitalists would have no recourse but to grant high wages. Most of what would otherwise have been realised as returns to capital could be confiscated by the union (STS, Chapter 10). But this, too, is subject to the “exploitation forecast is exploitation evaded” limitation. I will say more about this below.

When capital and labour are substitutes, could capital shut-out labour or labour shut-out capital? It is difficult to imagine how. When an entrepreneur adopts labour-saving managerial or technological innovations, that is not exploitation unless the displaced workers have extant hiring contracts that guarantee such substitutions will not be made during the life of the contract. Assuming no breach of contract, such a substitution would be part of the economising-displacement process by which new production would add to the sources of demands for non-competing production. The same has to be said for the adoption of capital-saving technological or managerial innovations. They are part of the continuous labour market competitive process which, over time, increases the wages and incomes flows.

Exploitation of capitalists by workers, or workers by capitalists, seems most likely when labour and capital are complementary inputs. And most of the time they are. Another pattern prediction of labour market process theory is that when labour and capital are substitutes, and when one of them is made redundant by the economising-displacement process, some entrepreneur will notice how it can be assembled into new, complementary relationships with other inputs for new production. In the end, all factors of production are assembled into complementary relationships with each other.

There are two possible cases of exploitation involving substitutes that I haven't yet mentioned – labour by labour, and capital by capital. While the latter is hard to imagine, if it does happen it would run afoul of the antitrust laws. The former is very easy to imagine, and it is immune to the antitrust laws. Union-free labour is obviously a substitute for unionised labour. And the *sine qua non* of unionism is shutting-out of union-free labour. The most important weapon in the union leader's arsenal is to use strike-threat duress and related methods like corporate campaigns to get above-market wage rates for unionised workers who continue to work. But at above-market wage rates there are many workers who would be eager to work for less than the union rate. To keep the union rate above the market, all competing labour must be shut-out. In other words, unions are cartels of sellers of labour services who take wages out of competition by agreeing among themselves not to work for less than the union rate; and, by intimidation with the support of government, they prevent other workers from under-bidding them. “Strike-threat gains are entirely, or almost entirely, at the expense of competing resources ‘shut-out’ and not at the expense of complementary resources ‘shut-in’” (STS, 96).

In sum, the two most likely forms of exploitation in the labour market are union labour exploiting union-free labour through shutting-out, and union labour exploiting investors in specific

capital that has no alternative uses. While the former can, and does, go on all the time, with explicit support from government, the latter cannot go on indefinitely. The reason is simple – “exploitation forecast is exploitation evaded.” Entrepreneurs who anticipate that unions will try to exploit their investments in fixed capital by strike-threat coercion will avoid investing their capital, or the capital that capitalists put in their charge, in exploitable forms. They will put their capital into less specific, and thus less wage-multiplying, but safer forms. These duress-imposed changes in the amounts, types and locations of capital goods will mean that production will be less efficient than it would have been if investors didn’t have to worry about strike-threat. This diminishes the sources of real demands and, therefore, the wages and incomes flows.

The effect of wage rates determined under labour union pressure is ... to distort society’s production structure, while it causes no redistribution whatsoever in favor of the poorer classes as such. The only income transfers that the use of strike power can effect are (1) in favor of those employed in one occupation at the expense of those in others, or (2) in favor of workers as such when entrepreneurs generally have failed to forecast the extent to which, as investors, they will be subjected to duress-imposed costs....

Through the consequences of the strike-threat system upon the composition of the assets-stock, and the nature of the outlets available, the flow of output as a whole and hence aggregate real income will be reduced. And, because *all* must admit that it is highly improbable that any *substantial* redistribution of the shrunken real income in favor of labour has ever been thereby effected, obviously *the system has all along been reducing the flow of real wages and the average of real wage rates* (STS, pp. 6-7).

Hutt’s version of Austrian business cycle theory

As I mentioned above, Austrian business cycle theory is based on the effects of inflation on the composition of the capital stock. The inflation causes false prices which, in turn, misdirects entrepreneurs into making erroneous investment decisions. When the inflation stops, or when it becomes anticipated, the errors are discovered and a period of correction of error begins. This correction period is a recession. In the second edition of TCB, Hutt discussed the effects of inflation on the deployment of labour as well as capital. He followed the Austrian story closely, but he added Say’s law and trade union considerations. He ended his discussion with a quote from Hayek. He told the story under the rubric, “*Unanticipated inflation can improve price-cost ratios in many sectors of the economy, but it attracts resources into kinds of production which cannot survive its cessation.*” He noted that the cause of a depression is a distorted pattern of prices, and he asked:

What would happen if, in depression, government did not frustrate the wages restoration process, or allow its private frustration by trade unions, but on the contrary encouraged it? The immediate consequence of cost reductions in any industry would be ... to increase the profitability of investment in capital and labour in that industry. But the *major* consequence would be indirect. Each repricing of labour, etc., for market clearance (which, *ceteris paribus*, would increase the supply of the corresponding output) would express an additional demand for whatever goods or services elsewhere in the economy the receivers of the additional income were destined to acquire. Through favorable reactions upon the ratios of costs to prices, inflation *can* extend the margins at which labour’s inputs and replacements or additions to the stock of assets (materials and equipment) are prospectively profitable

But the crudeness of the remedy creates such basic distortions in the pricing mechanism that *we must often blame the attempt to spend depression into prosperity for aggravating prospective and realised unemployment*. For the process leads to men finding kinds of occupation that will no longer remain profitable when the inflation

slows down or ceases. Inflation-induced investments, unless they happen to be in highly versatile assets, will turn out to have been wasteful as soon as inflation ceases to subsidise demand for their product. But workers and physical resources will then have become attached to kinds of economic activity which can no longer cover costs unless further inflation validates the raising of output prices. As Hayek has put it:

‘Inflation ... gives the whole structure of the economy a distorted, lopsided character which sooner or later makes a more extensive unemployment than that which the policy was intended to prevent. It does so by drawing more and more workers into kinds of jobs which depend on continuing or even accelerating inflation. And then ... every attempt to slow down inflation will at once lead to so much unemployment that the authorities will rapidly abandon it and resume inflation We have in fact been led into a frightful position. All politicians promise that they will stop inflation and preserve full employment. But they cannot do this.’

In this last sentence, Hayek is assuming that governments are not prepared to repeal minimum wage enactments or to take a stand against unions responsible for the repression of the flow of wages and income through strike-threat pressures (TCB, pp. 112-113).

Actually, in *his* last sentence Hutt put his own gloss on the Hayek passage. Hayek’s unemployment is due to the shutdown of plants because the investment in those plants is discovered not to be consistent with true consumer demands. Hayek didn’t bring minimum wages and strike-threat into the story. Hutt, very appropriately, did; and in so doing he made a significant improvement in Hayek’s analysis.

Do wage increases cause productivity increases?

Finally, in a straight forward application of his labour market process theory Hutt challenged what, even today, some labour economists – e.g., Freeman & Medoff (1984) – claim is a justification for unions. That is the idea that increased labour costs through strike-threat will shock employers into becoming more efficient managers and so the productivity of labour will increase to justify the wage rate increases. A related claim is that pay increases will directly cause the workers to increase their productivity. He considered the first fallacy in the first edition of TCB:

Views of this sort are popular, but are usually accepted very uncritically.... Surely this generalisation puts the cart before the horse. In so far as low wages are due to inefficiency, from whatever cause, the right thing to do is to tackle that inefficiency directly. Interference with the price mechanism seems to be the very worst way of trying to deal with it....

[I]f there were anything in the idea, would not employers have discovered it? Few of them are unaware of the effect on efficiency of the stimulus of piecework, of making increased income the certain reward of improved efficiency. May not their general doubt that increased reward will automatically bring greater efficiency be due to the simple fact that in general it does not? (TCB, pp. 33-34)

Here Hutt has a glimmer of the market process insight that alert, profit-seeking, loss-avoiding entrepreneurs can be expected to recognise and to adopt efficiency-enhancing measures without being jolted into it through coercion.

He confronted both fallacies in STS, destroying the first with a *reductio ad absurdum* and the second with an explicit appeal to entrepreneurial alertness:

This sophism was expressed quite often by labour union apologists during the nineteenth century; it was ultimately given respectability by Walker, Marshall, and Pigou; and it has been repeated again and again during the present century. Despite the intellectual caliber of the three famous economists just mentioned, I maintain that the argument is wholly indefensible.... If it were true, it would be wise for governments to impose burdens on any sector of the economy they wished to foster – taxing an industry to give it a jolt and thereby to cause it to flourish! (STS, pp. 157-158).

Parallel to the view that burdening the investor by duress-imposed labour costs forces managements to be more efficient is the view that paying workers more increases the workers' efficiency and therefore justifies the forcing up of costs. That theory appears to me to be equally unacceptable. If it were really true that the entrepreneur who paid more than the market wage rate would enjoy reduced labour costs, that would surely have been discovered by at least some entrepreneurs originally and thereby have forced competitors to follow suit (STS, pp. 159-160).

There are numerous other passages in the two books that could be cited in support of my thesis that Hutt considered unionism from a market process perspective, but I have said enough about that.

4

Four other issues in the two books

Now I will examine some other interesting points made by Hutt in TCB and STS. Space does not permit me to cover all of them, so I have chosen only four – inequality of bargaining power, Hutt's least-pay hypothesis, strikes and antitrust, and redistribution of income and a communal stock of capital. I agree with Hutt on the first two, disagree with him but understand his views on the third, and am totally bewildered by the fourth.

Inequality of bargaining power

Perhaps the hoariest myth of all is that unions are necessary because workers have an inherent bargaining power disadvantage relative to employers. In Chapter 19 of STS Hutt says that, "Lying preambles are all too common in acts of Congress and acts of parliament" (p. 286). The American National Labour Relations Act is an excellent example. The whole excuse for the special privileges and immunities given to unions by that 1935 Act is labour's alleged bargaining power disadvantage. Hutt devoted all of Chapter 5 in STS to exploding this myth.

In my words, Hutt's argument is the following. In any market, whether for labour, cars or apples, sellers compete with other sellers, and buyers compete with other buyers. Sellers do not compete with buyers. They bargain with each other over the actual terms of exchange, but every voluntary exchange yields gains to both the buyer and the seller. Voluntary exchange is a form of cooperation, not competition. The subject of bargaining is who gets what portion of the total gains such cooperation makes possible.

When buyers and sellers come together to bargain, their bargaining power depends on their alternatives. For example, with a given number of workers (sellers) seeking work of a particular type, any one worker has more bargaining power with any one employer when there are many employers (buyers) competing with each other to hire these workers than he would have if there were only one employer seeking to do so. Similarly, with a given number of competitive employers (buyers), any one employer has more bargaining power with any one worker when there are many workers (sellers) seeking such employment than he would have if only one worker were doing so. Workers (sellers) hate competition from other workers (sellers), but they love competition among employers (buyers). Similarly employers (buyers) hate competition from other employers (buyers), but they love competition among workers (sellers).

An employer will have a perception of an upper limit on what it is worthwhile to pay a worker for a given increment of his labour services. That "demand price" is the worker's net marginal revenue product to that employer. A worker will have a lower limit on what he will accept in payment for supplying an increment of his labour. That "supply price," or "reservation wage," depends on the worker's alternatives. The actual wage agreed to in the hiring contract depends on the extent of two kinds of competition – among employers and among workers. For a given amount of competition among employers, the wage will be higher with weak competition among workers than it will be with strong competition among workers. For a given amount of competition among workers, the wage will be higher with strong competition among employers than it will be with weak competition among employers.

At some times particular workers will have a bargaining power advantage relative to their employers, and at other times particular employers will have a bargaining power advantage relative to their employees. So long as an employer is not responsible for a worker's poor employment alternatives, he does not exploit him by taking advantage of the worker's weak bargaining power. Similarly, so long as a worker is not responsible for the lack of workers competing for a job, he does not exploit him by taking advantage of the employer's weak bargaining power. Now, there are few, if any, examples of successful collusion among employers to deny workers alternative

employment opportunities. As Morgan Reynolds (1995, p. 12) points out, real wages and worker-initiated job switching in the United States were both steadily increasing throughout the nineteenth century before there was any significant unionism. On the other hand, collusion among workers to take wages out of competition is the *sine qua non* of unionism in the twentieth century.

To a market process economist, all collusion is bad and will be eliminated by the market process itself. To the typical labour economist, collusion among employers is bad and ought to be prosecuted under the antitrust laws; but collusion among workers is good and is properly supported by the National Labour Relations Act.

Richard Epstein (1984) has another way of showing the absurdity of the inequality of bargaining power argument. The argument implies that all individual employment contracts are unjust because employers always have a bargaining power advantage over employees. Their advantage comes from being institutions (firms) rather than individual people. Individuals are supposed to be powerless relative to (big) institutions.

[I]f such an inequality did govern the employment relationship, we should expect to see conditions that exist in no labour market. Wages should be driven to zero, for no matter what their previous level, the employer could use his (inexhaustible) bargaining power to reduce them further, until the zero level was reached. Similarly, inequality of bargaining power implies that the employee will be bound for a term while the employer ... retains the power to terminate at will. Yet in practice we observe both positive wages and employees with the right to quit at will (Epstein, p. 973).

I doubt that even in Epstein's hypothetical world wage rates would be ground down to zero. Subsistence would provide a floor because workers always have the option of not working. But Epstein's point is well-taken. We have long observed above-subsistence wages and at-will quitting. They are not the result of unionisation addressing an imbalance of bargaining power. In a footnote to this passage, Epstein writes:

Note that the same arguments could be made in the consumer market as well, leading to the prediction that these same workers with a zero wage will pay infinite prices for the necessities of life. The only coherent models are those that assume that total wages and other income supply a budget constraint for purchases, so that both markets are in equilibrium simultaneously. Abstracting one market from another is a ploy that makes inequality of bargaining power seem more plausible than it is (Epstein, p. 973).

Hutt concluded Chapter 5 of STS with the following sentence, "Only when monopsonistic power can be wielded by managements to maintain or reduce wage rates below the free market level, by somehow excluding access to alternative employments, can it be claimed that phrases like 'labour's disadvantage in bargaining' are anything more than unintended euphemisms" (STS, p. 74).

Hutt's least-pay hypothesis

In an environment of scarcity, a community gets the most out its scarce resources if it always uses the least costly means to accomplish any specific end. This is pretty basic. It is elementary economics. Suppose there are two ways of accomplishing a particular end which is worth \$10. The first way involves a cost of \$5, and the second involves a cost of \$8. To get the most out of scarce means, the former must be used rather than the latter. Now, if the labour market is treated like any other market, this basic rule of common sense must be applied to labour. Hutt, of course, did so. But he stated the principle in terms that union apologists must consider bizarre.

To get our logic into perspective, it is useful to enunciate a general principle about the determinants of the wages flow and its distribution.... [I]n the absence of any 'shut-in' of labour contrived on behalf of investors, *the flow of wages will be highest and the distribution of the flow will be most equitable, when every wage rate is fixed at the*

lowest level necessary to retain or attract labour for each activity judged to be profitable (STS, p. 103).

I imagine the anguished cries of dissent from union apologists every time I read this passage. “Hutt claims that it is in the public interest for employers to pay the lowest wage rates they can get away with paying! Imagine that! Doesn’t he know that workers have to have high wages to have enough money to spend to keep the economy going? He is some kind of nut!”

Hutt, of course, was right. An employer who offers a wage rate that is higher than the minimum he must offer to get the quantity and quality of labour he wants is acting against the public interest. A worker’s supply price (or reservation wage) for any particular employment depends on his best alternative employment offer. The wage offers employers make are limited by what they perceive the value of their products will be to consumers. Suppose employer A wants to hire an additional worker. He could get the sort of worker he wants by offering \$5 per hour; but, being altruistic, he offers \$8 per hour. The \$8 offer may attract a worker away from his present job, where he is paid \$7, and where the value of the output that wouldn’t be produced per hour because of his absence is, say, \$9. The \$5 offer wouldn’t be attractive to this worker, so he will stay put. A worker who is currently paid less than \$5 per hour would be attracted by the offer. The reason this second worker is paid less than \$5 in his current job is because the value of the output per hour that wouldn’t be produced because of his absence is, say, \$6. In any case, that value will, because of labour market competition, be significantly less than \$9. Thus the community avoids sacrificing output valued at \$9 and instead sacrifices output valued at \$6 to get the additional output from employer A.

Strikes and antitrust

Hutt was very clear that he thought even peaceful strikes without any trespass ought to be forbidden by law. He devoted Chapter 4 of STS to this theme.

Public opinion, although often flouted, can sometimes temper the ruthlessness of union aggression; and it does tend today to look with disapproval at violence or intimidation. But they are regarded ... as abuses of the strike-threat system. The private use of coercive power as such is not condemned. Yet surely ... the concerted, disruptive withdrawal of labour, however ‘peacefully’ it is carried out ... should be recognised as *the* truly deplorable privilege.... It is the strike weapon itself as such, however ‘peaceful’ or lawful the negotiations in which a lurking threat to use it may appear to be, which I contend is responsible for the wage injustices and employment insecurities of the present era. For these reasons, I shall seek the reader’s support for the proposition that, even when the strike threat does not give rise to fears of physical sabotage, outrage or disorder, but merely to fears of disruption, its use remains objectionable (STS, p. 53).

Here I disagree with Hutt. In the absence of an existing contract that precludes him from doing so, any individual worker has a fundamental right to withhold his labour services when he doesn’t like an employer’s wage offer. If any one worker has this right, it follows that a group of like-minded workers can withhold their labour services together. So long as they do not trespass on the employer’s property, or threaten, intimidate, harass or harm replacement workers, suppliers and customers, the law should permit the striking workers to withhold their labour collectively. Of course, real world strikes include picket lines whose very reason for being is to threaten, intimidate and often harm replacement workers, suppliers and customers. But Hutt is adamant that even in the absence of those impermissible activities, a strike ought to be illegal.

The only argument that he came up with to support his view is that peaceful strikes are “disruptive.” But any seller of a product is “disrupted” when he loses customers or suppliers to competitors, and Hutt is clear about *not* wanting to make that sort of disruption illegal.

To understand Hutt's view on peaceful strikes it is necessary to recognise that Hutt thought that there should be *no* exceptions allowed to the common law proscription of combinations in restraint of trade. Most market process economists are opposed to antitrust laws, at least as they are enforced in the United States. According to Dominick Armentano (1982), American antitrust laws have been used to protect particular competitors rather than the process of competition. We would be much better off if we didn't have antitrust laws and relied on the automatic antitrust features of the market process – e.g., the problem of initial agreement, the prisoners' dilemma, interlopers and the varieties of ways to compete – to protect consumers and workers. But Hutt disagreed on this point. He was in favor of vigorous antitrust enforcement against all combinations in restraint of trade. He argued for "exceptional antitrust vigilance," and stated that, "I diagnose the repeal in 1824 of the ancient common law proscription of 'conspiracy' or 'combination' as having created the most burdensome institutional defect from which the British 'free enterprise system' has subsequently suffered" (STS, p. 288).

Hutt also expressed his antipathy to monopoly in the first edition of TCB.

In the absence of monopoly, the institution of property may be held to be the very institution which causes the various factors of production to move to the most profitable channels as determined by society. In its presence, that view cannot be held (TCB, p. 54).

Hutt elaborated on this point in a footnote to this passage:

[T]he usual defense of private property on economic grounds does not necessarily hold in [cases of monopoly]. That defense presupposes the most complete mobility and responsiveness of every unit of resources (TCB, p. 54).

Here, Hutt was not a market process analyst. The model that brought him to this startling conclusion is the traditional comparative statics of perfect competition v. monopoly. It is, Hutt asserted, only under conditions of perfect competition, that the case for private property rights is strong. He supported a regime of private property rights, so he favored antitrust to eliminate monopoly. Of course, Hutt wrote these passages in 1930, long before market process theory and the economics of property rights had been worked out.

At least Hutt was consistent. He applied the same economic way of thinking to product markets and labour markets. He wanted vigorous antitrust enforcement in both. I, too, am consistent on the point. I want to rely on the competitive market process to handle combinations in restraint of trade in both markets.

Redistribution of income and a communal capital stock

Hutt had a life-long concern for the underdog. His opposition to apartheid caused him to lose his South African passport in 1965. His conviction that unions hurt the least well off workers in society accounted for much of his strident antiunion advocacy. His appreciation of the free enterprise system was based on his unshakable belief that it was the only system that allowed ordinary people to succeed to the best of their abilities.

However, this commendable concern for ordinary people led him astray when he wrote about income redistribution. In the first edition of TCB he wrote:

Workers' combinations are impotent to secure a redistribution of the product of industry in favor of the relatively poor. Such a result cannot be achieved by interference with the value mechanism. Economists are all clearly conscious of the desirability of a more equal distribution of wealth; indeed, they base their case for it upon the firm foundation that it will lead to a maximisation of economic welfare, and not upon abstractions such as 'natural right' or 'justice.' There are means of achieving greater equality that will still

allow the value mechanism to function freely. It can be achieved by the thoughtful modification of economic institutions. But the consideration of this point lies outside the scope of this essay (TCB, pp. 73-74).

The references to “natural right” and “justice” are interesting. Hutt’s intent was to say that *proponents* of redistribution shouldn’t rest their arguments on such concepts. Rather, they should rely on welfare economics and the notion of declining marginal utility of income to make their case. (Remember, Hutt wrote this in 1930.) Later, many *opponents* of redistribution, such as Hayek (1960), rested much of their argument on “natural right” and “justice” precisely because they realised that welfare economics is incapable of making a sound argument on either side of the issue.

In STS Hutt gave a suggestion for a “thoughtful modification of economic institutions” that would serve his taste for income redistribution without “interfering with the value mechanism.”

What are widely felt to be inequities resulting from inherited wealth could, in my judgement, be materially mitigated without harmful repercussions. The case against progressive taxation is partly that it is seriously detrimental to incentives while the additional revenues governments obtain through it are almost negligible; and more important still, it is held that, through progressive taxation, part of the people’s stock of wage-multiplying assets is being continuously squandered in the vote-buying process. But even steeply progressive inheritance taxes ... accompanied by an enactment (preferably constitutional) to the effect that the proceeds must be maintained intact in the form of *collectively owned capital* , would exclude the capital squandering possibility. The yields could then be employed to reduce the level of taxes. Under such circumstances one objection to the progressive principle would fall away (STS, p. 286, emphasis added).

This is, to say the least, a misguided and naive suggestion. Misguided because part of the property rights of an owner of assets is to dispose of them as he sees fit, subject only to the constraint that no one else suffers any involuntary exchange. An owner can give away his property to anyone who is willing to receive it. The recipient may or may not be a relative. That is up to the owner. Further, while it makes sense to substitute a bad tax for a worse tax (I assume Hutt’s intention was to reduce income taxes), it makes more sense to minimise the tax burden subject to the constraint that constitutionally authorised government activities are funded. But that is not Hutt’s agenda.

The proposal is naive because it ignores the problem of the division of knowledge as well as the lessons of public choice. What central planner or regulator is to be given charge of this collectively owned capital? No matter which individual or which group of individuals is put in charge, the planning or regulatory authority cannot possibly know enough to allocate the capital efficiently. Moreover, the authority, lacking residual claimancy, will not have the appropriate incentives even to try to allocate the capital efficiently. The capital fund would inevitably become a political slush fund for those who wield political power. They, in turn, will have the usual bureaucratic incentive to expand the scope of their activities. They would inevitably advocate more and more taxes to build up the fund.

5

Criticisms of eighteenth and nineteenth century economists on labour

In the first edition of TCB Hutt was very critical of the way several early, and famous economists treated labour. Hutt is especially critical of woolly notions such as “labour’s disadvantage,” “the indeterminateness of the price of labour,” and “labour sold without reserve.” He laid the blame for the tendency of contemporary economists to treat labour as a special case, not subject to normal economic theory, at the feet of the notables. Consider, for example, what Hutt had to say about Adam Smith:

Adam Smith’s views bearing on what became later the theory of collective bargaining arose ... out of the subsistence theory. ‘Upon all ordinary occasions,’ he wrote, ‘the masters have the advantage in the dispute,’ and can force the men ‘into a compliance with their terms’.

His explanation of this vague power can be analysed into three separate ideas. First, there existed particular combinations of masters who agreed to force down wages to subsistence level. Second, there was a ‘tacit but uniform combination’ among employers to keep wages down. Third, that although in the long run the workman might be ‘as necessary to his master as his master is to him’ the necessity is ‘not so immediate.

Whereas masters,

‘though they did not employ a single workman, could generally live a year or two upon the stocks which they have already acquired, [many workmen] could not subsist a week, few could subsist a month, and scarce a year without employment.’

These factors, he thought, accounted for the employers’ power to force wages down to the subsistence level. He seems to have assumed that *how* they gave their employers this remarkable power was self-evident, for no further explanation of them was given.

The emptiness of the theory becomes clear when we consider the limits he assigned to the employers’ power in this respect. The limits were determined, not by the individual’s minimum requirements for survival, but by those of his family, because otherwise, said Smith, ‘it would be impossible for him to bring up a family, and the race of workmen could not last beyond the first generation.’ But as Professor Cannan asks, if the masters have this power why should they concern themselves about the labour supply of the next generation? ‘Trade rings,’ he says, ‘usually adopt the motto, ‘After us the deluge,’ and he points out that Adam Smith himself probably thought the doctrine was weak, as evidenced by his dragging in an irrelevant reference to such wages being the lowest ‘consistent with common humanity. ... (TCB, pp. 15-16)

Although, according to Hutt, Smith tacitly gave up this idea when he recognised that profit-seeking entrepreneurs would inevitably bid against each other to obtain under-priced labour,

the ideas about the employer’s advantage and his power to force down wages indefinitely and the workman’s corresponding disadvantage which originated thus have persisted right through to the present day (TCB, p. 17)

Hutt accused John Stuart Mill of being a shameless union apologist in a 1869 article in which Mill renounced the wages fund theory (which was, many thought, the sole theoretical basis for opposing unionism). Hutt quoted Mill, who wrote approvingly in the voice of a unionist defending shutting-out:

‘Those whom we exclude are a morally inferior class of labourers to us; their labour is worthless and their want of prudence and self-restraint makes them more active in adding to the population. We do them no wrong by entrenching ourselves behind a barrier, to exclude those whose competition would bring down our wages, without more than momentarily raising theirs, but only adding to the total numbers in existence’ (TCB, p. 10).

Earlier Hutt wrote the following about Mill and his 1869 article:

The ultimate defense of unionism in Mill’s 1869 article – the bold justification of monopoly – differed in no respect from the justification which he put forward in his *Principles* whilst he still believed in the wage fund. Those excluded did not suffer for their wages would, in any case, have been kept down to subsistence level. ‘Combinations to keep up wages,’ he wrote, ‘are therefore not only permissible, but useful, whenever really calculated to have that effect’ (TCB, p. 4).

In an earlier section I quoted Hutt from STS on Marshall’s complicity in propagating the jolt theory. In the first edition of TCB Hutt also criticised Marshall on the issue of the indeterminateness of the price of labour. The idea here is that the forces of supply and demand do not establish a unique equilibrium price for labour. The market, at best, sets a range of possible wages, and the actual outcomes of wage bargains is a question of bargaining power. Unions are justified because they increase labour’s bargaining power. According to Hutt, at one point Marshall believed that the indeterminateness of price of labour rested on the changing marginal utility of income. He quoted Marshall: “When a workman is in fear of hunger, the marginal utility of money to him is very high; and if at starting he gets the worst of the bargaining, and is employed at low wages, it remains low, and he may go on selling his labour at a low rate” (TCB, p. 44). But, Hutt said, this has nothing to do with the indeterminateness of wages:

It is quite true that the poorer a workman is, the higher will be the marginal utility to him of further increments of income – that is, of those commodities in general which satisfy his needs; but whilst it is clear that that will affect the intensity or amount of his efforts to get further income we have no reason at all to suppose that it will (a) prevent in any way the formation of an effective market for his labour, [or] (b) cause an equilibrium in the market at a lower rate than would result from the same quantity of labour being offered by workers to whom the marginal utilities of income were lower (TCB, pp. 45-46).

The only legitimate case of an indeterminate wage is bilateral monopoly where a union is the monopolist and an employer is the monopsonist.

In addition to Smith, Mill and Marshall, in TCB Hutt criticised Thornton, Jevons and Edgeworth, and several less well known economists, for their illegitimate attempts to treat labour as a special case, not subject to regular economic analysis. He repeated many of these criticisms in STS.

As I said earlier, I am agnostic on the question of whether Hutt’s criticisms of these notables and other early analysts are fair. I have not done enough research to settle the question. Certainly there are whole chapters and passages in Smith’s *The Wealth of Nations* (e.g., Book I, Chapter VIII), Mill’s *Principles of Political Economy* (e.g., Book II, Chapter XI), and Marshall’s *Principles*

of *Economics* (e.g., Book VI, Chapter III) which are pretty straight forward supply and demand analyses of labour, and which suggest that the passages quoted by Hutt were either taken out of context or were slips of the pen which are inconsistent with most of the earlier authors' labour theories. For example, Hutt criticised Marshall's use of the marginal utility of money with an argument based on the marginal utility of income. The two are not the same. A careful consideration of these questions should be made in a future paper by a historian of economic theory.

Nevertheless, Hutt is absolutely correct in his criticisms of many contemporary labour economists such as Clark Kerr and John Dunlop (STS, pp. 82, 151, 162, 180, 192, 194, 200-201, 204, 218, 237, 243, 246, 249-250). About such he wrote:

[M]any 'economists,' seeking fame and power, have observably swum with the tide, carefully pandering to current popular stereotypes. The most influential textbooks of 'labour economics' seem to me to be reprehensible in this respect (STS, p. 285).

In Conclusion

I am optimistic about the future of labour economics. The socialist world-view, and the sentimentality that made that world-view so attractive to so many well intentioned people, has collapsed. Eventually even pro-union labour economists will have to accept that fact. The impulse to treat labour as a special case was, I believe, based on socialist sentiments. Private sector unionism is declining throughout the developed world. According to Leo Troy (1994) American private sector union density will be 7 percent by the year 2000 – exactly what it was in 1900. Troy calls this the symmetry of history. Labour economists who focus on the private sector will come increasingly to regard unionism as irrelevant to contemporary analysis. They will come increasingly to believe, as Hutt always did, that labour economics should be nothing more or less than the application of economic principles to the labour market. More than most other economists of the twentieth century, Hutt has made straight the path to such a reconstruction of labour economics.

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¹ Throughout this paper all citations of *The Theory of Collective Bargaining* will be to the 1980 Cato edition.

² Kantor made these remarks on September 12, 1995 in a session on Hutt at the regional meeting of the Mont Pelerin Society in Cape Town, South Africa.