THE SOCIAL DIMENSIONS OF LABOUR
MARKET INSTITUTIONS

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Abstract

The labour market is both a market and a "social institution". But what do we mean by that? In the first part of this article we analyse different interpretations of the labour market's "social" dimension, starting with the versions postulated by economists and ending with those that invoke solidarity as a criterion. In the second part, we analyse the functions of the institutions that embody the labour market's social dimension, both from the positive viewpoint – correcting market failures – and the negative viewpoint – creating and capturing rents. Discussion of the factors that explain how these institutions come into being and evolve allows us to identify a number of institutions that perform a dual function: correcting market failures, and also correcting failures in other institutions.

Keywords: efficiency, institutions, labour market, new institutional economics, solidarity.

JEL Classification: B52, D63, J30, Z13.

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THE SOCIAL DIMENSIONS OF LABOUR MARKET INSTITUTIONS

1. Introduction

The labour market is both a market and a "social institution" (2). All the institutions of the economy are social but, perhaps, the labour market is more social than others, both quantitatively and qualitatively.

This paper is an attempt to clarify the "social dimension" of the labour market. This dimension is manifested in the institutions that change the "rules of the game", the agents' preferences or restrictions, and, consequently, the outcomes of their actions. Studying the social dimension of the labour market therefore requires studying the role of these institutions.

The neoclassical analysis does not ignore the role of institutions. It starts from the recognition that markets operate within an institutional framework that enables them to operate and to do so efficiently; it also considers the effects that changes in institutions have on economic performance. It does not, however, contain a theory of how institutions originate, develop and change (Demsetz, 2000). That is why it is useful to complete the neoclassical analysis with the contributions of the new institutional economics (3).

Our analysis will be conducted in two stages. In the first stage (section 2) we take the functions of the labour market as the basis for an exploration of its "economic" (efficiency) dimension, first in the absence of market failures and then with market failures. The need to correct these failures justifies the creation of institutions (2.1), particularly when other interests of the agents are taken into account (2.2). However, when we extend the "social" dimension to include the concept of solidarity, we identify other variables – social norms and values, besides the institutions – which complement our analysis (2.3 and 2.4).

In the second stage we develop our analysis of labour market institutions, building on some ideas taken from the new institutional economics (section 3). The generation of rents and the consequent possibility of opportunistic behaviours justifies the existence of institutions to correct those behaviours (3.1). Yet these institutions may themselves originate

(2) To quote the title of Solow's well-known book (1990).
(3) There is already an extensive bibliography on the new institutional economics. Klein (1998), Ménard (2000) and Williamson (2000) offer recent overviews of the subject. Of particular interest in this context is the approach to complexity developed at the Santa Fe Institute; cf. Colander (2000).

from attempts to appropriate rents, or even create them (3.2). This explains the ambiguity created by institutions, especially in the labour market: institutions whose purpose is to increase efficiency may in fact reduce it, and vice versa. What is more, the institutions are likely to go through cyclical phases of advance and regression, both in efficiency and in solidarity. This prompts us to ask whether there are any mechanisms that could ensure a stable evolution of institutions, such that the losses of efficiency are steadily decreasing (3.3). On this point, the fact that we can identify several different levels (values, institutions and social norms) is again illuminating (3.4). The paper ends with some conclusions (section 4).

2. The functions of the labour market

The underlying reason for this article is the ambiguity of the word "social" as applied to the labour market as a "social institution". What do we mean by this word? Is there room in economics, as it is usually understood, for a "social" dimension? Is there any need to "correct" the way the market operates using "social" institutions? Who decides which "social" institutions should be established? On what criteria? Does this disrupt economic rationality?

Our starting point will be the functions that any labour market must perform. On this question, the views of economists, politicians and other social scientists range between two extremes: 1) there are those who view the labour market as a market like any other, operating in conditions close to perfect competition, which means that there is no sense in "correcting" its functioning with "social" institutions; and 2) there are those who consider that the labour market must not be treated as a market at all but purely as a "social" institution which must not be governed by the laws of economics (or, given that these laws exist and cannot be escaped, which must be governed by such laws but suitably "corrected" by "social" institutions, regulations or interventions).

In short, the former point of view emphasises efficiency as the criterion for evaluating the labour market, while the latter emphasises equity or solidarity. And it is assumed that the attainment of either one of these goals does not guarantee the attainment of the other.

2.1 Arguments based on efficiency

In perfect competition, any worker looking for a job will find one (at the prevailing wage) (4), and any company looking for workers will find them (also at the prevailing wage). But this is one way of defining full employment. Therefore, an "efficient" labour market will be one in which there is no involuntary unemployment (5). If that is so, there will be no need to introduce institutions that interfere with the normal functioning of the market, beyond "a generic moral and legal framework that underlies all capitalist regimes" which "will stress the obligatory nature of contract, respect for property (...) and the myriad of rules and practices that make exchange possible" (Barry, 2000, 400). This leads us to the distinction between certain (generic) institutions that make up the framework or foundation of the market and guarantee its efficiency, and other institutions, interventions or regulations that interfere with the normal functioning of the market and may reduce its efficiency.

(4) The reference to the prevailing wage is intended as a reminder that the agents seek to optimise their decisions on the basis of their preferences and the corresponding restrictions.
(5) For our purposes, an efficient market is one that performs its functions satisfactorily.

However, the argument put forward in the previous paragraph is not valid if there are market failures (6). These can be corrected by what, in a broad sense, we shall call “institutions”: laws on worker rights, mechanisms for collective representation, minimum wages, centralized negotiation of collective agreements, severance pay, unemployment insurance, labour courts and tribunals, etc.

Seen from this angle, the “social” dimension of the labour market will be embodied by the “institutions” which propose to correct market failures (7) (although the mere existence of a failure does not automatically justify the existence of an institution).

2.2 The agents’ viewpoint

The agents (primarily workers and companies) who are parties to the employment relationship are likely to have their own views about what is or is not “efficient” functioning of the labour market. As we have already said, they expect anyone who is looking for a job to find one (at the prevailing rate of pay), and any company that is looking for workers to find them. But they also expect “something more”.

The labour supply is the result of a series of decisions people take throughout the different stages of their life cycle: decisions concerning education and occupational training, job searches, investment in on-the-job human capital and in designing and developing a career, the decision to put more or less effort and initiative into one’s work, etc., culminating in the decision to retire. And these decisions condition the whole of a person’s life: the volume, stability and distribution of her income over time (which will determine her consumption and saving, whether she buys a house and where she lives, whether she starts a family, etc.), the risks she takes (voluntarily or otherwise), her quality of life, the way she solves some of her conflicts, how she contributes to the learning of her colleagues and subordinates, etc. (8).

Likewise, companies’ labour demand is also the result of a broad range of decisions (cf. Argandoña, 1999b, chap. 3). Some of these decisions determine the size of the company’s plant, its location, the technology it uses, and the factor mix it chooses, on the basis, among other things, of the quantity and quality of labour available and its present and expected future cost over the relevant time frame (the “long term”). Other decisions respond to changes in the “short term”, including the more or less intensive use of plant and equipment, or the temporary adaptation of the workforce to fluctuations in demand or costs, etc.

In view of this, it seems logical to conclude that workers do indeed expect “something more” from the labour market than a job at the prevailing wage: they expect a more or less stable employment relationship, depending on their stage in life and

(6) Here are a few examples of such failures. With limited information and search costs, the optimal volume of unemployment will be different from zero. If there are public goods or externalities (such as health risks for workers in the production process), the level of employment will not be optimal (the measures to protect workers’ health may have the consideration of a public good). There is no competitive market that would allow employees to insure themselves against the risk of job loss or loss of income, due to moral hazard and adverse selection problems. And so on.

(7) Failures in other goods, services and inputs markets also have a negative impact on the labour market’s efficiency. And, although they can be corrected by labour institutions, it would seem more logical to act directly on the markets in question.

(8) The fact that labour supply decisions are often taken within the framework of the family does not alter our main conclusions. Cf. Blundell and MaCurdy (1999).

circumstances; they expect training and career opportunities, the coverage of certain risks, a balanced distribution of income over time, a reasonable match between their pay and that of their peers, etc., and finally, a pension that matches their previous standard of living. And a similar list can be drawn up for employers.

No doubt, they would like to have all this without any restrictions. But they realise they cannot have everything: first, because of their own limitations as regards time, resources, technology, etc.; and, second, because each agent's plans must be compatible with those of the others. Yet these are precisely the functions attributed to an "efficient" labour market without market failures: coordinating the agents' decisions, signalling the relative scarcity of different types of labour, providing incentives (for effort, training, etc.), etc.

From this point of view, a reasonable definition of an efficient labour market would be that proposed by Schwab: it is a market in which employers provide "all the benefits and protections that employees demand and are willing to pay for" (9), given the above-stated restrictions. And if they do not provide this, it must be due to a market failure (10). Thus, from the agents' viewpoint, labour market efficiency coincides with what we earlier defined as the efficient functioning of a competitive market, once its failures have been corrected by the appropriate institutions (11).

In view of the above, many economists identify the labour market's "social" dimension with the body of institutions (laws, rules, social norms, customs, practices, contracts, etc.) aimed at correcting market failures and offering channels to enable agents to carry out their plans with reasonable success, given the existing restrictions (in addition to the "generic" institutions mentioned earlier, which constitute the framework of an economy and are the necessary condition for its efficiency).

2.3 Arguments based on solidarity

There are, however, other ways of understanding the social dimension of the labour market. All of them have in common the proposal to provide a series of benefits or protections not for reasons of efficiency (i.e., to correct market failures), but for reasons of equity or solidarity (12).

This is the approach adopted, for example, in many of the studies that compare labour "models" ("North American" or "Anglo-Saxon", "Continental European", "Scandinavian", "Japanese", etc.) (cf. Freeman, 2000). What is the reason for this variety of "models"? Is there a trade-off between different goals? Does it make sense for a society to want to "buy" solidarity in exchange for less efficiency?

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(9) Ayres and Schwab (2000, 1). We would also have to include, where appropriate, the benefits provided by other agents, e.g. by the State (education, health services, etc.), which, although they are not actually a part of the employment relationship, nevertheless depend on it and influence it. And, naturally, if it is the company that establishes additional conditions, it must be prepared to pay their price: a higher cost of labour.

(10) Ayres and Schwab (2000) offer an interesting discussion of non-provision cases, showing that they are indeed attributable to market failures (assuming that the agents are rational).

(11) Obviously, this may fall short of the truth if we consider that the agents are looking for "even more" than this, in terms of attitudes, feelings, interpersonal relations, etc. (cf. Akerlof, 1982). We shall come back to this later.

(12) Or not *only* of efficiency: the benefit or protection in question may correct market failures, as in the case of an obligatory accident insurance, but it may also have other additional characteristics, such as a subsidised premium, which give it a redistributive function.

To understand the problem better, we need to distinguish between three different senses of the term “solidarity”:

1) As an outcome, that is, as the set of effects produced by the labour market institutions, primarily in terms of (relative) income levels and the stability of incomes over time (13). In this sense, solidarity has both a horizontal dimension (a more egalitarian distribution of income) (14) and a vertical dimension (guaranteeing the maintenance of incomes over time or, at least, providing cover against contingencies that may give rise to a loss of income).

2) As a set of institutions specifically designed to achieve this outcome. In this sense, many labour market institutions –the minimum wage, retirement insurance, illness and unemployment insurance, collective bargaining, etc.– have a dimension of solidarity or equity, which is presented as being complementary to the dimension of efficiency.

3) As a value or social norm, that is, as a higher-order institution which justifies the institutions mentioned in the previous paragraph (15).

For centuries, agrarian and, later, industrial societies dealt with situations of unemployment, recession, poverty, etc. by setting up (private or public) institutions for protection and redistribution, such as the extended family, charities, and debt remission practices (16). The aim in these cases was to resolve problems of collective action by creating institutions. The distinctive feature of these institutions, however, was that they were founded on the adoption of socially accepted values or principles and were reinforced by a (coercive) social norm that discouraged opportunistic behaviours (free riding) deriving from the problems (adverse selection and moral hazard) inherent in institutions of solidarity (17).

Accordingly, when we talk about solidarity in the labour market, the important thing is not the outcome but, first of all, the value or principle that sustains it (such as “all citizens should share risks and transfer income towards the less well off”), which legitimates the outcome (the redistribution of income or the spreading of risk); and, secondly, the social norm which reinforces it and prevents opportunistic behaviours. That is why it is still believed that these institutions define a model of “solidarity” whose achievement depends not only on law but also, and more importantly, on that attitude (value) of income and risk sharing, reinforced by a social norm that gives it a certain obligatory force.

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(13) Wage dispersion (between occupations, skill levels, regions, etc.), the level and degree of tax progression, the amount and coverage provided by pensions, the duration and amount of unemployment, sickness, injury or invalidity insurance, maternity or paternity leave, job protection (types of contracts, limitations on dismissal, severance payments), etc.

(14) See, for example, Calmfors and Drifill (1988). In welfare economics, vertical equity has a different meaning to do with the relative merits of different people (cf., for example, Lambert and Yitzhaki, 1995). It could also be argued that it is important “how” the income is obtained – but, in that case, we would be moving away from the concept of solidarity as an outcome.

(15) On the introduction of values in the field of economics, see Ben-Ner and Putterman (1998b). Here we follow, roughly, the definition of value given by Ben-Ner and Putterman (1998a, 6-7) as preferences regarding the agents’ behaviour towards one another, including how they achieve outcomes that are of interest to them. We understand the social norm as something that is external to the agent or that results from interaction among agents (Axelrod, 1986; Hechter, 1993).

(16) Agell (2000), Blank and Freeman (1993) and Gregg and Manning (1997) point to this as the origin of the institutions aimed at sharing the risks deriving from unemployment, illness, etc.

(17) These institutions can also be explained as solutions for market failures (for example, the lack of a complete range of markets for old age insurance), but adding values and social norms makes for a more complete description.

Therefore, when people compare the “Anglo-Saxon model” with the different varieties of “Continental European model” (cf. Albert, 1993; Freeman, 1998), they usually stress the fact that European society considers it a value and a social duty that income be redistributed, that wage differentials be reduced, that risks be covered on the same terms for all, and that all situations of extreme poverty be avoided. The “social” dimension of the labour market, therefore, is rooted not only in institutions, but, above all, in values or attitudes (supposedly shared by all) and the norms that sustain them.

Thus, introducing the concept of “solidarity” has enabled us to identify a series of principles, attitudes and values that can be widely accepted because they make it possible to solve common problems by creating specific institutions (laws, agreements, collective agreements, social norms, etc.), and that in some sense reflect shared visions. These institutions will be very varied and changeable, and this may create the impression that those values and attitudes are very volatile – when, in fact, they tend to be very stable, at least at the higher levels.

These higher-order institutions can play an important role in explaining the social dimensions – whether based on efficiency or on equality – of the different labour market models and the way they evolve over time. Rather than different versions of the social dimension, what we find are different levels of analysis, from that of the lower-order institutions to that of the values, ethical principles and attitudes that are the basis for some of the institutions and that express general principles of behaviour for the achievement of personal and collective outcomes.

2.4. Summary: Institutions for efficiency and solidarity

Besides the institutions designed to resolve market failures, we have found others whose goal is solidarity. In practice, they tend to be the same institutions: the unemployment insurance that “corrects” the lack of a market for the coverage of labour risks also makes it possible to maintain the income of the unemployed; and the union that emerges as the solution to problems of collective action ends up effecting a redistribution of income (though not necessarily in the direction required by the principle of solidarity).

The fact that they are the same institutions simplifies the analysis. Yet dealing with a plurality of goals, in the labour market as a whole and in each of its institutions, remains a complicated task. There is always the temptation to conduct the analysis exclusively in terms of efficiency: for example, analysing the cost of an increase in the minimum wage in terms of employment growth (18). Yet it does not seem right to forget the dimension of solidarity, if only because, as we said earlier, it is the historical origin of a good many institutions. And also because it is still very present in the minds of the citizens and governments of many countries, who appear to be willing to forego a certain amount of efficiency in exchange for a different distribution of the cake or of the risks (19).

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(18) The concept of efficiency (comparing the resources used with the results obtained) is itself not free of ambiguity. At bottom, when solidarity is cited as a value or attitude, the argument is about what should be included in the “results obtained” and the “resources used” when it comes to measuring the efficiency of an action, institution or economic system. It is significant that the debate about economic systems is not centred on efficiency (except on the part of economists) but, above all, on the legitimacy of introducing other goals and how best to achieve them. It can be useful, for example, to compare the viewpoints of Albert (1993), Barry (1999) and Williams (1994).

(19) And because the outcome in terms of income or employment does not have to coincide with the outcome in terms of welfare, among other reasons because there are certain assumptions to be made concerning the distribution of this effect among different groups, as Agell (2000) makes clear.

3. The institutions of the labour market

Having explained the dual role – efficiency and solidarity – of institutions in the labour market, our purpose in this section is to apply what the analysis of institutions has shown us in other areas to the exchanges and equilibria that take place in the labour market. In this market, the relationships between agents are mediated or conditioned by "social norms", "laws", "rules", "customs", "contracts", "collective agreements", "organisations", etc.: in short, by what we have called labour market "institutions" (20).

These institutions set the "rules of the game" in the market, reduce transaction costs, provide information, promote cooperative behaviour, restrict some behaviours and enable others, reduce the uncertainty about other people's behaviour, etc. – in other words, they perform functions that have to do with solving market failures and altering market outcomes. The institutions may take the form of social norms, conventions, patterns of behaviour, spontaneous arrangements, etc. (in line with the definitions found in the new institutional economics); or that of laws, decrees, collective agreements, contracts, pacts, etc. (more commonly found in the literature on the labour market) (21). And they may be rules that provide efficient solutions to economic problems, or regularities (restrictions) of behaviour that reduce uncertainty and define social outcomes (22).

Our thesis is that the institutions play both a positive and a negative role: they limit or correct the appropriation of rents (which is related to the correction of market failures we talked about earlier); and they also allow or foster that same appropriation. This dual and contradictory role is, we believe, at the root of many of the frequent discussions about institutions, particularly in the labour market. And it may go some way towards explaining successive moves to regulate or deregulate the market. What is more, the institutions change the agents' incentives, so that changes in behaviour may take place with a considerable time lag, and with largely unpredictable future effects. We shall discuss this in the next section.

3.1 Institutions and the appropriation of rents

Whenever, in the price setting process in a market, there is a surplus or rent which one of the parties may try to appropriate at the expense of the other, through opportunistic behaviour, an institution may arise spontaneously, or be deliberately created, to correct that capture of rents (23). Clearly, if a worker is paid a competitive wage, equal to the value of his marginal productivity and equal to his reserve wage (the wage he would earn in another company, or the benefit he would receive from unemployment insurance, corrected for the gain in leisure), there is no point in limiting the company's or the worker's right to freely

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(20) This terminology is common in the literature on the labour market (cf., for example, Freeman, 1998a; Nickell and Layard, 1999; Blau and Kahn, 1999).

(21) The institutions can also be organizations (regulatory bodies, labour tribunals, employers' organizations, unions, etc.); in other words, new agents who interact with the old agents, usually according to different rules (cf. Greif, 1997), though there are also some organizations that are spontaneous institutions, such as families and companies.

(22) Long-term contracts, for example, which save transaction and decision costs and reduce uncertainty, or unions, which interiorise externalities, are examples of the first type of institution (cf. Coase, 1992; Williamson, 1985). And the norm (not necessarily expressed in a law, collective agreement or contract) that a veteran worker cannot be dismissed, even if his marginal productivity is less than his wage, is an example of the second type of institution (cf. North, 1981; Schotter, 1981; Sugden, 1989).

(23) Opportunism is identified with the furtherance of one's own interest with deceit or guile, to the detriment of others, and has been extensively studied in organisation theory. Cf., for example, Williamson (1975, 1985).

terminate the employment relationship (for example, by requiring that there be grounds for dismissal or that it be accompanied by compensation) (24). However, there may be a surplus or rent, a difference between the wage the worker earns now and the wage he would earn somewhere else (25), or between what the company pays now and the cost of hiring another similar worker. This difference may be due to many causes: the existence of hiring or dismissal costs (26), the presence of fixed factors of production (which generate rents of scarcity, location, skill, etc.), the presence of specific (physical, human or organizational) capital (27), the existence of other termination costs, uncertainty about the environment (about future demand, for instance), a long time frame (so that the benefits from the employment relationship will only be obtained after a certain period), asymmetrical information (the employee knows his own attitude towards making effort in his job, but the company does not; or the employee has imperfect information about the state of demand that the company may cite as a reason to justify his dismissal or a cut in his wage), restrictions on competition in other goods or service markets, etc.

All of the above explains how institutions come to be created: for example, the obligation to pay compensation for unfair dismissal restricts opportunistic behaviour on the part of companies; and the loss of seniority rights likewise moderates the behaviour of employees. All the same, this does not give us any grounds to be over-optimistic about how effective these institutions are:

1) Explaining the functions an institution performs is not the same as explaining why it came into being (this is the "functionalist fallacy").

2) The fact that a certain institution exists is no guarantee that there is not a better alternative: institutions may be suboptimal, even if there are no transaction costs that justify not adopting a better alternative. And, what is more, there are reasons to believe that the institutions we know are not optimal (28).

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(24) The company will have no interest in dismissing the employee so long as his wage is equal to the value of his marginal productivity; and the employee will suffer no harm if he is dismissed, because he will find another job paying the same wage. Likewise, the employee will have no interest in leaving so long as his wage is equal to his opportunity cost, nor will the company suffer any harm if he leaves, because it will find another worker with the same productivity to whom it will pay the same wage. Cf. Carmichael (1989). It is assumed that all the relevant variables for this decision can be expressed in terms of wages.

(25) Strictly speaking, between the worker's welfare in his present job and the welfare he would have if he had a different job or was unemployed.

(26) The worker can appropriate the rent created if he (credibly) threatens the company, saying that he will reduce his effort or leave if he is not paid a wage above his reserve wage (provided the difference is not greater than the cost of dismissing him and selecting, hiring and training another employee, over the relevant period of time); and the company may threaten to dismiss him if he does not accept a lower wage (provided the difference is not greater than the cost to the worker of looking for another job).

(27) Specific human capital has become a major issue in recent discussions on opportunism in the labour market. Cf. Topel (1990) and Farber (1999) on its importance. See Klein et al. (1978) on the appropriation of its rents.

(28) This statement may have an exception in the institutions that are informal rules and social norms (such as not dismissing an employee immediately when sales temporarily dip, because this discourages the recruitment of high-quality workers and reduces the other employees' motivation), if we accept that they contain the accumulated wisdom and experience about the other agents' interests, attitudes and conducts and, therefore, are "interpersonal depositories of coordinative knowledge" (Langlois, 1986, 237). However, this is only applicable to certain institutions that have come about spontaneously as a result of repeated games and, obviously, is not applicable to most labour market institutions. In any case, there are no reasons for expecting natural selection mechanisms (Alchian, 1950) or those related to the emergence of spontaneous orders (Hayek, 1978) to operate in labour market institutions, which are (mostly) the result of human design.

3) The distribution of the rents between the two parties remains to be resolved. It will usually be decided in the contract (or in a social norm) (29).

4) The existence of institutions may open up the possibility of creating new rents and, therefore, of new opportunistic behaviour.

5) And, above all, institutions may be created solely (or mainly) to serve private interests and to create and appropriate rents: this is the point of view of the "political economy" or "conflict" school (30). Let us look at this in more detail.

3.2 Institutions for creating rents

The idea that certain institutions designed to correct market failures may also foster behaviours aimed at securing benefits for some agents at the expense of others goes back a long way (31). If a factor of production – for example, labour – wishes to increase its share of national income, it may do so by reducing its supply. This raises its price and reduces the marginal productivity of the other complementary fixed factors of production. The end result is a transfer of rents from these fixed factors to labour. But for this transfer to be sustainable, there have to be institutions that make it possible to keep the supply of labour relatively low, thus creating the lasting rent captured by the workers.

As Saint-Paul (1999c) points out, the first thing that comes to mind in connection with this thesis is the conflict between labour and capital. Yet capital is not a fixed factor but an accumulable one, so the decline in the rate of return will lead to a reduction of investment and the stock of capital, bringing the marginal productivity of capital back up again and the marginal productivity of labour down, at which point the battle for appropriation runs out of steam (32). For this reason, the institutional conflict ends up becoming a struggle between different types of labour and, specifically, between skilled and unskilled labour, on the one hand (what Saint-Paul calls the "internal" conflict), and between employed and unemployed labour (and new entrants in the labour market), on the other (the "external" conflict). This means that unskilled employed workers (the "insiders") use a series of institutions as barriers

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(30) Cf. MacLeod and Malcolmson (1989). In general, when unemployment is high, the cost of leaving is high for the worker and, consequently, it will be the company that appropriates the rent. The opposite will occur when unemployment is low. However, it is also possible that social norms be created about what is acceptable in these cases. It must also be remembered that there are costs – such as court costs, solicitors' fees, etc., in the case of dismissals – which create rents that may be exploited by the parties but that directly benefit third parties.

(31) On the political economy school, cf. Hassler et al. (1998), Robinson (1997), Saint-Paul (1993, 1996a,b, 1999a,b,c). A precedent is the insiders-outsiders theory (cf., for example, Lindbeck and Snower, 1988). On the conflict school in the new institutional economics, cf. Knight (1992).

(32) Institutions do not arise from the fact that there is opportunistic behaviour, but from the possibility that there may be such behaviour, together with the fact that it is not possible to write contingent contracts that cover all possible situations (Williamson, 1996). If the agents could fully trust the other party to never try to appropriate the rent created, many of these institutions would not be needed.

to reduce the competition from the "outsiders", in order to create and retain a market power that enables them to appropriate the rent generated.

Labour market institutions are involved in the creation, maintenance and appropriation of rents because they have increasing returns and create non-competitive situations. An institution's increasing returns may come from the high costs of creating the institution (entry barriers), learning or coordination effects (advantages of cooperating with others who are doing the same thing), or adaptive expectations (the hypothesis that institutions endure) (cf. Arthur, 1988) – and all of this is commonly found in the labour market (33). There are also numerous examples of market power: incomplete markets, imperfect information, high transaction costs, etc.

This means that labour institutions may be the result of a political conflict between the interests of different social groups, which use their votes and generate pressure and strategic coalitions to create a framework that will allow them to extract greater rents from other agents over time. This is compatible with the idea that institutions are justified as a means of correcting market failures (cf. Agell, 2000), or as channels for introducing a "social" dimension. But it introduces a new variable: labour market institutions are open to opportunistic uses.

And this explains the ambiguity we find in labout market institutions: even those created to correct market failures may end up reducing market efficiency. Conversely, institutions that were set up to redistribute income according to criteria of solidarity may end up improving efficiency, or they may degenerate into institutions that undermine solidarity. From the "conflict viewpoint" (Knight, 1992) this ambiguity is inevitable: sooner or later the existence of rents will give rise to the creation of institutions to appropriate them, and the mere possibility of the existence of rents will end up generating institutions that create them.

And all of this takes place over time in a process that, for the time being, we do not fully understand. An institution may persist for years without giving rise to opportunistic behaviours, or it may deteriorate rapidly. Therefore, the degree of efficiency of a market may change over time, owing to changes in its institutions (cf. North, 2000).

Taken to the extreme, this means that there is not, in effect, a single "labour market" but a labour market for every set of institutions, norms or rules; just as there is no single equilibrium (still less a single Pareto-optimal equilibrium) (Samuels, 2000, 392). As Ben-Ner and Putterman explain, "once the institutions of the economy were themselves to be explained, benign and 'well-behaved' equilibria seemed far less assured" (1998a, 4; cf. also Brock and Colander, 2000, 78).

(33) Here are a few examples. Setting up a union and establishing its credibility may require a significant investment of time and resources. Hiring and dismissal costs, whether natural or artificially induced, create rents that may be appropriated by insiders. Unemployment or sickness insurance may give rise to learning phenomena, such that agents who initially are reluctant to take advantage of it (stigma effect) use it cautiously at first, then more boldly and aggressively, until finally they resort to fraud, as Lindbeck (1995) has explained. Finally, the advantages of coordination are obvious, for example, in the institutions that back insiders' conduct.

3.3 Are there any automatic mechanisms in the evolution of institutions?

The authors who have written on the reform of labour market institutions have highlighted their complexity, their interrelatedness, the difficulty of predicting the consequences of any change that is made to them, the existence of multiple equilibria and path-dependencies (a solution that may have been adopted arbitrarily can end up decisively conditioning future evolution), the possibility of being locked in to an institution, etc. (cf. Freeman, 1998b) (34). There are many reasons why this might happen, beginning with our own ignorance of how these networks of institutions operate. Nevertheless, is there any mechanism whereby labour market institutions might evolve towards a steadily more optimal social situation? (35)

The authors of the new institutional economics will probably say that no, for various reasons:

1) We do not know exactly why some societies have succeeded in creating and developing favourable institutions, while others have not (North, 1990). In any case, there are grounds for believing that existing labour market institutions are not optimal (36).

2) The variety of institutions and their persistence in very different environments suggests that, if there is some kind of selection mechanism, it must be very slow. Or, more likely, many different equilibria are possible (cf. Freeman, 1998a; Lindbeck, 1996b; Nickell, 1997).

3) If the market is an institution, just as there are "market failures", there must also be "institutional failures" (37).

4) In a changing economy, there is likely to be a spontaneous process of "institutional deterioration" due simply to changes in technology, in relative prices, or in other variables that affect the creation and evolution of institutions.

Here we shall add another factor that we consider particularly important: the existence of processes of personal and social learning – the learning of knowledge, skills, attitudes and values. We assume that, in the process of creating and appropriating rents, the agents discover, first, the opportunities that arise (38); then, the means (institutions) for taking advantage of

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(34) For example, a country may have a highly developed system of social protection, with a high, increasing and relatively stable level of production, or a less highly developed system, with lower income and lower growth, more unemployment and more abrupt cyclical variations – that is, multiple equilibria (Lindbeck, 1996a). Insider-controlled markets are examples of situations in which institutions tend to endure, even if they are inefficient, so long as the cost of dismissing insiders and replacing them with outsiders is high enough (which depends, in turn, on other institutions, such as employment protection, education, occupational training, employee selection and recruitment, the right to strike, etc.). And the dependence of subsequent developments on the path followed previously is illustrated by the effects that generous, long-term unemployment benefits can have on labour supply and wage levels.

(35) This would give rise to what North (1990) calls "adaptive" efficiency, which refers to the rules or institutions that shape an economy as it evolves over time, as opposed to "assignative" (Paretian) efficiency, i.e. efficiency within existing institutions.

(36) Marsden (1995a,b) demonstrates that institutions do not evolve in a straight line. For example, during the '60s and '70s, business and union practices were accepted that later had very damaging effects on the functioning of the labour market.

(37) Cf. North (1990). There is a very substantial body of evidence on these failures, although I am not aware that this term has actually been used.

(38) Our knowledge of how this is done is limited. Cf. Casson (1990) and Kirzner (1973) for some suggestions.

these opportunities; and, later, the (expected or unexpected) consequences of their actions (for themselves and for others), which starts off a new process of learning and change (39). And on the basis of this knowledge, they develop new skills, attitudes, values and virtues: they "learn" to respect social norms (such as the norm that prohibits pretending to be ill in order to obtain a benefit), or not to respect them, and so acquire habits of behaviour (virtues) which either facilitate or hamper their decisions in the future (40).

As we said, this is both a personal and a social process which takes place in and through institutions (41). For this reason, the long-term effects of institutional change are difficult to predict: because we do not know how this learning takes place, nor how it alters people's restrictions and behaviours (42). For that reason, too, the existence of a short-term equilibrium – for example, concerning the sustainability of a national pension system – is no guarantee of future equilibria.

This conclusion is certainly disheartening. Is there anything else we can say about the stability of this process of institutional change? Is it reasonable to expect a "convergence" towards solutions that are sufficiently stable and not excessively suboptimal?

3.4 Higher-level institutions

We believe that, in the long term, the key to these questions is to be found in the institutions that govern the agents' learning processes and that can correct the "institutional failures" we mentioned ealier (43). For lack of a better name, we shall call them higher-order institutions (44).

Let us suppose that a worker and an employer enter into a long-term employment relationship that includes an investment in specific human capital. As we have seen, the existence of a rent, arising from this investment, raises the possibility that both will engage in opportunistic behaviours; and to prevent such behaviours institutions have to be created: for example, the undertaking to pay the worker compensation if the company dismisses him for

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(39) The development of the welfare state may serve to illustrate some of these learning processes (cf. Lindbeck, 1995; Argandoña, 1999a): a generous system of social protection may generate behaviours of fraud, adverse selection and moral hazard, which will depend, among other factors, on the social and ethical norms regarding these conducts, the frequency with which other people engage in them, the general opinion of society about misusing unemployment insurance or pretending to be ill to obtain benefits, etc. And all of these factors change precisely as a result of the learning processes we have been talking about. It may be for this reason that Ben-Ner and Putterman (1998a, 53-54) say that national social security systems require of the population a certain "moral attitude".

(40) Pérez-López (1993) explains these processes in decision-making.

(41) The agents act within the framework of certain institutions, but the institutions change, largely as a result of the agents' actions; specifically, when there are changes in relative prices, technology, information costs, or the agents' bargaining power (Knight, 1992; North, 1990).

(42) Also, the empirical evidence on this kind of learning is not encouraging: it is very slow, and there is no guarantee that it will work in the right direction. Cf. Mullainathan and Thaler (2000). This latter threat is what Pérez-López (1993) calls the possibility of "negative learning".

(43) A parallel approach is the one adopted by Frank (1996) in discussing the inefficiencies that can be corrected if the agents are capable of behaving responsibly towards others. Cf., also, Donaldson (2000).

(44) The name is not chosen at random. Williamson (2000) distinguishes four levels of analysis: the higher order is represented by the institutions we are referring to here (which he calls norms, customs, mores, traditions). The others are the institutional level, the level of governance institutions and the level of resource allocation. The institutions of the labour market (unions, minimum wage, unemployment insurance, collective agreements, etc.) belong to the second or third levels. The fourth level is that of neoclassical analysis, which takes the other levels as data.

no good reason, or the deferral of payment of part of the employee's remuneration to the end of the employment relationship to give the employee an incentive to continue in the job. However, even this simple case is fraught with problems (45). Is there any institution that performs the previous institutions' functions without having their drawbacks?

Earlier, we spoke of institutions that are "social norms", whose force is not derived from external coercive mechanisms (laws, agreements or contracts) and which distil the wisdom of generations (46). For example: "if there are no just grounds, a company shall not dismiss, before the end of his career, a long-serving worker who was hired on a low wage (below his marginal productivity) on the (possibly tacit) understanding that his compensation would increase as the years went by".

Informal norms like this perform a function similar to that of other formal labour market institutions, but they have major advantages – and some risks (47).

- They are flexible, which reduces the likelihood of opportunistic use (48) and allows them to be adapted to changing circumstances (49).
- They are reciprocal: one party cannot be expected to observe them scrupulously unless the other party does the same.
- They encompass the entire employment relationship: it is not reasonable to expect the norms on effort and punctuality to be observed if attention is not also given, for example, to the work atmosphere and on-the-job training.
- They are easy to enforce: they have no external monitoring or control costs, because they are based on trust.
- They are fragile, because trust can be lost.
- But not too fragile, because trust can be regained.
- They demand a constant attitude of attention towards the other party, of anticipating changes in circumstances, and of willingness to talk (50).
- They cannot be translated into rigid rules, but must be applied with prudence.

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(45) The mere existence of these elementary institutions may raise the amount of rents accumulated and, thus also, the incentive for further opportunistic behaviours.

(46) The literature on social norms is extensive, but it tends to focus on whether or not social norms are a substitute for the law – that is to say, whether informal institutions can be a substitute for formal institutions. Cf., for example, Basu (1998).

(47) The distinction between formal and informal institutions or norms is common in the new institutional economics literature. Cf., for example, Aoki (2000), North (1995).

(48) The employer who considers that his employee is abusing his trust in an opportunistic manner may dismiss him, because the norm allows it. But no doubt he will not do this without first trying to correct the employee's conduct and explaining to the other workers the reasons for his decision, because it is important that the norm continue to be accepted by everyone and that the dismissal is not considered an opportunistic act.

(49) In the previous example, there are licit reasons for dismissal: not only the employee's laziness but also changes in demand, competition, technology, etc. Whether it is easy to explain that the dismissal was necessary and not an act of opportunism on the part of the employer is a different matter.

(50) Many of the behaviours that can be interpreted as violations of trust are due to these reasons.

- They cannot always be expressed clearly, and yet they are effective. Their effectiveness depends on their being applied, not on their being defined (51).

- Unlike other institutions, they do not administer or moderate opportunism, but rather seek to eradicate it (cf. Bouckaert, 2000).

- They demand an attitude of openness towards others: they go beyond mere restrictions on personal behaviour and consider one agent's actions towards another not only insofar as they affect the agent (altruism, reputation) but also, and above all, insofar as they affect the other (or other agents) (cf. Pérez-López, 1993, 1998).

The existence of this type of institutions can account for apparent paradoxes such as the fact that employees are prepared to endure significant financial hardship in order to oppose business decisions they consider unjust (52). Does such behaviour make sense? Not from the point of view of strict neoclassical rationality; but it does if they think that the principle or higher-order institution of justice is important, for them and for others, because it governs many behaviours, so that abandoning it would legitimate opportunistic behaviour (by employers and by employees), increase uncertainty (which is something that institutions try to avoid), change people's behaviour, etc. (53).

Higher-order institutions of this kind – equity in labour relationships, mutual trust, loyalty, etc. – are desirable in themselves, independently of their desirability in any particular case. They do not wholly replace the lower-level institutions (honest and fair employers and employees will still need contracts, collective bargaining, and tribunals), but they may become irrelevant when certain lower-level institutions are introduced. If, for example, a collective agreement stipulates exactly what employees must do and leaves very little margin for prudential interpretation of the social norm (of what justice requires, regardless of whether the agreement requires it or not), in the long run the higher-order institution may fall into disuse – or, more precisely, it will still be valid, although it will need to be redefined, since it will (appear to) have lost validity in one particular case.

This type of institution tends to be oriented towards the solidarity we spoke of earlier: not solidarity as an outcome (redistribution of income and risks), but the whole set of

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(51) In practice, the problem arises from the fact that, when institutions change, the agents only have direct access to the lower-level institutions, i.e. the formal system of rules. And that changes behaviours, but not necessarily in a consistent fashion, which leads to a new equilibrium (North, 2000).

(52) See Bewley (1999); also Agell and Lundborg (1995). Camerer and Thaler (1995) sum up the empirical evidence on these "ultimatum games"; cf., also, Güth and Tietz (1990), Roth (1995). It is worth pointing out that this behaviour cannot be explained solely in terms of bounded rationality, but that the agents take "something else" into account, as we point out.

(53) This goes further than Agell's (1999) explanation based on gift exchange: the key is not to do something so that the other person will do something in return, but to do something because it is best for both. This is the ethical dimension, which we will talk about further on.

values and social norms on which this outcome is founded (54). When we invoke solidarity in this sense, we are referring, in a word, to those higher values that are considered desirable for all, as a defence of the interests of the agents involved and of society as a whole (55).

The ultimate problem of this type of institution is that it demands that the agents have certain attitudes, values or virtues that exclude opportunism. Is it realistic to think that such an attitude can exist in the labour market? We think it is (56): this attitude has existed in the past; it continues to exist in many companies today, and in many other aspects of our lives (57); and, above all, it continues to be necessary, because, without it, the labour market is likely to attain suboptimal equilibria.

Of course, this type of institution can also fall prey to opportunism: in a world in which employers and employees are concerned about each other, have mutual trust and live in accordance with justice, the free-rider will always stand to win (albeit only in the short term: in the long run, they all lose). However, all that this means is that the world of institutions may be subject to chronic instability (58). But that does not lessen the importance of the higher-order institutions: "it is easy to see why one might wish for a world in which people are motivated by self-interest in those choices where this proves collectively beneficial but are internally deterred from acting self-interestedly in situations in which opportunism is collectively harmful" (Ben-Ner and Putterman, 1998a, 5). To sum up, the norms we have been talking about perform this function – and serve, at least in theory, to identify when personal interest needs to be restricted (59).

Many of these higher-order institutions are, in short, ethical norms, understood not in the mechanistic sense in which ethics is usually understood in economics (60), nor as more

(54) There are plenty of precedents for this point of view. See, for example Kahneman et al. (1986) and Rabin (1993).

(55) These interests do not have to be static. For example, a relatively homogenous social group with similar opportunities and shared risks that cannot be evaluated in advance or defended separately is likely to adopt a system of shared protection: for example, the same dismissal rules and working conditions, a form of collective bargaining that avoids wage dispersion, etc. But if some agents have different incentives, if the risks can be assessed individually, or if new means of protection and insurance appear that allow personalized coverage, the system will end up "losing" solidarity – or, rather, it will end up changing the nature, content or expression of that solidarity, but not its role as a higher-order institution. For example, senior managers are not covered by the workers' collective agreements because they have different opportunities. For the same reason, the presence of highly differentiated groups, such as information technology personnel in the "new economy", tends to break the unity of collective agreements. This explains, for example, the sensation of a "crisis of solidarity" that takes place when, owing to the proliferation of such interests, the prevailing rules are abandoned. It may also explain the opposition in continental European countries to the "Anglo-Saxon" model. All of the above is, of course, compatible with changes in values and higher-order institutions: in an "individualistic" society solidarity may lose all meaning. Though, as we have explained here, part of this loss of meaning may be due not to a change in values but to the existence of new institutions or to changes in circumstances (cf. Argandoña, 2001).

(56) Williamson (1996) shares the same opinion, with reference to organisations.

(57) Stutzer and Lalive (2000) provide empirical evidence of the existence of a social norm that considers it a duty to work.

(58) Remember what we said before about the generation and modification of institutions that appropriate or create rents.

(59) The literature on social capital, begun by Putnam (1993), also underlines the role of social interactions in correcting problems of opportunism. Cf. Glaeser et al. (2000).

(60) Ethics is often considered a mere question of personal preferences (altruism, for example), or as a body of rules for action that are accepted because of their positive effects in maximising the agents' welfare or companies' profits (for example, reputation as a means of reducing transaction costs). However, all this remains within the realm of economic analysis, without ethics really having anything to say. On the conception of ethics proposed here, see Argandoña (1996b, 1999c).

or less arbitrary restrictions imposed "from without", but in the classical sense of ethics as the science that seeks to improve people: the agent himself and others (61).

This is not the place to discuss the role that ethics should play in the consideration of labour market institutions. Too often, however, it is omitted entirely. Without it, our view of the social dimension of the labour market is incomplete: not because ethics replaces the other institutions (which are necessary, if only because not everyone behaves ethically), but because it is the key to the arch that supports them, the key that can correct their tendency towards opportunism and deterioration, the key that must preside over all attempts to reform the labour market (62).

4. Conclusions

What do we mean when we say that the labour market is a "social" institution? What does this "social" dimension consist of? We have found a broad range of answers that may help us structure the dialogue between economists and other social scientists, politicians, journalists, and union leaders.

For some, the labour market does not need a social dimension: it is a competitive market, and does not need institutions that correct it. Or perhaps they think that such institutions already exist, that we do not need any more and that, more likely, we need a lot less.

For most economists, the institutions serve to correct market failures. The debate therefore focuses on the functions these institutions perform, the results they achieve and, therefore, how they should be changed if the goal is to reform the labour market in order to make it more efficient.

Others reject the idea that the labour market has goals of its own, and believe that it should be subordinated to higher ends. Some of these ends are easily dismissed, because they are based on partisan arguments or personal interests. Others, however, invoke the higher ends of society, or of the economic system, and so propose that the institutions of the labour market be subordinated to those ends. In response, economists might point to the effects these institutions have on economic efficiency, growth, macroeconomic equilibria or income distribution – a fruitful task that economists have been performing for very many years. On the strictly economic plane, however, an economist cannot go any further than that.

We have also seen that the labour market's "social" institutions always create rents and, at the same time, the possibility of opportunistic appropriation of those rents. This is what makes the labour market's "social" dimension so controversial: correcting an inefficiency may create other inefficiencies, even injustices, and introducing solidarity may be inefficient and end up causing opportunistic and self-interested behaviours. Hence the need to understand the dynamics of the processes whereby institutions are created and evolve.

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(61) Not all social norms are ethical in nature. Mansbridge (1998) offers a criterion for identifying them: breaking a social norm causes "irritation", whereas breaking a norm of justice causes "resentment", perhaps owing to the impression that what is being violated is of particular personal and social importance.

(62) See Argandoña (1996a) on the relationship between ethics and the other institutions, and Argandoña (1991) on ethics as a condition for long-term "equilibrium".

Of all the different aspects of these processes, we have concentrated on individual and social learning. Conventional economics explains how equilibria are achieved in the short and long term, given the institutions and assuming that social values and norms are irrelevant or, alternatively, that they do not change. However, these equilibria do not consider the learning we mentioned earlier, at least not much of it, not the most important part.

We can conclude, therefore, that the discussion, at its highest level, should take this learning into account. And we have pointed out that at least part of this learning is embodied in higher-order institutions, including social norms, some of which – those that have an ethical content – seem to have the mission of establishing the conditions for a long-term meta-economic equilibrium, because they are institutions that correct "institutional failures".

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