The Secretary
Royal Commission into the Building and Construction Industry
GPO Box 2577
Melbourne
Vic 3001

14 November, 2002

Dear Sir

Re: Submission by the H R Nicholls Society Inc concerning Discussion Paper 13.

Introduction

1. The H R Nicholls Society was incorporated in March 1986 with the aims of :

> (a). promoting discussion about the operation of industrial relations in Australia including the system of determining wages and other conditions of employment.
>
> (b). promoting the rule of law with respect to employer and employee organisations alike
>
> (c). promoting reform of the current wage-fixing system.
>
> (d). supporting the necessity for labour relations to be conducted in such a way as to promote economic development in Australia..

2. Since 1986 the Society has conducted conferences and published proceedings and engaged in other activities with the aim of promoting debate and discussion about the need for labour market reform. It maintains a large website, www.hrnicholls.com.au, which has become a significant resource base for students of industrial relations and labour market economics.

3. In response to the Issues Paper 13, which discusses the contradictions arising from the impact of the Trade Practices Act (TPA) on commercial contracts on the one hand, but the exclusion of contracts of employment from the aegis of the TPA on the other, the H R Nicholls Society seeks to draw to the Commissioner's attention a recent and important chapter in the history of economic theory known as the 'theory of rent-seeking'. This branch of economics, in our view, provides a useful and insightful framework for analysing the behaviour of labour unions and contractors in the construction industry.

4. The term 'rent-seeking' was first used by Anne O Krueger[1], in a land-mark paper entitled "The Political Economy of the Rent-Seeking Society" published in 1974 in the American Economic

[1]Anne O Krueger, formerly Professor of Economics at Stanford University, is now First Deputy Managing Director of the International Monetary Fund

Review. Because the theory explains a wide range of observed behaviour in the interface between markets, governments and statutory law, this paper has become widely and frequently cited in the economics literature.

5. The essence of the theory of rent-seeking is that people seek to manipulate political and\or legal processes in order to obtain privileged positions in the economy; privileges which enable them to establish and maintain monopoly power in the supply of a particular good or service. The resultant monopoly power is used by these rent-seeking groups to extract transfers of income and wealth from their fellow citizens by restricting the quantities supplied of the particular goods or services under their control, with the objective of raising prices above those that would prevail in openly competitive or contestable markets. The ability to extract and capture wealth transfers by obliging others to pay above-market prices depends crucially on blocking alternative sources of supply.

6. These wealth transfers are known as 'economic rents' because they derive from the rent-seeker's exclusive, politically-derived power to set prices significantly above the corresponding prices which would be struck in an openly competitive market. Economic rents are conceptually distinct from commercial rents, the latter being money paid for leasing property such as a house, an office, or a shop. Protectionist policies provide the archetypal example of rents created through the political process. Manufacturers of particular traded goods in a country can effectively create and extract rents by persuading the government to restrict imports through tariffs, quotas and other barriers to trade. These restrictions enable them to extract rents from domestic consumers by setting prices for those goods above the international price. These rents are distributed amongst the rent-seekers in the form of higher profits, higher wages, and feather bedding

7. In many circumstances, it may be mutually beneficial for other rent-seeking groups, notably trade unions and suppliers of other inputs, to act in concert with manufacturers to establish and maintain the monopoly positions which generate rents. Clearly, the prospect of such success in the political process will encourage rent-seekers who will spend time, energy and resources, in persuading governments to introduce the legal and political instruments (tariffs, quotas, import licences and various non-tariff barriers) which give them effective monopoly power and to ensuring that they are maintained and extended over time. For this reason, Harvard University's Jagdish Bhagwati, another important contributor to the rent-seeking literature, has coined the term 'directly unproductive profit-seeking activities' (DUP activities) because resources devoted to such activities produce nothing of value to society.

Trade Unions and Rent-Seeking

8. Whatever their ostensible objectives might be, most trade unions, in their day-by-day activities, give meaning, purpose and substance to their institutional lives by using *de facto* and *de jure* privileges to create and maintain monopolies in the supply of labour to particular industries and enterprises, from which they extract continuing streams of economic rents. These rents are distributed to union members in the form of above-market wages and other perquisites, and to union organisations through membership fees which are used to fund rent creation activities (lobbying, donations to political parties) and rent-extraction activities (mounting 'industrial action').

9. There are two prerequisites for union success in rent-seeking. First, if a trade union attempts to extract rents from an enterprise which does not have the capacity to generate revenue in excess of the opportunity costs of productive inputs, then that enterprise will eventually be forced into insolvency, as exemplified by the recent demise of Ansett Airlines. Accordingly, above market wages and other perquisites can be extracted only from enterprises which can generate rents. It is for this reason that effective unions are concentrated in industries where enterprises have natural advantages (e.g. mines based on rich mineral deposits; natural monopolies attributable to economics of scale or scope such as water, telephone, and electricity distribution networks) or politically created advantages (e.g. tariff protection or valuable patent rights). Strong unions are also to be found in the public sector (which is not normally subject to the constraint of insolvency).

10. The second prerequisite for success in extracting rents is the ability to eliminate competition from non-union sources of labour. A necessary condition for unions to achieve above-market wages through bargaining, is the power to prevent employers from hiring non-union labour. This power is based on the capacity to mount credible threats of violent resistance to any attempt to cross a picket line. Trade unions have, consequently, sought tenaciously for many decades to legitimise the use of pickets and other forms of intimidation and coercion. A withdrawal of labour poses little threat to a firm which can employ other people to replace those who have walked off the job. Hence the picket line, and the use of the term "scab", are essential corollaries to the use of the strike weapon, so as to ensure that the workers who have "withdrawn their labour" cannot be replaced. The picket line is not only designed to prevent new workers from entering the plant, but also to prevent supplies and finished products from entering and leaving the plant.

11. When these two conditions are satisfied the union then has the capacity to mount a credible threat of striking to close down a business, a tactic which forces the owners (or the mangers who are responsible to the owners) to choose between earning no revenue, or acceding to union demands for some part of the future revenue stream of the business (rent) in the form of above-market wages and working conditions, and/or excessive staffing. Sometimes direct payments to unions and union officials take place, but the amounts of money involved (although large on a personal scale) are trivial in the overall scheme of rent transfers. Such rent extraction is equivalent to extortion by hold-up. The funds diverted deprive other people (primarily the business owners and the ultimate consumers of the products of the business) of income at least equal to the value of the extracted rents (often substantially more). Today the business owners are usually other workers whose superannuation funds are channelled into share ownership.

12. The history of trade unionism and the arbitration system in Australia, since 1904, is most clearly understood from a rent-seeking perspective. The close interconnection between industrial arbitration and protectionism is succinctly described in G O (Gerry) Gutman's book, *Retreat of the Dodo* published in 1982. Tariffs and quotas provided the rents, often equivalent in magnitude to federal government budget outlays, and the arbitral tribunals were quick to claim the role of distributing the proceeds between the owners and the workers in the protected industries. Although Australian consumers as a whole paid more for a wide range of goods, in sectoral terms the farming and mining export industries bore the heaviest burden in providing the rents, and the manufacturing, textile, clothing, footwear, and paper industries absorbed them.

13. The Hawke Government, supported by the Coalition in Opposition, began unwinding

protectionism in Australia in 1983, and the extraordinary resiliency and dynamism of the Australian economy since the late 1980's, manifest most clearly in the rapid growth and increasing diversity of Australian exports, demonstrates how severely the protectionist policies of the Deakin Settlement of 1904-1908 greatly impeded economic growth and development in Australia for nearly 80 years.

14. As protectionism has been wound back, the role of trade unions, as key institutions in the management of rent distribution, has correspondingly declined. The decline of trade union membership in the private sector is, today, an uncontroversial fact of life, and as tariffs continue to be phased out in those industries such as textiles, clothing, and motor cars, which still enjoy a significant measure of protection, then the purpose and vitality of trade unionism in those industries will also decline.

Rent-seeking in the Construction Industry

15. The relevance of these observations to the Royal Commission is that in the construction industry, which is not subject to threats from import competition, the role of the unions is not only to distribute the rents, but to create them in the first instance, and the Royal Commission has already made significant progress in elucidating how those rents are created.

16. In the construction industry, unions (in conjunction with employers) are able to extract rents (ultimately from the tenants who occupy the buildings) by successfully contriving to become monopoly suppliers of labour (no ticket-no start) and then requiring the head-contractors to pay above-market wages, to feather-bed the work-force, and to pay secret commissions. Such extortion, however, can only work if the entire industry is "roped in" to the rent-extraction process. The arbitral tribunals, and the labour market legislation under which the tribunals operate, greatly facilitate that process. But the unions themselves act as guarantors of the 'closed shop', by making it virtually impossible for new entrants to break in, except under the same terms which apply to the incumbents.

17. In all such cases, the rent-extraction process is based on the capacity of a trade union to enforce its position as a monopoly supplier of labour. This makes the threat to strike, or its implementation, no different in kind from the offer which a Mafia boss puts to a prospective victim, telling him that it is "too good to refuse". The argument which the trade union movement has assiduously promoted over the years, in an attempt to legitimise what in any other field of activity would be recognised as demanding money with menaces, (ie criminal extortion), is that the strike is a morally justifiable strategy. Workers, so the argument goes, are justified in combining to create a monopoly, in order to offset the imbalance of power which is claimed to be intrinsic to the employer-employee relationship, and then to negotiate terms and conditions of employment from the position of strength which monopoly power provides.

18. The doctrines which legitimised the legal privileges which were bestowed on trade unions a century ago, and which they still enjoy, derived from Marxian ideas of class warfare. Today, unions depend for legitimacy entirely on the alleged imbalance of power between employer and employee, an imbalance which is easy to assert but difficult to find in reality. However, the violence that was frequently manifested in picket lines was never accepted by mainstream Australia as legitimate behaviour, and the common law antipathy to strikes and other forms of "industrial coercion" was a reflection of this mainstream sentiment. However, the common law

(and common-sense) position regarding the illegality of strikes was cut down by the passage of the *Industrial Relations Reform Act* of 1993 (the Brereton Act) and re-affirmed in the 1996 *Workplace Relations Act* (WRA) (the Reith-Kernot Act), which provided statutory legitimacy to "the right to strike" and to "the right to lock-out". The parliamentary legitimisation of the "right to strike" has made it politically more difficult for those who uphold the traditional common law antipathy to the coercion and the threat of violence required to maintain union monopoly power, to maintain their hostility to union sponsored lawlessness.

19. It is not uncommon for firms which find themselves subject to trade union demands for monopoly rights concerning labour supply to acquiesce in the demands made upon them; the quid pro quo usually being that the unions will act to prevent new contestants entering the market. Indeed, the simple fact of the existence of an effective instrument for raising barriers to new entrants into an industry, can become a great temptation to incumbents to use that instrument to make the industry effectively incontestable, by arranging for the unions to crush new competitors. The existence of rents, sometimes very substantial rents, provides a continuing incentive to new contestants, but the problem facing a new contestant is finding a labour force which will not be roped into the existing arrangements of rent extraction and rent disbursement. The success which Patrick's enjoyed in breaking the monopoly power of the MUA on the waterfront was not achieved without substantial risk-taking and trauma. Indeed the Australian waterfront provided a classic example of collusion between incumbent firms and unions which guaranteed continuing immunity from new contestants, and massive rent extraction, for more than 60 years.

20. The process of transforming what is essentially criminal behaviour into socially acceptable conduct (accepted at least by many in the media and some in society generally) has been assisted by the arbitral tribunals, and most recently even by the Federal Court in the Electrolux decision, which have variously acceded to the first increment of lawlessness, and then the next incremental demand, and so on, as part of a code of 'industrial realism'. Thus over the decades, and through the back door, the strike weapon was quasi-legitimised, inevitably leading to the increasing use of strikes and the threat of strikes as part of normal life. This climaxed in the early 1980s. The election of the Hawke Government in 1983 was, in part, a response to the Fraser Government's inability to uphold the law, and thereby maintain peace and concord in the labour market. The 'Accord' between the Labor Government and the ACTU was a promise of a return to quietude in the labour market, a promise which was largely fulfilled.

21. It is not only in Australia where the construction industry has been an industry subject to predatory rent-seekers. In various parts of the US the Mafia has long sought, often with considerable success, to become the monopoly labour supplier in the construction industry, and the current TV series 'The Sopranos' featuring the life of Tony Soprano, a Mafia Boss operating in the construction industry in Newark, New Jersey, has become a smash hit in the US, to the extent that Tony Soprano cook books are on the market.

22. The hostility which the construction industry unions (and the construction companies and head contractors to whom they are affianced) have shown to the use of independent contractors in 'their' industry (in marked contrast to the domestic building industry in which employees are rarely found) demonstrates that the exclusion of employment contracts from the purview of the ACCC is of critical importance to the creation of rents. In its most fundamental sense the TPA is an Act to prevent private cartels from lawfully creating rents in the market for goods and

services. The Conciliation and Arbitration Act of 1904, and its successor Acts, contrariwise, facilitated and bestowed legal privileges upon registered trade unions, whose raison d'etre was either the distribution of government created rents (as in tariffs or import quotas) or in the creation and distribution of rents in industries which were immune from import competition. The creation of such rents, however, ultimately required the use of techniques of extortion which were unacceptable to deeply entrenched common law principles of contract and tort, and the history of trade unionism can be seen as an ongoing campaign to legitimise tactics such as picket lines, which were rightly seen as crucial in the establishment and maintenance of a tight monopoly position in the supply of labour.

23. The tradition of legal privilege which registered trade unions enjoyed from 1904 onwards was extended during the 1960s by excluding them from the reach of the TPA. As part of the overarching strategy of building and maintaining the widest possible coalition in support of Australia's anti-communist position within the American alliance, Prime Minister Menzies chose Ministers for Labour whose primary task was maintaining a close relationship with the trade union movement, and with the ACTU in particular in order to ensure that the trade union movement was never, as a whole, captured by the Communist Party. Thus, in the early 1960s under Menzies, or a decade later under Whitlam (but for different reasons), there would never have been any question of bringing the trade unions within the reach of the TPA.

24. The estimates of the magnitude of the rents which the construction industry unions extract from the industry vary from 20 to 30 percent of turnover. These estimates, presumably, do not include the rent-seeking expenditure by the unions and the legal apparatus which supports them. One of Krueger's most interesting conclusions was that expenditure on rent-seeking was often equal to and sometimes exceeded the returns from the perceived rents. It is difficult to believe that this is true of the Australian construction industry, although the costs associated with strikes and other forms of 'industrial activity' are clearly substantial. It would be a valuable contribution to Australian public knowledge and political debate if the Commission was able to consider expert witness on the magnitude of the rents which the unions have generated and the expense involved in maintaining them.

25. The life of a rent-seeker is not a comfortable one. Rents are always extracted from unwilling or unknowing fellow citizens, and if the rents are ordained by government (as in tariffs or import quotas) then considerable and continuing political activity is required to maintain the political support which governments require to continue the transfers. If the rents are created through illegal, or legal but morally distasteful methods, then the rent-seeker can find himself subject to Macbeth type fits of doubt and remorse. Usually, however, rent-seekers at the rough end of the rent-seeking spectrum take after Richard III, rather than Macbeth, and a substantial upheaval in the industry (as in the Waterfront dispute of 1998) is required to change the rent-seeking and rent-maintaining culture of an industry.

26. If the construction industry were to change its mode of operation from one where employment contracts are the norm, to one where independent contracting were the norm, the rents would vanish overnight. Cartels between independent firms and contractors are not unknown, but there is no question of their illegality, and the capacity of the ACCC to detect and prosecute offenders is increasing. The domestic housing industry has suffered from time to time from fraud and contrived bankruptcy, but its efficiency and competitiveness is recognised as world class. This competitiveness is a consequence of fact that most workers in this industry are

contractors, not employees. The transaction costs that are now imposed upon the employment relationship, and the use of the industrial relations system as a rent-seeking and rent-collecting instrument have, in many industries, made the contracting relationship far more attractive than the employment relationship, particularly for the ordinary worker who can capture for himself a significant percentage of the transaction costs which he would otherwise pay as an employee. The construction industry, more than most other industries, is an industry in which contracting rather than employment would provide a far more efficient way of organising the daily work of the industry, and everyone involved in it would benefit from the removal not only of the rents, but of the burdensome costs, both financial and psychic, of rent-seeking.

Ray Evans
President