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COMMENTARY

Agency Shops and the Public Sector: An Economic Analysis

ROBERT J. STAAF* AND EDWIN G. WEST**

Traditionally, legislators and jurists have justified union and agency shops by resorting to the twin spectors of unequal bargaining power and free riders. Recently, the Supreme Court of the United States upheld the constitutionality of a state statute requiring an exclusive agency shop in the public educational labor market. Using this decision as a reference point, the authors present a critical economic analysis of exclusive agency shops in the public sector labor market utilizing both a competitive and monopoly labor market model. They argue that the social and economic costs of a labor monopoly, the exclusive agency shop, may outweigh any possible benefits. Furthermore, they argue that the free rider hypothesis does not have an empirical foundation. Thus, they conclude that the arguments in favor of intervention in the competitive labor market are not persuasive.

I. INTRODUCTION

Agency shops are to be distinguished from union shops in that although agency shops compel employees to pay a service charge as a contribution to the union's collective bargaining expenses, they do

not require actual membership in the union. The Supreme Court of the United States has previously ruled that public sector labor agreements which condition employment on agency or union shop membership do not, on their face, impinge upon constitutionally protected rights of association.[1] Recently, in *Abood v. Detroit Board of Education*,[2] the Court upheld the constitutionality of agency shop clauses in the public employment sector. It held that public sector employees, like those in the private sector, may be compelled to pay union service charges for legitimate collective bargaining activities.[3]

The Court refused to hold unconstitutional the state statute[4] out of deference to the state legislature,[5] analogizing it[6] to the National Labor Relations Act ("NLRA")[7] and the Railway Labor Act ("RLA").[8] The economic analysis employed by the Court parallels the construction given the NLRA and the RLA,[9] and this analysis is representative of that used on other occasions.[10]

This commentary presents a critical economic analysis of the central reasoning underlying the legislative and judicial approval of agency shops.

II. THE PREMISES UNDERLYING COLLECTIVE BARGAINING

The NLRA leaves regulation of the labor relations of state and local governments to the states.[11] The Michigan law in question in *Abood*, however, was broadly modeled after federal law.[12] The Court, therefore, drew upon past judicial interpretations of federal labor law in construing the state statute.[13] One of the central theses

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1. International Ass'n of Machinists v. Street, 367 U.S. 740 (1961).

2. 431 U.S. 209 (1977).

3. *Id.* at 232. In order to avoid any violations of the first and fourteenth amendments, the Court further held that the assessments were to be used exclusively to finance expenditures for collective bargaining, contract administration and grievance adjustment purposes. Consequently, nonunion employees may not be compelled to pay for "political" expenditures. *Id.* at 232-37.

4. MICH. STAT. ANN. § 17.455(10) (1975).

5. 431 U.S. at 224-25.

6. *Id.* at 223.

7. 29 U.S.C. §§ 151-69 (1970).

8. 45 U.S.C. §§ 151-88 (1970).

9. On their face, neither the NLRA nor the RLA adopted any particular economic premises; *see* 29 U.S.C. § 151 (1970); 45 U.S.C. § 151a (1970). The Supreme Court, however, has read certain economic premises into the statutes; *e.g., Abood*, 431 U.S. at 220-23; Oil, Chem. & Atomic Workers Int'l Union v. Mobile Oil Corp., 426 U.S. 407, 416 (1976); Emporium Capwell Co. v. Western Addition Organization, 420 U.S. 50, 67-70 (1974); NLRB v. General Motors Corp., 373 U.S. 734, 740-41 (1962); International Ass'n of Machinists v. Street, 367 U.S. 740, 760-61 (1961).

10. *E.g.*, Railway Employes' Dep't v. Hanson, 351 U.S. 225 (1956).

11. 29 U.S.C. § 152(2) (1970).

12. 431 U.S. at 223.

13. *Id.* at 217-37.

of the Court's economic analysis was the reasoning which gave rise to the NLRA and the RLA.[14] The goals of federal labor law, *inter alia,* have previously been interpreted as redressing unequal bargaining power and the maintenance of industrial peace.[15] Moreover, collective bargaining and exclusive representation have been seen as a means of accomplishing both of these goals. The Court in *Abood,* however, was notably silent on any reference to unequal bargaining power and its analysis emphasized the goal of labor stability and peace.

In spite of the restrictions to free employment that the union shop created, Congress had nevertheless decided that nonunion employees could be legitimately obliged to defray the substantial expense involved in union bargaining activities.[16] The majority opinion observed:

> The designation of a single representative avoids the confusion that would result from attempting to enforce two or more agreements specifying different terms and conditions of employment. It prevents inter-union rivalries from creating dissension within the work force and eliminating the advantages to the employee of collectivization. It also frees the employer from the possibility of facing conflicting demands from different unions, and permits the employer and a single union to reach agreements and settlements that are not subject to attack from rival labor organizations.[17]

This reasoning merely amounts to an argument that the per capita cost of negotiation is lower when channelled through an exclusive agent. In addition, the argument assumes that the use of compulsion to oblige all employees to contribute to the negotiation costs is necessary in order to alleviate the effects of the "free rider" problem.[18] The Court presumed that where free riders are allowed to operate in a noncompulsory setting, serious disharmony in labor relations will result. Furthermore, it was emphasized that the problem of free riders was not confined to the private sector.[19] Under the paradigm adopted by the Court, labor stability and peace would be achieved only in a system of exclusive representation.[20]

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14. *Id.*

15. NLRB v. Allis-Chambers Mfg. Co., 388 U.S. 175, 180 (1966).

16. *See* 45 U.S.C. § 152, Eleventh (1970) (authorizes union shops). The Supreme Court has held that this section of the RLA is designed to force all employees to share the costs of negotiation and general administration of the bargaining system. International Ass'n of Machinists v. Street, 367 U.S. 740, 749 (1961).

17. 431 U.S. at 220-21.

18. *Id.* at 221-22; *see* section III-C *infra.*

19. "The desirability of labor peace is no less important in the public sector, nor is the risk of 'free riders' any smaller." 431 U.S. at 224.

20. The Court accepted the legislative findings because it was not competent "to judge the wisdom of Michigan's decision to authorize the agency shop in public employment." *Id.* at 224-25 (footnote omitted).

III. An Economic Model: The Competitive Market Case

A. *The Basic Analysis*

The first model posited begins with an assumption of a competitive market in the field of education, which is entirely nonpublic. As in any market, buyers seek out sellers and sellers seek out buyers. This process involves, at the very least, the expenditure of time which has an economic value. Moreover, objective resources are expended in transportation and communication. Once in touch with each other, buyers and sellers have to search for mutually acceptable terms of employment. This too takes time and involves further costs such as legal documentation, setting up and conducting interviews, and employing experts.

It is important to notice that both buyers and sellers share in the search costs. For instance, a seller of labor will incur time costs of consulting job-opportunity columns, costs of mailing and following up applications, and costs of transportation. Once in touch with a prospective buyer of his labor, the potential worker will undergo costs of negotiating terms and conditions. The purchaser of labor, meanwhile, will be involved in search costs which involve expenses in advertising, transportation and preliminary screening of suitable candidates for the vacancies in question. Once the buyer is in touch with prospective candidates, he will then contribute his further share of the search costs by meeting the cost of interviews, by more specific screening operations and by covering the costs of legal documentation. Figure I illustrates the competitive market for teachers. The curve D_1 is the employer's demand curve for teaching services per time period; the curve S_1 is the supply curve for teaching services. In the absence of any search costs and assuming a competitive market with homogeneous workers, the wage will be determined at the industry level where the demand curve intersects the supply curve at point E. The resulting wage will be *We,* and the quantity of labor employed will be Q_0.

The presence of search and negotiation costs inevitably result in a contraction of the quantity of labor employed to Q_1. The determination of Q_1 can be viewed as a decrease in supply causing the supply curve to shift to the left with a new intersect at point F. Alternatively, the situation can be seen as a decrease in demand causing a parallel shift of the demand curve to the left, involving a new intersect with the original supply curve at G.[21] If, as is usually

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21. The industry supply curve *S1* is the horizontal sum of the supply curves of all sellers of labor in the market. When each supplier has to spend more time searching for an employment position he incurs an additional cost for each additional unit of "teaching services" he

WAGE AND
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D_1

Wg

We

W_1

F

E

H

G

O

S_1

Q_1 Q_0
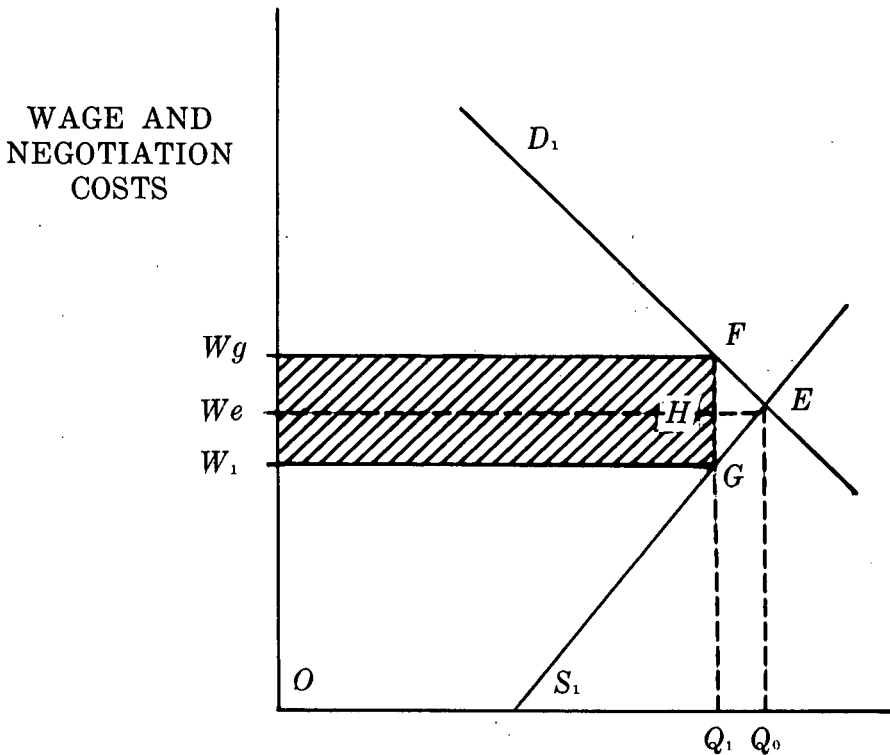
QUANTITY OF TEACHERS OR TEACHING SERVICES
EMPLOYED
Figure I

the case, the costs are borne by both the employer and employee,
both the supply and demand curve will shift. In Figure I, at Q_1
employment, the search costs per unit of labor are represented by
the gap GF. If these costs are shared equally, the curves will inter-
sect at point H with the quantity of labor employed at Q_1 and a
corresponding wage of We.[22]

Compared with the prior situation of zero negotiation cost

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seeks to supply. Aggregated, this leads to a leftward shift of the supply curve in that each
quantity of teaching service will be forthcoming only at a higher price than before.

The industry demand curve D_1 reflects the aggregate amounts of teaching service that
society desires at various prices. An individual, however, may not obtain this, or any other
service, without searching for it. If the cost of the search is significant, the consumer must
substitute resources searching for the service that he would have spent in purchasing it. This
leads to a leftward shift in the demand curve in that each quantity of teaching services will
only be demanded at a price lower than before. *See generally* P. SAMUELSON, ECONOMICS 64
(9th ed. 1973).

22. The search costs are shared because it is assumed that both the demand and supply
curves shift to the left so as to intersect at point H: The more elastic the supply or the demand
schedule, the less the search costs will be borne by the employee or the employer respectively.

(equilibrium at E and a corresponding wage of We), the employer now is faced with an equilibrium at F, with a corresponding higher gross wage Wg.[23] The employer's share of the costs of negotiation is the difference between We and Wg (or HF). The employee, meanwhile, faces a new net wage[24] of W_1, determined by the equilibrium at G. His share of the search and negotiation costs is the difference between We and W_1 or HG. The total search and negotiation costs are the costs per worker (FG) times the number employed. This is shown as the shaded area of the diagram, $WgFGW_1$. These costs, as illustrated, are shared equally between the buyers and sellers of labor.[25]

B. Institutional Frameworks for Handling the Costs of Negotiation

Conceptually, there are three basic institutional frameworks for handling the costs of negotiation.[26] First, employers may make individual contracts with each separate employee. One way of doing this would be for the employer to advertise a fixed wage, specific qualifications and enumerated employment conditions. The employees in this case are price-takers. Although all the costs of negotiation would be handled directly by the employer, this is not to say that a share of these costs would not be borne by the employee. Some costs would undoubtedly be reflected in a lower net wage.

The second method is the institution of the union or closed shop. In this case, all employers would agree to negotiate exclusively through one union. All employees, meanwhile, would be obliged to be members of that union.

A third method, the one favored by the Court in *Abood*, is that of the agency shop. In this alternative, all employees are obliged to pay agency fees limited to the costs of negotiation. In the terminology of the *Abood* decision, these include the costs of collective bargaining, administering the contract and grievance procedures.[27] Nonunion employees would not be obliged to pay for other expenses,

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23. Gross wages include the employer's share of the search costs.

24. Net wages are market equilibrium wages less search costs.

25. To give a numerical example, suppose that in the absence of search costs the equilibrium wage We equals $100 per time period. Further assume search costs equal to $50; that is, in the given time period, it costs buyers and sellers an aggregate of $50 to meet and negotiate a contract. FG represents this $50 cost. Assuming that search costs are shared equally, at the market wage We (inclusive of search costs) the employee's paycheck remains at $100. He expends $25, however, in search costs, as does his employer, resulting in a net wage to the employee of $75 and a gross wage to the employer of $125.

26. These methods are not exclusive and variations may exist. One variation, periodic competitive bidding by unions for the right of exclusive representation, will be discussed later. *See* section IV-D *infra*.

27. 431 U.S. at 217-23.

such as the cost of political lobbying by the union. Within the para-
meters of the analysis posited in this commentary, however, there
is no economic difference between an agency shop and a union or
closed shop.

The reasoning underlying both the *Abood* decision and the con-
gressional intent in enacting the NLRA is that exclusive representa-
tion through one agent keeps negotiation costs at their lowest.[28] In
Figure I, this smallest possible negotiation cost is assumed to be the
shaded area.[29] The presumption is that any alternative proposals
would result in a larger shaded cost area.

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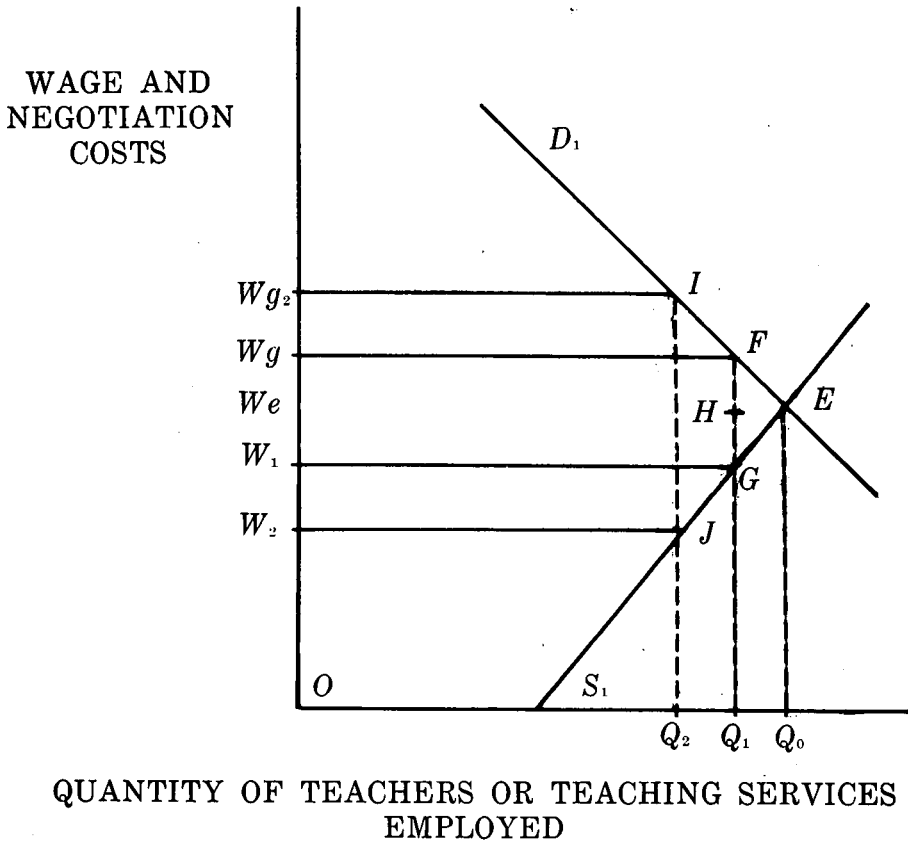EMPLOYED

Figure II

Figure II compares the situation in Figure I with the costs of
applying the first method: each employer negotiates a separate con-
tract with each employee. These higher costs are assumed, in Figure

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28. *See* notes 17-18 and accompanying text *supra.*

29. This area represents the search costs, *GF*, multiplied by the total amount of employ-
ment, Q_1.

II, to be JI and would result in a total lower employment of Q_2. The new cost area would be Wg_2IJW_2. Assuming that the legislature's view of comparative costs is accurate, the result of a change from exclusive agent to individual negotiation would have two disadvantages. The first is a reduction in employment from Q_1 to Q_2. The second is an increase in search costs which would, if shared by both sides, increase the total cost to the employer and reduce the net wage to the employee.[30]

C. *Free Riders*

Assume that the labor market is structured so that employees have to negotiate their own contracts; some workers would attempt to join unions or other collective agents in an effort to reduce negotiation costs. It would soon become apparent to them, however, that other workers would "free ride" in the sense that they will offer their services at the wage negotiated by others and therefore escape many of the negotiation costs. Because of the manifestation of free riders, the potential users of collective negotiation agents would eventually hold back or withdraw from them unless all other workers were obliged to pay their share of the costs.

This is the scenario that the Court had in mind when it referred to free riders and the labor instability caused thereby. It should be noted, however, that only when attempts are made by some workers to obtain the services of collective agents, while other workers stand back, is there any possible chance for the occurrence of worker dissension, disturbances of industrial peace or interference with labor stability. When potential members of collective agents eventually abandon their attempt to join because of the lack of cooperation from the free riders, the situation reverts back to the first institutional alternative: individual negotiation. This is represented in Figure II with employment of Q_2 and search costs of JI.

It is apparent, however, that the Court was in error in believing that this situation is synonymous with labor instability. At this new point of equilibrium, labor stability prevails because there is no further incentive to change from this position. A further reason for concluding that labor dissension will not occur, at least in the long run, is that at this equilibrium all workers will contribute the same amount in negotiation costs. In the competitive situation assumed

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30. Continuing with the example developed in note 25 *supra,* the difference between *FG* and *IJ* is $50. If this additional negotiation cost is shared equally, then the employee's paycheck is still $100; however, he now expends $50 in search costs to find the employer and the employer spends $50 to find the employee. The result is that the employee's net wage is $50 and the employer's gross wage is $150.

here, if any one employer attempts to impose a higher negotiation cost on one employee, employers elsewhere in the system will bid for the services of the "exploited" worker at a lower cost of negotiation. A succession of such costs will bring all negotiation costs to equality. Such an outcome also rules out another of the fears of the legislature and the Court: fear that confusion will prevail in the absence of an agency shop. Clearly, there can be no confusion if uniformity of gross and net wages prevails.

The free rider argument is premised on the assumption that consumers of public goods and services will fail to reveal their true preferences.[31] In the conventional competitive market of divisible private goods, such demand revelation problems do not occur. If the consumer should attempt to feign his preferences for a private good or service in an attempt to pay a lower than competitive price for it, he will simply fail to make a purchase because the seller can turn to alternative buyers who are willing to pay a higher price. Moreover, the consumer will generally find it more economical, in terms of transaction costs, to turn to competitive sellers if he believes he can purchase goods or services more cheaply rather than by engaging in expensive bargaining costs with a single seller.

The essential characteristic of a private good or service is that the individual consumer is the sole beneficiary of its acquisition. The usual example of the polar opposite is the public good or service, with its attributes of jointness of efficiencies in production and nonexcludability.[32] Once the public good is produced, the addition of any number of members to the consuming population will not increase the costs even though everyone, including the new members, will benefit. In other words, the marginal costs of production are zero, and if one unit of the commodity is produced, it is impossible to exclude consumers even though they have not contributed to the costs. It is in the case of public goods, therefore, where incentives exist for individuals to understate or fail to reveal their true preferences and to become free riders.

The difficulty with public goods or services, such as national defense, is that if everyone takes a free ride in the sense of relying on others to provide the commodity, none of the public commodity will be voluntarily provided. In order to assure that essential public goods are provided, a system of coercion, such as compulsory taxation, is established. It is on this reasoning that agency shops are often justified.

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31. Brubaker, *Free Ride, Free Revelation, or Golden Rule?*, 18 J.L. Econ. 147, 147 (1975).
32. C. Ferguson & S. Maurice, Economic Analysis 399-400 (rev. ed. 1974).

IV. An Economic Model: The Labor Monopoly Case

A. *The Basic Analysis*

The public goods component of agency shops is the supposed reduction in costs that can be obtained from the agency shop as compared with alternative bargaining methods. Without a collective agent the transaction costs of individual bargaining, which are shared by the employer and the employee, are assumed to be area Wg_2IJW_2 in Figure II. The introduction of the bargaining agent is argued to reduce these costs to $WgFGW_1$. The public goods reduction in transaction costs would then equal Wg_2IJW_2 less $WgFGW_1$. Under this assumption everyone gains. The government (and therefore the taxpayers) pay a reduced gross wage rate, *i.e.,* Wg instead of Wg_2. Employees, on the other hand, receive a higher net wage, *i.e.,* W_1 instead of W_2, and the demand for teachers expands from Q_2 to Q_1. Thus, the external benefits accrue to the taxpayers, present employees and potential employees.

There is, however, a free rider problem in that, in the absence of coercion, once a collective bargaining agreement has been reached and cost savings are realized, one member may refuse to pay his union dues which are somewhere between the difference of W_1 and W_2. He will thereby increase his net wage above those of his fellow employees and at their expense. If one individual has an incentive to take a free ride, so do all employees. Eventually, the voluntary collective bargaining unit will collapse; the situation will revert to individual bargaining and higher transaction costs where everyone is worse off.

While coercion can eliminate the free rider, it may also result in other problems. The coercion involved in the agency shop may lead to other side effects which fall in the general category of negative externalities. The point may be illustrated by reference to Figure III.

WAGE AND
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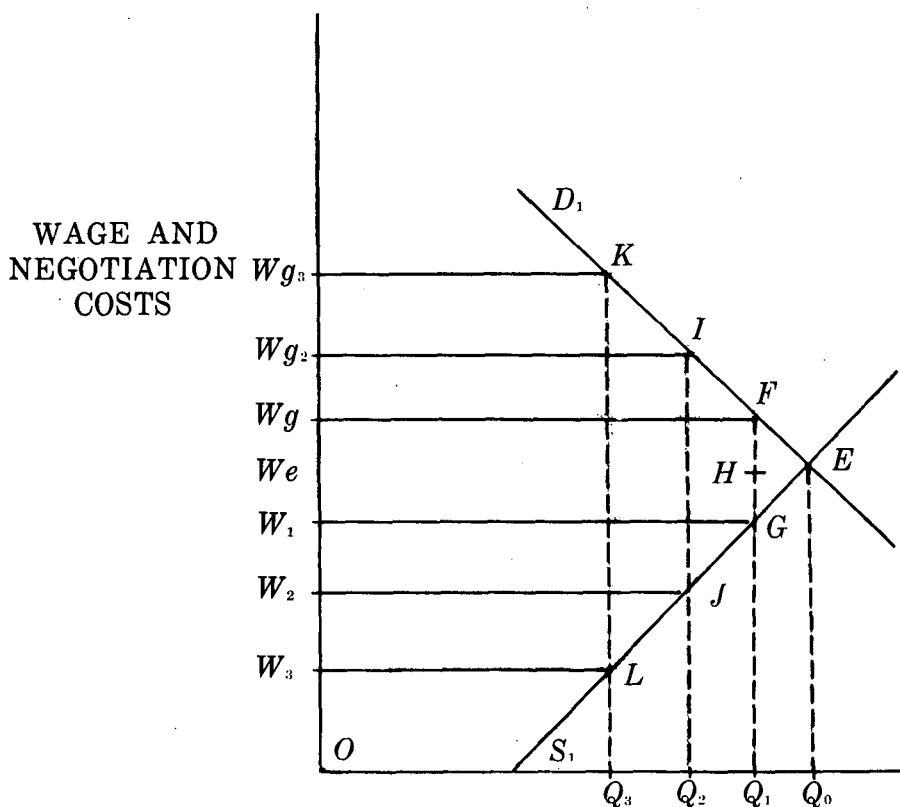
QUANTITY OF TEACHERS OR TEACHING SERVICES
EMPLOYED
Figure III

Assume that equilibrium has been reached at Q_1 employment and search costs of FG. The legislature grants exclusive negotiation rights to one agent, who is given a monopoly which will be enforced by the full backing of the authorities. The agent will attempt, in time, to exploit this monopoly position and eventually to charge a higher monopoly price for the union's services.[33] Although the negotiation costs are priced initially at FG, there is no reason to suppose that the price charged will stay at this level for long. Ultimately, the price charged for exclusive bargaining rights may be pushed higher

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33. A monopolist attempts to equate his marginal revenue with his marginal costs. Marginal revenue differs from the demand curve in the monopoly case, absent price discrimination, in that a decrease in the price charged for the nth unit will affect revenues for all the previous units. Thus, marginal revenue falls faster than the demand or average revenue curve. The monopolist, therefore, charges a price higher than the marginal cost. G. STIGLER, THE THEORY OF PRICE 195-99 (3d ed. 1966).

This concept can be illustrated by the following diagram:
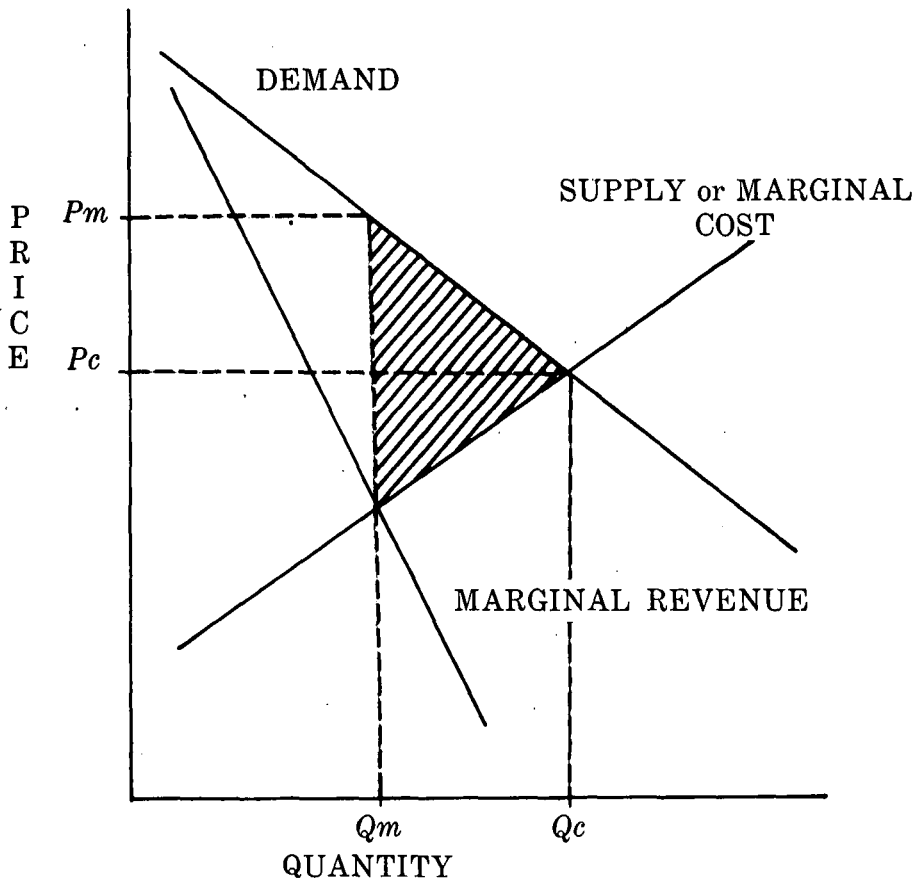
Pm and *Qm* are, respectively, the monopoly price and quantity. Note that the price is higher and the quantity lower in the monopoly situation as compared to the competitive situation, *Pc* and *Qc*. The loss to society is represented by the shaded triangular area.

   Trade unions in the 1950's increased the relative union/nonunion wage by an estimated 10% to 15%. H. LEWIS, UNIONISM AND RELATIVE WAGES IN THE UNITED STATES 193 (1963). The relative wage differential in Great Britain is estimated to be between 19% and 60%. Metcalf, *Unions Income Policy and Relative Wages in Britain,* 15 BRIT. J. INDUS. REL. 157, 159-62 (1977). *See also* Johnson & Mieszkowski, *The Effects of Unionization on the Distribution of Income: A General Equilibrium Approach,* 84 Q.J. ECON. 539 (1970); Rees, *The Effects of Unions on Resource Allocation,* 6 J.L. ECON. 69 (1963).

   The above figures probably underestimate the total loss to national income because they do not include expenditures incurred to obtain the monopoly rent which is a deadweight loss because it is an activity that results in a zero sum redistribution. Such costs have been estimated to be as high as $30 billion per year. M. Reynolds, The Free Riders Argument for Compulsory Union Dues 17-18 (Sept. 15, 1978) (paper presented at the Conference on Economic Aspects of Union Membership: Free Riders or Paying Customers; on file *University of Miami Law Review). See also* Kuhn, *Right-to-Work Laws—Symbols or Substance?,* 14 INDUS. LAB. REL. REV. 587 (1961); Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft,* 5 W. ECON. J. 224 (1967).

than the individual contracting equilibrium.[34]

In terms of Figure III, the initial benefits in contracting cost reductions is Wg_2IJW_2 less $WgFGW_1$. Since the exclusive agent has a monopoly on bargaining, it is possible, at one extreme, that most of these benefits will eventually be appropriated by him.[35] A possible means of avoiding monopoly rents is through the implementation of a competitive bidding process. Different agents could place bids with employees and employers on alternative contract packages that include the administrative costs of executing the agreements. Employees and their employers could negotiate over which of these competitive bids are to be accepted. The single agent selected would enjoy the right to provide the services for a particular period, *e.g.*, two or three years. After the agent's contractual period has expired, he would have to compete with other agency bidders for future business. This type of competition for collective agents would result in a competitive price charge of FG.[36] There is little evidence, however, of any recognition of the need for this provision. Indeed, the Court in *Abood* spoke of the social value of reducing competition between unions, a situation it condemned as resulting from "union rivalries."[37]

An even greater loss to society results if the agency uses its monopoly power in selling the services of the groups it represents. The agency can undertake "aggressive" bargaining that leads to wages above the normally competitive level of Wg_2 in Figure III.[38] Suppose such aggressive bargaining leads to a wage of Wg_3. This new monopoly wage will enlarge the total wage bill,[39] and will have two negative effects. First, there is an injury to a minority of teachers who will lose their jobs.[40] This minority would be the difference

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34. In Figure III these costs are represented by gap IJ.

35. The agent will offer the employees whom he represents a wage that is only slightly above the net wage they received before the exclusive agency agreement. At the same time, he will demand a sum from the employer that is only slightly below the search costs prior to the agency agreements. While both parties will be slightly better off, the exclusive agent will appropriate almost the entire amount previously spent by the parties on search costs. This sum will not be reduced through competitive bidding because the agency is an exclusive one.

36. *See* Demsetz, *Why Regulate Utilities?*, 11 J.L. ECON. 55 (1968).

37. 431 U.S. at 220-21.

38. For an analysis of a similar situation, see note 33 *supra*.

39. In Figure III, the area of Wg_3KQ_3O is greater than the area of Wg_2IQ_2O. A debate exists over what union leaders attempt to maximize. The union may attempt to maximize the total wage bill. This situation has the smallest effect on employment. On the other hand, the union may attempt to negotiate the highest wage possible which would result in much higher unemployment. Plausible union goals are the highest wage rate possible with the smallest reduction in employment, but the demand curve illustrates that these are conflicting goals. Because a union operates under majority rule, however, it is able to sacrifice a minority of employees to the unemployment rolls for the benefit of the majority. *See generally* A. REES, THE ECONOMICS OF TRADE UNIONS 52-54, 170-73 (1962); G. STIGLER, *supra* note 33, at 270.

40. The resulting unemployment suggests one line of constitutional attack on agency

between Q_2 and Q_3 labor units. The second negative factor is the increased bill to the taxpayers represented by the difference between OWg_3KQ_3 and OWg_2IQ_2.

B. *Forced Riders*

Under a market structure dominated by government intervention into private transactions, there exists the possibility that "forced riding" may occur. The concept of forced riding involves the mandatory participation by private parties in economic transactions which are intrinsically considered to involve public good components without empirical estimates of the demand for such goods or services. If the demand for the good or service is miscalculated by the government, too many resources will be allocated to its production, thus resulting in forced riding by those who are required to participate. The crucial question then is the determination of where forced riding ends and free riding begins.

It is significant that, for policy purposes, the notion of the free rider has, hitherto, rested on a priori reasoning. There has been no empirical evidence that enables policymakers to make an informed choice between the competing theories of revelation and nonrevelation of demands for public goods or services.[41] While the existing empirical evidence has not supported the free rider hypothesis,[42] it

shops. In its decision in Greene v. McElroy, 360 U.S. 474 (1959), the Court recognized that "the right to hold specific private employment and to follow a chosen profession free from unreasonable governmental interference comes within the 'liberty' and 'property' concepts of the Fifth Amendment." *Id.* at 492 (dicta). As can be seen, the compulsory agency shop curtails employment opportunities, thus interfering with the liberty of some teachers to sell their services at mutually agreeable wages. This results from the legislatively imposed exclusive agency.

41. The problem of excluding free riders becomes costly primarily after the creation of a collective good or service by voluntary agreement. Prior to a contract within the community to produce the collective good, the good will not exist for any member and exclusion will apply to all by definition. Since exclusion is the factor that elicits demand, private entrepreneurs might suggest terms requiring an offer from an individual, provided that it is matched by some assurance that the remainder of the community would make a similar offer. If other members of the community do not eventually pay, the individual will have, in effect, a "money-back" guarantee. At this *ex ante* stage, the dominant motive thus switches away from the desire to free ride at the expense of the group to the wish to be assured that the others will make an appropriate contribution. Similarly, the individual's offer becomes not only his actual payment but also a commitment to others that he will participate. Brubaker, *supra* note 31, at 152. Thus, individuals will behave according to Brubaker's "golden rule of revelation" of demand for collective goods, rather than as free riders who purposefully fail to reveal their preferences. *Id.* at 150-58. Under the rule of precontractual group excludability, the dominant tendency will be for each individual to reveal accurately his preference for a collective good or service, provided that he has some assurance that others will match his offer in appropriate amounts. Thus, the golden rule of revelation hypothesis is a rival of the free rider hypothesis.

42. The only scientific method of choosing between the golden rule of revelation and free rider hypotheses is empirical testing; the results thus far have failed to support the free rider

has been ignored by legislators and jurists. The proposition that people do not reveal their preferences seems to have prevailed even though it amounts to only an assertion. This assertion, moreover, has typically been followed by another: the coercive police power of government is required to induce full expression of demand for public goods. The difficulty with this argument, however, is that obvious police power alone cannot generate the necessary missing information. The resort to blunt coercion in the face of unverified information may lead to unintended yet detrimental side effects. A possible consequence is forced riding by individuals who are coerced into expressing nonexistent demands for collective goods.

C. *Agency Shops as the Cause of Free Riding*

The *Abood* decision implies that one of the benefits of an agency shop is its ability to use the power of collective bargaining to countervail the power of a strong and potentially exploiting employer.[43] The extreme case of potential exploitation of employees is a "monopsony." A monopsony is a market situation in which there is only one buyer for a given service; in the context of the employment market there would be only one employer. Such an employer, in order to maximize profits, will usually pay a wage that is below the marginal product of the employee. This lower wage results from the fact that the employer is conscious that his demand for labor is so large, relative to the supply, that his monopsony position requires him to consider the effect of the increased wage rate he is required to pay to enlarge his labor force.[44]

Suppose an employer employed ten people at $100 each per week; this results in a total weekly wage bill of $1,000. To get an eleventh employee, he will have to pay him a higher wage, *e.g.*, $105. This new wage, however, will have to be paid to all of the previously hired ten workers. The total wage bill, therefore, will be eleven times $105 or $1,155, and the difference in the total wage bill will be $155. This amount is the marginal wage. It exceeds the average wage of $105 by $50. A maximizing employer would take on workers up to the point where the value of their marginal product was equal, not to the average wage, but to the marginal wage. In this example, the marginal employee would, at a minimum, produce a marginal product of $155, yet he would be paid a wage of only $105. The difference

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hypothesis. Bohm, *An Approach to the Problem of Estimating Demand for Public Goods*, 73 SWED. J. ECON. 55, 55-56 (1971).

43. The Court adopted the reasoning of the NLRA. *See* note 14 and accompanying text *supra*. The findings and declarations of policy of the NLRA specifically mention inequality of bargaining power. 29 U.S.C. § 151 (1970).

44. *See* G. STIGLER, *supra* note 33, at 244-45.

is sometimes referred to as the gains from monopsonistic exploita-
tion.[45]

It is arguable that an agency shop system can so offset the
monopsony power as to bring back the equality between the value
of the marginal product and the wage. In this case the theory pre-
dicts an expansion of employment.[46] The policy implications, how-
ever, are obscure. It would only be by coincidence that the bargain-
ing powers of both sides exactly offset each other to bring about the
solution just described. A newly authorized agency shop may have
monopoly powers stronger than those of the employer he is supposed
to offset. In this case the negotiated monopoly wage will be higher
than optimal and would result in unemployment. A further consid-
eration is that the extra gains from bargaining on the union's side
might be appropriated largely by the agent himself rather than
being distributed to the members of the agency.[47] The predictions
of the benign monopsony hypothesis are capable of being tested. If
agency shop legislation is soon followed by some decrease in employ-
ment, or even by no increase in employment, the benign monopsony
model would have been proven false.[48]

In the original model posited, the competitive model, monop-
sony was absent because an employee could choose among a large
number of competing schools. The recent trend towards consolida-
tion of school districts may well have reduced considerably the num-
ber of alternative employers in most public educational systems.
Nevertheless, some choice still remains. It is not obvious, therefore,
that the description of the typical educational employer in *Abood*
approaches the monopsony model.[49]

The fundamental objection to erecting a monopoly union in the
Abood situation, with the aim of countervailing the power of a mon-
opsonistic employer, is that the employer is the government. As one
commentator has argued:

> [I]t is one thing for private groups to countervail a big private
> profit-seeking corporation and quite another for them to counter-
> vail the government. (A system of *political* checks and balances
> already exists.) The public employer is financed by the taxpayer
> and is supposed to be subject to the control of and answerable to
> the citizenry. In these respects, the public employer is irreducibly
> different from the private employer.[50]

45. *See id.* at 205-07.
46. *Id.*
47. *See* note 33 and accompanying text *supra*.
48. *See* G. STIGLER, *supra* note 33, at 239-42.
49. As the Court recognized, "government officials making decisions as the public
'employer' are less likely to act as a cohesive unit than are managers in private industry."
431 U.S. at 228.
50. R. Summers, Collective Bargaining and Public Benefit Conferral: A Jurisprudential

The exclusive agency is often justified by cumulating the rationale of redressing an unfair bargaining advantage with other rationales such as a desire for stability and the eradication of free riders.[51] Such strong agency shops, however, will actually encourage free riders, a result that is neither in the public's nor the employee's interest.[52]

Assume that unequal bargaining power prevails in the educational market and that teachers voluntarily organize and hire a collective bargaining agent. Furthermore, assume that the agent redresses unequal bargaining power so that the wages of all are increased. Now, suppose that the bargaining agent bills his clients for his services and that some teachers will free ride and refuse to pay their portion of the fee. The necessary conclusion is that the agency will eventually collapse.[53]

A compulsory exclusive agency would, in the above hypothetical, safeguard the agency from collapse and preserve the gains achieved, but it might also give rise to harmful effects. Assume that the collective agent now tries to redistribute these gains to a majority of his clients so that a minority are worse off.[54] Under voluntary membership agreements, those who lost on the redistribution would obviously drop out of the union and bargain individually with the employer. Thus, the voluntary withdrawal acts as a check on the collective agent.

In contrast, compulsory membership and fees coupled with the exclusive agent eliminates the check on the agent. Some employees may subsequently form a majority coalition to elect an agent who has the exclusive right of bargaining. This majority will now free ride, not by avoiding a share of the costs of collective bargaining, but by utilizing their majority voting power to reap all the gains of the collective bargaining while forcing the minority to contribute to the costs. Another form of free riding occurs as a result of increasing wages to the point that unemployment results. In this case the majority is receiving a free ride from those who were formerly employed and who thereafter became unemployed.

This kind of free riding is much more pernicious than the type sought to be remedied by the exclusive agency. Under voluntary

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Critique 11 (Nov. 1976) (IPE Monograph No. 7, Institute of Public Employment, N.Y. State School of Industrial and Labor Relations) (on file *University of Miami Law Review*).

51. *See* International Ass'n of Machinists v. Street, 367 U.S. 740, 753-64 (1961).

52. *See* notes 33-40 and accompanying text *supra.*

53. *See* section III-C *supra.*

54. An extreme example of this redistribution could occur if the union raises the price of labor above the optimal level. Under such circumstances there would be a decline in employment. Thus, the majority would benefit from higher wages while the minority would not receive anything.

arrangements, the costs of the free ride are shared by a large number of fellow employees whereas under compulsory systems free riding imposes costs that are concentrated on a few.

D. *Individual Versus Collective Agencies*

In order to illustrate the effects of governmental interference in competitive markets, the example will be changed from purchases of teaching services to the residential real estate market. This market is generally comprised of an equal number of buyers and sellers of homes. Some individual buyers and sellers do not attempt to utilize a real estate agent for negotiating and transacting because they believe that they can make a better bargain on their own. Others, however, voluntarily utilize the services of real estate agents to lower their transaction costs. As anyone who has purchased a house knows, a real estate sale is a complex transaction. Real estate agents specialize in such transactions and lower information search costs by acting as a central depository of information of prices, characteristics and sale terms of houses in the area.

These savings are apportioned among: (1) the buyer in the form of a lower price of housing; (2) the seller in the form of a higher price received than if he did not list with the agent; and (3) the agent in the form of a commission. Note that all three participants gain through voluntary agreements without compulsion. Thus, in a competitive market, while transaction costs can often be lowered by the use of agents, there will be competing agents in the market. Collective bargaining agents, reflecting the interests of a collectivity of buyers and sellers through a majority voting rule, will typically not emerge.[55] The example need not be confined to real estate; employment agencies, stock brokers, department stores and automobile dealers all serve to reduce transaction costs in the same manner.

Returning to the case of the educational labor market, it is possible to imagine a world in which each teacher hires an agent just as he or she employs an agent to purchase a house. Given this market setting it would be difficult to imagine, where each individual teacher possesses unique qualities, that he or she would be willing to deal with an agent who bargained for a unitary wage simultaneously on behalf of several principals, perhaps not as highly qualified.

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55. Majority voting rules do not govern transactions in the competitive market. Instead, dollar votes, based upon the resources each individual is willing to expend on his particular wants, determine the goods that will be produced and consumed by society. Since people have different wants and resources, a system of allocation of goods based upon majority voting rules is highly unlikely to emerge in a free society which respects individual property rights. *See* A. ALCHIAN & W. ALLEN, EXCHANGE AND PRODUCTION: THEORY IN USE 50-51 (1969).

To take a simple illustration, imagine a situation where there are five teachers of varying qualifications. Assume that the first teacher has a marginal productivity[56] worth $5,000 per year; the second, $10,000; the third, $15,000; the fourth, $20,000; and the fifth, $25,000. If private and separate contracting was followed, there would be five separate transactions using a maximum of five separate agents. Furthermore, assume that each contract has negotiation costs equal to $100. The total transaction costs would then be $500. Next, assume that an agent approaches all of the teachers with the proposition that he could reduce the total transaction costs from $500 to something just above $100 provided he was given permission to negotiate a uniform wage which is the average of the presently earned wages, $15,000 per annum. Each teacher would then have to face negotiation costs of just over $20 instead of $100. While there is no proof that this reduction is possible, assume that everyone concerned believes that it is achievable. Such a proposition would clearly produce the expected public good of reduced negotiation costs. It would nevertheless be rejected under private voluntary contracting because two of the teachers, namely those already earning $20,000 and $25,000, would be worse off. The proposed transaction would, in addition to reducing negotiation costs, compress wage differentials. Only coercion of some kind could achieve this result.

Consider the alternative example where a single agent offers to organize a common transaction that would obtain a single wage of $26,000 a year, which is just above the highest wage already being earned. In the absence of promised teacher productivity improvements, the agent could only do this by attempting to offer two services: the service of reduced transaction costs and the service of producing a labor monopoly for his clients that could force a wage of $26,000. In all probability this arrangement would also fail because the change to a monopoly wage results in a move upwards along the demand curve and, as a result, some teachers will lose their jobs. The unemployed teachers would cease to have loyalty to the bargaining agent and would no longer support the cartel. Their return to the marketplace would result in their underbidding the cartel which would then cause its breakup and a return to the five separate wages at the lower average of $15,000. For the monopoly to be viable, therefore, the single agent has to have full control of the supply of labor.

In a third scenario, the single agent, realizing that private coer-

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56. Marginal productivity equals the wage that the individual would receive in a competitive market for his labor. *See* G. STIGLER, *supra* note 33, at 239-42.

cion is insufficient and that the government power of legislation alone will provide him with the necessary controls on the labor supply, decides to turn to the political process. After successful lobbying, the government enacts legislation that results in a new wage of $26,000 and prevents the employer from employing anybody at less than this wage. The latter provision creates the power of coercion that is necessary to make the monopoly viable. Moreover, the chances of the lobby succeeding will be increased if, as is likely, a majority of the five teachers can be obtained in support. Indeed, it is not necessary to obtain a new monopoly wage of $26,000; a wage of $16,000, for instance, would suffice because three out of the five teachers would support it. In general, when the proposed mean wage exceeds the present median, a majority of the employees can always be predicted to favor redistribution in favor of the lower paid employees and a reduced dispersion of wages. It is not necessary for the monopoly benefits of the new arrangement to be taken out entirely in the form of monetary income increases. There are a variety of ways, all of them nonpecuniary, of obtaining equal benefits. For instance, teachers may bargain for preferred curricula, increased vacations or a reduction in hours.[57]

The negotiator will lobby the government with the argument that the chief benefit from the new arrangement, effected through the agency shop, is a reduction in transaction costs. Based on the assumptions of the posited model, these transaction costs are expected to be reduced from $500 to something just above $100. This will be the public good or service aspect of the agent's argument to the legislature. He will also argue that he is unable to achieve this cost savings because individuals will not operate voluntarily to achieve the same result due to a tendency to free ride. The agent, of course, will not make conspicuous the other and more important cost of his proposal, the cost of monopoly pricing.[58]

V. CONCLUSION

A critical economic analysis of the underlying policy rationales given in support of mandatory agency shops within the public sector reveals the existence of economic ramifications not usually taken

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57. It should be expected that, as higher incomes are negotiated, there will be increasing pressure to take benefits in reduced hours because leisure is not taxed, while marginal increments to income are.

58. A testable hypothesis arising out of this reasoning is that collective bargaining via legislatively-induced union and agency shops will be followed by a reduction in the dispersion of wages. This hypothesis has been firmly supported by recent empirical tests. R. Freeman, Unionism and the Dispersion of Wages (June 1978) (Harvard University Discussion Paper, No. 629 on file *University of Miami Law Review*).

into account in governmental decisionmaking on the subject. Courts and legislatures have too often relied upon considerations of industrial peace and stability or unequal bargaining power to justify mandatory collective bargaining under majority voting rules without giving due regard to the economic costs borne by society due to the abrogation of the competitive marketplace. This commentary has demonstrated that these costs could include monopoly rents appropriated by the exclusive bargaining agents at the expense of the taxpayer and the employee, increased unemployment and monopoly pricing. The economic concepts of free rider and forced rider have been utilized to examine critically the proposition of permitting competition in the public sector employment market and to question the traditional arguments supporting compulsory collective bargaining.

Moreover, federal labor law has developed largely within the context of the private labor market and has been targeted at redressing unfair bargaining power and promoting labor peace. In *Abood,* the Court focused its analysis on labor peace. Consequently, assuming that unfair bargaining power is not a problem, the only argument the Court could use to support its analysis was the supposed irritation caused by free riders and the ability of agency shops to reduce and distribute fairly the transaction costs of bargaining. It has been shown, however, that if unfair bargaining power is not initially a problem, the adoption of an agency shop can create unfair bargaining power of a different form. The agency shop establishes a monopoly on one side of the bargaining process—the union. This results in unfair bargaining from the perspective of the buyers of labor, the taxpayer and those employees who lose their jobs from the reduced demand for labor. Thus, reliance upon the premises underlying a body of law meant to regulate the private labor market is inappropriate when analyzing a case arising in the public labor market.