

# Institutions, Policy and the Labour Market: The Contribution of the Old Institutional Economics\*

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## Abstract

This paper seeks to examine the relationship and the interaction between institutions, policy and the labour market in the light of the ideas of the first generation of institutional economists, who, in contrast to neoclassicals, conceived of the economy as a nexus of institutions, underlining, therefore, the significant role of institutional and non-market factors in the functioning of an economic system. They also criticised those who define (economic) welfare only in terms of efficiency and satisfaction of consumer interests; institutionalists instead focus on issues related to justice, human self-development and labourers' welfare. In addition, early institutionalists paid considerable attention to the institutional framework of the labour market. In particular, the first generation of institutional economists highlighted the importance of institutions and other non-market parameters in determining the level of wages and employment (e.g. the role of the bargaining power of workers and employers). Furthermore, they made substantial contributions towards the field of labour policy and they were pioneers in the formulation of economic and social policy. Specifically, various modern institutions and labour market policies, such as unemployment benefits, industrial training and active employment policies, were implemented in the US, during the first decades of the 20th century, after the recommendation of the institutional labour economists. Therefore, their ideas, besides being interesting from a historical point of view, may also be useful in today's analysis of workers' problems and the functioning of modern labour markets.

**Keywords:** Institutional School, History of Labour Economics, Labour Policy, Labour Market Institutions

**JEL classification:** B15, B25, J08

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## 1. Introduction

It has long been recognised that the labour market is different from the other markets due to the peculiar nature of labour as a 'commodity'. Contrary to other 'commodities', labour has a soul. Thus, in order to understand the labour market functioning, we should not focus exclusively on the price mechanism, but should also take into consideration other crucial factors and parameters. Specifically, such factors may be the social norms, which influence – *inter alia* – the wage levels and workers' behaviour, psychological factors affecting the workers' effort and motivation, as well as labour institutions such as unemployment benefits

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or trade unions. The so-called 'Institutional Economics' has long attached great significance to the above-mentioned factors, and that was one of the main reasons for its intellectual dominance in the economic analysis of labour markets during the first decades of the 20<sup>th</sup> century.

Early institutional economists conceived of the economy as a nexus of institutions, highlighting the important role of non-market factors such as proprietary rights, professional and trade associations, traditions, customs, etc. in economies' functioning. Furthermore, they expressed the belief that the economic concept of welfare, in addition to the criterion of effectiveness and satisfaction of consumer desires, should also include issues concerning human 'self-development', justice and workers' well-being.

This paper seeks to examine the relationship and the interaction between institutions, policy and the labour market in the light of the ideas of the first generation of institutional economists. The paper has the following structure: section 2 briefly presents the main characteristics of the old institutional economics, while section 3 succinctly compares Institutional and Neoclassical economics focusing on labour market issues. The next section presents the main theses and approaches of institutional labour economics. After this discussion, section 5 looks at the old institutional approach with respect to the labour market functioning, labour policy and the role of institutions. Section 6 briefly discusses the case of minimum wages policy in order to highlight the relevance of early institutional ideas in analysing contemporary labour market issues. Finally, the concluding remarks bring together some key arguments of the paper.

## **2. The Old Institutional School of Economics: A Brief Overview**

Institutional school of economics emerged in the United States by the end of the 19<sup>th</sup> century and flourished in the first decades of the 20<sup>th</sup> century. The three generally accepted major figures of early institutional economics were Thorstein Veblen (1857-1929), Wesley Clair Mitchell (1874-1948) and John Rogers Commons (1862-1945). The first explicit (at least prominent) reference to the term "institutional economics" seems to have appeared in an article written by Walton Hamilton in 1919, entitled "The Institutional Approach to Economic Theory", which was published in the *American Economic Review*. However, as Hamilton pointed out, Robert Hoxie had first called himself an "institutional economist" in 1916 (Rutherford, 2003).<sup>1</sup> The old institutional school of economics reached its peak in the 1920s, while in the 1930s its influence gradually began to decline, so that by the end of World War II it had lost much of its previous sway on economic thought (Kaufman, 2000; Rutherford, 2000; 2003; for a recent discussion about the causes of this decline see Hermann, 2018; Mayhew, 2018).

One of the fundamental institutionalist theses was that an economy should not be conceived only in terms of the market mechanism, but should also include all those institutions that operate through the market and interact with it (Samuels, 1987). In this context, the institutional structure and arrangements of the economy – and not just the market mechanism – were the crucial factors for good economic performance and the effective allocation of productive resources; the market is nothing more than a mere, though very important, institution. But, how exactly is an institution defined? The answer to such a question cannot be absolute and unique. John Commons, for example, gives the following

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<sup>1</sup> According to Kenneth Boulding (1957, p. 3), "Wesley Mitchell claimed Richard Jones, a somewhat obscure contemporary of Ricardo, as perhaps the first institutionalist, though if we make the term vague enough Sir William Petty has a good claim to this somewhat dubious honor."

definition: "(...) We may define an institution as collective action in control, liberation and expansion of individual action. Collective action ranges all the way from unorganised custom to the many organised going concerns, such as the family, the corporation, the trade association, the trade union, the reserve system, the state" (Commons, 1931, p. 649). On the other hand, Veblen identifies institutions in his *Theory of Leisure Class* (1899) as follows:

"Products of the past process, are adapted to the past circumstances, and therefore never in full accord with the requirements of the present (...) At the same time, men's present habits of thought tend to persist indefinitely, except as circumstances enforce a change. These institutions which so have been handed down, these habits of thought, points of view, mental attitudes and aptitudes, or what not, are therefore a conservative factor" (Veblen, 1911 [1899], p. 191; see also Papageorgiou et al., 2013).

In any case, institutions, whether conservative or progressive, are human constructs and thus are subject to continuing modification. In institutionalists' view, institutions play a significant role, not only in the shaping of human behavior, but also in the evolution of capitalism. However, this role is in fact quite intricate given that institutions are part of the contradictory powers that form instincts, conducts, and habits of thought (see e.g. Veblen, 1909).

In addition, Commons argued that the evolution of the economic system and the development of institutions is a process of purposeful, "artificial selection". The interaction between individual actions and specific organisations can lead to institutional alteration. In Commons' view, individuals

"meet each other, not as physiological bodies moved by glands, nor as 'globules of desire' moved by pain and pleasure similar to the forces of physical and animal nature, but as prepared more or less by habit, induced by the pressure of custom to engage in those highly artificial transactions created by the collective human will" (Commons, 1934, p. 74).

In other words, Commons and other institutionalists who follow his approach, by repudiating the psychological background of the neoclassical paradigm, contended that institutional shift takes place due to individuals' choices, actions, and efforts to overcome their problems, which are connected to the (institutional) situation of each individual in society (Rutherford, 1983; for more details see Papageorgiou et al., 2013). By contrast, Veblen contended that in social evolution there was a "natural selection of institutions". In his own words: "The life of man in society, just like the life of other species, is a struggle for existence, and therefore it is a process of selective adaptation" (Veblen, 1911 [1899], p. 188). Therefore, according to the Veblenian tradition, the human institutions' progress

"may be set down, broadly, to a natural selection of the fittest habits of thought and to a process of enforced adaptation of individuals to an environment that has progressively changed with the growth of community and with the changing institutions" (Papageorgiou et al., 2003, pp. 1236-1237; see also Veblen 1911 [1899]).

During the period under consideration, both institutional and non-institutional economists put emphasis on "practical economic problems", though their focus was on different issues. In particular, the non-institutional economists of the early 20<sup>th</sup> century were primarily focused on

issues of pricing and of money, while the old institutionalists were highly interested in labour issues.<sup>2</sup> Accordingly, the old Institutional school of economics compiled many studies concerning the conditions of work and employment, playing also a substantial role in the formation of US labour legislation during the first decades of the 20<sup>th</sup> century (Katselidis, 2011). In the words of Edwin Witte, who was a prominent institutional economist at Wisconsin School,

“Institutional economists are not so much concerned with the explanation of all economic phenomena as with the solution of particular economic problems of immediate significance. John R. Commons studied labour problems to find out what was the best way for dealing with industrial conflict, with child labour, industrial accidents, sweat shop wages, and many similar questions (...) It is the practical problems approach which above all others characterizes institutional economics” (Witte, 1954, p. 133).

Furthermore, these reform-minded academic economists founded in 1906 the American Association for Labour Legislation (AALL),

“launching a national movement for compulsory social insurance and protective labour legislation. The leaders of the AALL were motivated primarily by the problem of worker insecurity (...) They believed that state intervention was necessary because workers and their families were unable to protect themselves against potentially devastating industrial hazards” (Moss, 1996, pp. 2-3).

Thus, they had a significant impact on the formation of the US welfare state<sup>3</sup> and highly affected the making of the New Deal policy of President Roosevelt in the 1930s.<sup>4</sup> Finally, institutionalists, by adopting an interdisciplinary approach in their works, extended as well their contributions to non-economic fields such as sociology, psychology and labour history (Hermann, 2018).

Labour institutionalism had several roots, such as the “German Historical School” of economics, the progressive reform movement in America and some dissenting British economists, including Sidney and Beatrice Webb and William Beveridge (Kaufman, 2004). In addition, some late 19<sup>th</sup>-century American economists, such as Richard Ely and Henry Carter Adams, who both had studied in Germany and were influenced by the historical school of economics, were the main origins of the Institutionalists’ emphasis on legal institutions (Rutherford, 2003). Finally, both the interest of institutional economists in social reform and their belief that the state can significantly contribute to this end also had roots in “historical economics” (Tribe, 2003).

All the above-mentioned sources of influence led many

“institutional economists to adopt an empiricist approach to theorising, namely they first collect the data and the observations, involving themselves in the facts (Richard Ely’s ‘look and see’ method), and then adduce from the facts and other grounded empirical work the major premises for theorising, so

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<sup>2</sup> I wish to thank Anne Mayhew for this point.

<sup>3</sup> For instance, John Commons played a significant role in formulating the 1932 “Wisconsin Unemployment and Compensation Law”. I thank Arturo Hermann for reminding me of this fact.

<sup>4</sup> Specifically, the institutional economists of Wisconsin school made significant contributions to the New Deal policies (Kaufman, 2003).

as to draw conclusions about reality. This approach was opposed to the deductive, *a priori* method of mainstream economics” (Katselidis, 2011, pp. 988-989; see also Chasse, 2017).

However, it should be explicitly noted that the aforementioned empiricist approach mainly characterises the institutionalist tradition of Commons and Mitchell, and not the Veblenian approach. Veblen’s main contribution to labour issues, as we will see in the next section, is related to his rejection of the (neoclassical) pleasure-pain approach to labour theorising. Though this rejection might be based on observation, it was not of the “go and see” kind that Commons and his fellows used.<sup>5</sup>

The philosophical background (*Weltanschauung*) of old institutional economics was shaped by both European (e.g. Hegel, Darwin and Spencer) and American (e.g. Peirce, James and Dewey) intellectual influences, leading the institutionalists to “view the economic order as an evolving scheme of things or cultural process (...) [that is] as an open system subject to change and growth” (Gruchy, 1967 [1947], pp. 17, 19). Within such a system, the individual is considered a social being whose behaviour is affected by the force of habit and formed by the individual’s interaction with the other members of the community. Thus, in contrast to the mechanistic and static perception of the classical and neoclassical economic tradition, institutional economists regarded the economic system as a dynamic and evolutionary process (Papageorgiou et al., 2013). Their methodological approach has been characterised as holistic since they were interested in the functioning of the economy as a whole, as opposed to the methodological individualism of the neoclassical paradigm (Biddle and Samuels, 1998).

Institutionalists argued that an understanding of the institutional structure of the economy is also a basic prerequisite for finding solutions to problems of economic and labour policy. Nevertheless, institutions, as already noted, should not be regarded as given, since they are human constructs and are subject to perpetual change (Witte, 1954). Furthermore, the (direct) observation of the real world – and not the construction of (abstract) models – was a main component of institutional economics, whose members did not regard economics as an exercise of logic, but as an endeavour to explain the behaviour of the real economies. As Bruce Kaufman put the matter:

“The labour institutionalist’s methodological approach to research is distinguished by four key features: the emphasis on fact-gathering, the importance of realism of assumptions, the virtues of a “go and see” participant/observer method of investigation, and the necessity of an interdisciplinary approach to theory construction. These methodological predispositions arose, in turn, from the institutionalist’s dual focus on reforming both orthodox theory and national labour policy and workplace employment practices” (Kaufman, 2004, pp. 16-17).

### **3. Institutionalism vs. Neoclassical Economics: A Brief Comparison Focused on Labour Market Issues**

The early economic literature on labour institutions and their objectives was rather short and incomplete. Despite the fact that from the beginnings of economic science both the concept of the market and that of labour had a central role in economic thought, labour market analysis

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<sup>5</sup> Many thanks to Anne Mayhew for this argument.

and the examination of industrial problems had been limited for a very long time. In particular, “classical economic thought advocated free labour markets and considered the relationship between capital and labour to be non-competitive” (Drakopoulos and Katselidis, 2014, p. 1135). In addition, classical economists were more interested in long-term economic processes under the assumption of perfectly competitive markets, and less about the actual conditions of the (imperfect) job market. On the other hand, marginalists and early neoclassical analysts, such as Stanley Jevons and Francis Edgeworth, asserted that the existence of labour institutions, like trade unions, renders the labour market problem mathematically indeterminate (Edgeworth, 1881; Jevons, 1882). Therefore, practical issues concerning labour did not pertain to economic science (see e.g. Jevons, 1882, pp. 154-155). In other words, “according to orthodox theory, labour problems either do not exist (e.g., unemployment is a voluntary choice) or are best solved by individual initiative and market forces” (Kaufman, 2004, p. 18).

Therefore, it was clear that neoclassical economics, applying the hypothesis of perfectly competitive markets, could not shed light on fundamental labour market issues, including the role of collective bargaining, the interplay between labour unions and employers’ associations, or labour legislation matters. Thus, the goal of institutional economists was twofold:

“On the one hand, they attempted to make labour problems more widely known, emphasizing the crucial role of labour issues both in the economy and the society. On the other hand, they tried to ‘prove’ that the neoclassical analysis could not contribute to any solution of this kind of problems; therefore, a different scientific approach was needed” (Katselidis, 2011, p. 988).

Neoclassical theorists have conceived of labour as a pure commodity or a factor of production. Hence, the payment of labour in the neoclassical system is determined by marginal productivity theory, according to which wages are equal to the value of the marginal product of labour, under the hypothesis of perfect competition both between workers and between employers (see e.g. Clark, 1899, pp. 166, 179). Moreover, the marginal productivity condition determines also the level of the demand for labour. Nevertheless, the final magnitude of wages and employment is also influenced by the supply of labour. In the words of Alfred Marshall ([1920/1890]1949, p. 442), “demand and supply exert co-ordinate influences on wages; neither has a claim to predominance; any more than has either blade of a pair of scissors, or either pier of an arch”. The neoclassical supply of labour relied upon the utilitarian hedonic principle, according to which, the labour supply has a negative utility for the worker. Therefore, for Jevons, the founder of the neoclassical theory of the supply of labour, labour may be defined as follows:

“Labour is any painful exertion of mind or body undergone partly or wholly with a view to future good (...) It is possible that the true solution will consist in treating labour as a case of negative utility, or negative mingled with positive utility” (Jevons [1879/1871] 1965, pp. 168-169).

The neoclassical conception of labour was in full contrast to the institutional viewpoint; for instance, the institutional-Veblenian notion of the “instinct of workmanship” was diametrically opposed to the hedonistic interpretation of human behaviour (Veblen, 1898; 1914). More precisely, Veblen identified three basic drives or instincts that govern human behavior and

individual action: “the instinct of workmanship” or the impulse to work so as to “turn things to human use” closely related to the habits of thought (Veblen, 1898, p. 191), “the instinct of idle curiosity”, referring to the propensity to comprehend how the external world works through the use of imagination; and “the instinct of parental bent”, emphasising human interest in the welfare of others (Veblen, 1898; 1914; see also Papageorgiou et al., 2013). However, the instinct of workmanship is regarded as the most fundamental and generic trait of human nature (Veblen, 1898).

Veblen’s theory was in sharp contrast to that of orthodox economic theory, which asserted that one of the basic characteristics of the “economic man” is his aversion to work. In addition, according to the idea of the “instinct of workmanship”, the neoclassical hypothesis of the negative utility of labor is incompatible with human biological evolution, since if humans systematically avoided useful labor, then the human species would not have survived. “In contrast, hundreds of thousands of years of human evolution must have led to the [natural] selection of some propensity to engage in work that was useful for [human] survival” (Hodgson, 2004, p. 196; brackets added). Veblen, therefore, strongly criticised the neoclassical theory of labor, which, by adopting the utilitarian and hedonistic interpretations of human behavior, incorrectly ignored “the instinct of workmanship” which, as stated above, “is a generic feature of human nature that guides the life of man in his utilisation of material things and gives rise to a proclivity for purposeful action” (Cordes, 2005, p. 2).

Furthermore, during at least the first third of the 20<sup>th</sup> century, Arthur Pigou may be regarded as the most prominent early neoclassical author on labour market analysis. Specifically, Pigou was one of the first neoclassical economists who found a strong positive correlation between the real wage rate and unemployment level, attributing more and more importance to wage rigidities as the main cause of the unemployment problem. Additionally, in contrast to the institutional economists, he considered particular institutional factors like the trade unions’ power or the minimum wages to be mainly responsible for labour market malfunctioning (Pigou, 1913; 1927; see below section 6).

On the other hand, the majority of the institutional economists underlined the importance of social and institutional parameters in determining the level of wages and strongly expressed their reservations as regards the connection of the principle of marginal productivity with the real firms’ conduct (see e.g. Lescohier, 1935). Moreover, institutionalists argued that the nature of labour supply is totally different from the supply of other input factors or commodities. For instance, Wisconsin institutionalism emphasised the significant role of human will in economic life and tried to construct a human theory of labour as an alternative to a mechanical / physics type theory of mainstream / neoclassical economics (Commons, 1964 [1913]; Commons, 1950; Kaufman, 2008). In the words of Don Lescohier, an influential member of the Wisconsin institutional school,

“labour is an expression of the personal energy of a human being. The productive energy which the labourer sells to his employer is inseparable in existence and in use from the personality of the labourer (...) The labour supply has other interests than work. It is produced in response to other than economic motives. It comes into existence through human reasons, not for market demands” (Lescohier, 1919a, pp. 10-11).

In spite of the aforementioned differences – both in theory and methods – between early neoclassical and institutional economists, it is worth noting that there were also some convergent points of view. For instance, Arthur Pigou, in his work *Unemployment* (1913), endorsed some policies and labour market institutions proposed by institutional economists,

such as insurance against unemployment or a net of labour exchanges (Katselidis, 2011). In particular, Pigou stated that “the volume of unemployment is likely to be diminished by any device which enables workpeople to ascertain where work is wanted and to move freely towards available vacancies. Labour Exchanges are a device of this kind” (Pigou, 1913, p. 245).

In addition, he asserted that,

“besides investigating *remedies* (...) it has also been found necessary to investigate *palliatives*, in the sense of means to alleviate the evil consequences to which a given amount of unemployment leads. Among these palliatives the most important are the device of meeting periods of depression by organized short-time instead of the dismissal of hands, and the device of insurance against unemployment” (Pigou, 1913, p. 246, italics in original).

Moreover, it is also noteworthy that Alfred Marshall did not piously adopt the abstract-deductive approach with respect to labour issues. Although Marshall’s labour market approach was not differentiated from the competitive market reasoning, he developed some arguments which seem to bear close resemblance to institutional analysis. As Marshall put the matter:

“In fact there is no such thing in modern civilization as a general rate of wages. Each of a hundred or more groups of workers has its own wage problem, its own set of special causes, natural and artificial, controlling the supply-price, and limiting the number of its members; each has its own demand-price governed by the need that other agents of production have of its services” (Marshall, [1920/1890]1949, p. 442).

#### **4. Institutional Labour Economics**

As already noted, the first systematic and special studies on the labour markets and their problems emerged in the last decades of the 19<sup>th</sup> century and the first decades of the 20<sup>th</sup> century. During that period, the large Western economies were gradually driven to full industrialisation and production concentrated in big factories where, in many cases, mainly in the US, a scientific organisation of the work process (Taylorism) was adopted. At the same time, labour was taking the form of “regular employment”, and a large part of the workforce consisted of salaried employees (Dedousopoulos, 2000; Wisman and Pacitti, 2004). Then, the trade union movement in Europe and America was significantly strengthened, and the first powerful factory unions, which contained thousands of members, were created. Within this historical context, the first generation of institutional economists provided their analyses on numerous labour issues.

The labour market, as an imperfect human-made institution, may break down due to various reasons, causing thus a host of problems. Institutional labour economists tried to resolve these “labour questions” primarily through three means / methods: unions, labour law and (personnel) management. Firstly, mainly during the period from 1885-86 to 1905-06, there were a considerable number of labour studies and books focusing on the problems of organised-unionised labour. Accordingly, that trend in labour studies placed emphasis on the various evils connected to the use of labour in an industrial system, on trade unionism and



collective bargaining (McNulty, 1980). For example, a popular work in American literature related to the study of organized labour was Thomas S. Adams and Helen L. Sumner's textbook *Labour Problems* (1905).<sup>6</sup> However, it is noteworthy that of all these works published during the first phase of labour institutionalism, most concerned the impact of labour problems on individuals rather than on the economy (Brissenden, 1926).

After about 1905, there was a shift as regards the ways to address various labour issues, instigating thus the second "phase" in the study of labour problems and solutions. In particular, labour specialists and policy makers attributed more and more importance to labour law, and specifically to social insurance and protective labour legislation (Kaufman, 2003). "That shift played also a role to the gradual emphasis given to the labour market as an institution and how the employment relationship is embedded and operates within a web of institutions" (Katselidis, 2011, p. 993). In addition, as has been mentioned, the "American Association for the Labour Legislation" was founded in 1906, encouraging this kind of research, and Commons and Andrews's book entitled *Principles of Labour Legislation* (1916) was regarded as the leading work in this area until about the mid-1930s. Labour institutionalists, by underlying the peculiar nature of the labour contract, conceived of labour and the "free access to a labour market" as an intangible property right: "It is intangible because it is merely the act of offering and yet withholding services or commodities. It is property and becomes labour in the sense that it is the power of getting value in exchange" (Commons and Andrews, 1916, p. 8). For that reason, the government should intervene both in the economy and the labour market in order to protect the aforementioned property right.

Around World War I the field of industrial relations / personnel management emerged, commencing a third "phase" of labour institutionalism. Don Lescohier, who was one of the pioneers in the study and instruction of personnel management (see Lescohier, 1960), recommended the creation of employment departments within industries in order to "reduce labour turnover, improve labour selection, improve the training of workers, and increase per capita productivity" (Brandeis and Lescohier, 1935, p. 324). In general, early labour institutionalists, such as John Commons, Don Lescohier, William Leiserson and Sumner Slichter, made a substantial contribution towards the examination, development and promotion of this new approach to labour management, stressing its positive impact both on employee relations as well as on firms' profits (Kaufman, 2008). For instance, Commons, in his book *Industrial Goodwill* (1919), strongly criticised the old personnel methods such as the so-called "drive" methods of management and the scientific management, known as Taylorism. On the other hand, he highlighted the positive consequences of more participative and collaborative practices like his "goodwill" approach. Specifically, in the words of Commons, "scientific management, since it begins and ends with individuals separated from their fellows, has the defects of autocracy. It means government by experts (...) But goodwill is reciprocity. It is not government at all, but mutual concession" (Commons, 1919, p. 19).

It is worth pointing out here that all the above-mentioned research approaches and programs were influenced both by the scientific progress in the labour studies field and by the real life phenomena such as the disorganised nature of the American labour market or the pervasive dissatisfaction displayed by workers.

"Thus, the serious economic and political pressures generated by the WWI, in conjunction with the development of the institutional program of labour studies, help explain why institutional economists gave emphasis to certain subjects such as labour turnover, labour management or the organisation of

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<sup>6</sup> To be accurate, we should note that some (not many) chapters in the Adams and Sumner's textbook dealt with non-union issues.

the labour market through an extensive system of labour Exchanges” (Katselidis, 2011, p. 993).

In short, as seen above, labour institutionalists strongly criticised both the unreal character of the various neoclassical assumptions and the overreliance on abstract mathematical analysis. For instance, in a review of the Paul Douglas’s outstanding work *The Theory of Wages*, Lescohier held that

“Professor Douglas relies too much upon the truth of assumptions and estimated probabilities which he incorporates as raw materials into his analysis; and that the reader must watch carefully lest he accept conclusions based in part upon foundations that are questionable” (Lescohier, 1935, p. 277).

To sum up, in institutionalists’ work can be found the “rejection of the three then-prevalent orthodox doctrines: the commodity conception of labour, a laissez-faire approach to market / employment regulation, and the monarchical or ‘employer autocracy’ model of work force governance” (Kaufman, 2003, p. 4).

## **5. The Labour Market Functioning, Labour Policy and the Role of Institutions**

As has been stressed, the American institutionalists held that the labour market should be conceived as a major institution which significantly affects and organises the employment relationship. This employee–employer relationship, as embedded in the employment contract, is not regarded only as a kind of market transaction, but it is also formed through the interaction of legal, economic, social and political factors. For that reason, institutional economists contended that the study of labour issues requires the adoption of a multidisciplinary approach (Kaufman, 2006). In addition, they recognised that labour, even conceived as a commodity, displays at least two important peculiarities: (a) in a free labour market, the “labour commodity” is sold for a specified time period, preserving thus the worker’s personal freedom, and (b) it is a commodity that cannot be separated from its owner. Therefore, institutionalists argued that the labourer is not just an input in the productive process or a tool of production. On the contrary, most emphasised the human and social aspects of work, regarding the worker as a citizen and a social being who has family, personal life, etc. (see e.g. Commons and Andrews, 1916; Lescohier, 1919b). They also considered that the monolithic perception of labour as a market commodity and a supplement to the other factors of production impedes the implementation of those policies which promote labourers’ welfare, a better education system, health protection, improvement of living conditions of the working class etc. (Commons, 1964 [1913]; Commons and Andrews, 1916; see also Gruchy 1967 [1947]). In short, “labour, unlike other inputs, is embodied in human beings and the condition and outcomes of work experienced by human beings carry a much higher moral significance” (Kaufman, 2006, p. 302).

Furthermore, institutional economists, by stressing the importance of collective action, rejected the neoclassical conception of society as a simple sum of individuals (Commons, 1934). Therefore, an additional essential characteristic that differentiates labour from other factors of production is the collective behaviour of individuals that induce them to form groups and unions based on common interests and goals (Wolman, 1924; Perlman, 1928; 1936; see also Tarling, 1987, p. 87). Accordingly, early institutional economists, such as John R.

Commons, were advocates of collective action through unionism, claiming that the bulk of the American union movement (the American Federation of Labour) was chiefly motivated by economic concerns (Commons et al., 1918; Rutherford, 2000; Drakopoulos and Katselidis, 2014). Moreover, old institutional economists, such as George Barnett, Robert Hoxie and Selig Perlman, by adopting an interdisciplinary – more sociological-historical – approach, did not seek to formalise their ideas on trade unions. This perspective, in accordance with their holistic methodological approach, placed emphasis “on the social nature of man, collective decision making, and particular institutional histories” (Drakopoulos and Katselidis, 2014, p. 1136; for a discussion, see Rutherford, 1989; 2009). In general, institutionalists

“conceived of unions as politico-economic organisations whose members were motivated by relative comparisons and were concerned with issues of equity and justice (...) They also sought to place unions into different categories according to their structure, specific purpose, or social function<sup>7</sup> (...) Additionally, they described in detail the various duties and responsibilities of unions, and explained the factors that influenced the development of unionism” (Drakopoulos and Katselidis, 2014, p. 1136).

Institutional labour economists were, at that time, in front of a host of labour issues and questions that require investigation and resolution: first, workers were exposed to many risks, facing a variety of problems such as low wages, poor and unhealthy working conditions, frequent labour accidents, gruelling working hours, unemployment etc. Therefore, the creation of those institutions – for example, minimum wages and accident prevention statutes, that would protect employees and restrict their suffering – was indispensable (Commons and Andrews, 1916). Second, cyclical as well as seasonal fluctuations were permanent in the US economy, making both product and labour markets highly volatile. Thus, the stabilisation of these markets and the reduction of casual and unstable employment were also two crucial issues (Lescohier, 1919a). Third, the relationship between workers and employers was to some degree confrontational; institutionalists were in favour of the alleviation of this struggle through institutional measures and labour laws. In a similar vein, they also supported the equality of bargaining power of employers and workers (Commons, 1919). Finally, a fourth important issue, with adverse effects both on employees and employers, was related to the workers’ behaviour and attitude. Specifically, workers were often indifferent to their work and their duties; for that reason, institutionalists proposed ways of improving the work climate and employee involvement in the operation and management of the companies (Slichter, 1926).

The main pillars of the institutional school’s agenda with respect to labour market policy and the creation of appropriate institutions were the following: first of all, the American institutional economists strongly supported the systematic organisation of the labour market through the institution of manpower employment agencies that would contribute, *inter alia*, to the increase of market efficiency (Leiserson, 1914; 1917; Lescohier, 1919a). Second, they suggested strengthening regular and stable employment and reducing the very high rate of labour turnover, i.e. the workers’ movement rate from one job to another, which was considered to be one of the most serious evils of the industrial life. Besides their attempt to find the causes and remedies of the problem, institutionalists tried to statistically analyse it so as to determine, if possible, the optimal-normal turnover rate (Slichter, 1919; Brissenden and Frankel, 1922). Thirdly, they underlined the importance of the systematic policy of vocational education and training with a view to further developing employee skills (Lescohier, 1919a). Institutional economists seem to have been influenced by the so-called industrial education /

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<sup>7</sup> Hoxie’s discussion (1914a; 1914b) of various “types” of unionism is indicative of this direction.

vocational guidance movement developed in the United States in the period under consideration. The “Vocationalists”, like Frank Parsons and Meyer Bloomfield, argued that the school, viz. the education of the young people, and the labour market should be closely connected (Katselidis, 2011). In a similar vein, they stated that “social problems could be solved by changing the individual (...) and had long criticized industry for its ‘wasteful’ recruiting techniques” (Jacoby, 2004, pp. 51, 68). Fourthly, institutional economists were the founders of the personnel management and industrial relations, developing progressive ideas about how to manage employees in enterprises (Commons, 1919; Leiserson, 1959). Here again we may find an intellectual connection between Institutionalists and Vocationalists, since the latter “became some of the most active proponents of personnel management, and they infused the new profession with an abiding interest in employee selection and career development” (Jacoby, 2004, p. 50).

Moreover, a fifth pillar of the early institutional labour market policy agenda is related to the institutionalists’ aim to improve working conditions with an emphasis on healthy workplaces (Lescohier, 1919a). Sixth, they proposed a counter-cyclical macroeconomic policy aimed at smoothing both cyclical economic fluctuations and the destructive, as proved, rapid rises and falls in the size of production activity and employment (Commons, 1934; for a discussion see Kaufman, 2006). Finally, institutionalists were pioneers in the issue of social security, proposing, for example, insurance against unemployment and medical insurance (Altmeyer, 1937; 1950; Witte, 1935). For instance, Edwin Witte writes:

“Unemployment compensation is not conceived of as a complete protection against the hazards of unemployment. In no country in the world has it proved so. This does not mean that unemployment compensation is valueless. Far from it. It is a first line of defence, valuable particularly for those workers who are ordinarily regularly employed – the great majority of our industrial workers and the largest element in our entire population” (Witte, 1935, p. 90).

## **6. Old Institutional Economics and Current Labour Issues: The Case of Minimum Wages**

For neoclassical / mainstream economics, in general, the enforcement of a minimum wage is considered to be foreign to the laws of political economy, diminishing the size of employment – especially of low-wages workers – and discouraging capital and firms from expanding. For instance, A. C. Pigou, though accepting of a broad Minimum Conditions programme with respect to several aspects of life (e.g. education, consumption, medical care and housing), he argued that a minimum wage was a deficient measure mainly due to its possible negative impact on employment (Pigou, 1913; see also Katselidis, 2016).

Nowadays, although there is no consensus among economists on the effect of minimum wages on the unemployment level, it is argued that the imposition of minimum wages mainly has an adverse impact on the employment of young people and low-skilled workers (see e.g. Nickell and Layard, 1999; Neumark and Wascher, 2008; Ehrenberg and Smith, 2017). The opponents of minimum wages hold that though those workers who remain in the labor market have higher wages, this is in fact at the expense of both firms’ profits and employment, both of which are lower as a result. However, this analysis assumes that firms operate in competitive markets with little or no economic rent that can be extracted in the form of higher wages. But what happens if the labour market does not function in a competitive

framework? After the publication of Card and Krueger's influential book *Myth and Measurement* (1995), there have been many mainstream economists who assert that imposing a minimum wage may have a positive effect on employment (increase in employment) (only) when the business firm has some form of monopsony power in the labour market due to, for example, labour immobility (Card and Krueger, 1995). In this case, a monopsonistic firm pays a wage significantly lower than both the competitive one and the marginal product of labour, employing also fewer workers than it would if it were in a competitive labour market. The introduction here of a minimum wage will be expected to increase employment up to the point where the minimum wage level is equal to the competitive equilibrium wage (Polachek and Siebert, 1993). Even then, nevertheless, neoclassical practitioners are likely to contend that monopsony conditions do not characterise the real markets where minimum wages apply.

On the other hand, for institutionalists, as already noted, this is the wrong way to conceive of markets. Therefore, as Kaufman (2010) points out, institutional theory tells a more convincing story and presents a more positive case for minimum wages, broadening also the relevant theory and policy debate. Specifically, according to the early institutional economics' viewpoint, the implementation of a statutory minimum wage may affect positively both workers and employers, promoting long-term economic efficiency and productivity. For instance, "high road" employers, who face an increased production cost due to the existence of a minimum wage, will be forced to improve their production methods, investing in new technologies, R&D and human capital (Kaufman, 2010). In addition, the enforcement of a minimum wage higher than the competitive one will lead to a revision of firms' hiring policy; firms will mainly turn to hiring permanent and capable employees, thus reducing the number of low-quality casual workers. This may also have a positive impact on workers, provided that they will try to improve their technical dexterities and qualitative characteristics with a view to become more competitive (Commons, 1921). Consequently, in the long-run, the most effective and advanced enterprises survive in markets, since they gradually displace those firms which follow old and obsolete management and production methods.

Early institutional economists also held that minimum wages legislation is one of the instruments against the exacerbation of labour standards caused by adverse economic circumstances like unemployment, which gives employers the power to exploit the labourers' need to work, leading also to more elastic employment conditions (lower wages, worse working conditions, illegal labour with close to zero salaries, etc.). Additionally, workers have no power to react since they are easily replaceable and have a strong need to work at any labour price. In other words, this power structure violates any equality in the negotiations between employers and workers, giving the comparative advantage to the stronger part. Therefore, the minimum wages measure can also contribute towards the reduction of inequality of bargaining power (Commons and Andrews, 1916). Finally, early institutionalists, in a "proto-Keynesians" vein, connected minimum wages to macroeconomic stability and aggregate demand's boost (Kaufman, 2010).

## **7. Concluding Remarks**

The early institutional economists helped shape labour market policy in the US during the first decades of the 20<sup>th</sup> century, aiming both at the improvement of working conditions and the rise in labourers' standard of living. The observed labour market inequalities and malfunctions rendered imperative the creation of mechanisms for the redistribution and readjustment of power between employees and employers. The majority of the old institutional economists

attached great significance and attention to real life economic phenomena and empirical facts, stressing that not only should the economic theory of labour markets be based on realistic assumptions, but it should also be tested empirically.

Institutional economists, in contrast to neoclassicals, regarded economy as a nexus of institutions, underlining, therefore, the important role of institutional and non-market factors (e.g. property rights, professional and trade associations, tradition, social norms and customs) in the functioning of an economic system. They also criticised those who define (economic) welfare only in terms of efficiency and satisfaction of consumer wants; institutionalists instead focus on issues related to justice, human self-development and labourers' welfare.

Classical and early neoclassical economists did not pay much attention to the economic analysis of labour market institutions, since they contended that such an issue was outside the standard domain of economic analysis (e.g. Jevons, 1882), and that, moreover, such an institutional presence hampered the application of formalism to economics (e.g. Edgeworth, 1881). By contrast, early institutionalists paid considerable attention to the examination of the institutional framework of the labour market. In particular, the first generation of institutional economists highlighted the importance of institutions and other non-market factors in determining the level of wages and employment (e.g. the role of the bargaining power of workers and employers). Furthermore, they made substantial contributions towards the field of labour policy; indeed they were pioneers in the formulation of economic and social policy. Specifically, acting on the recommendation of the institutional labour economists, various modern institutions and labour market policies, such as unemployment benefits, industrial training and active employment policies, were implemented in the US during the period under consideration. Hence, judging by the number of their published papers in leading scientific economic journals, and by their participation in various committees and councils, it seems that institutionalists were very influential both in the scientific and government circles. Therefore, their ideas, besides being interesting from a historical point of view, may also be useful in today's analysis of workers' problems and the functioning of modern labour markets.

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