

Reconsidering Institutional Labor Economics

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Abstract

The goal of this paper is to reconsider institutional labor economics and make a renewed case for it. Two recent developments motivate this effort: the rise of New Personnel Economics (NPE) as a significant subfield of labor economics and the very substantial shifts in work organization that have taken place in recent years. NPE offers explanations for how firms organize work which challenge institutional models. Yet understanding how and why firms have reorganized work opens the door for a renewed interest in institutional approaches.

The focus is upon how organizations structure their internal labor market (ILM) rules. The argument is that these rules emerge from the interplay of competing groups and competing rationalities (in both union and non-union environments). As such the role of power and influence in establishing work rules is central although more conventional optimizing considerations also remain important. Although both social-psychological arguments as well as national level “varieties of capitalism” approaches are fruitful they are not the topic of the paper.

The paper illustrates the utility of institutional labor economics by reviewing evidence regarding features of ILMs and how they are changing. The empirical material includes the emergence of ILMs, patterns of diffusion of high performance work organization, variation across firms in obtaining effort and commitment from their workforce, the use of contingent labor, the increased diversity of ILM patterns, and the rise of equal employment opportunity and due process functions. The paper then concludes by addressing a possible response to the argument developed here: that deviations from standard theory are merely transitory and will be eliminated by market discipline. The final section draws together the argument and its implications and discusses limitations and possible next steps.

A chestnut in any course on Industrial Relations is a review of old debates between the so-called institutionalists and more mainstream labor economists. Ross (1948) and Dunlop (1950) argued about whether unions were primarily political or economic institutions and Lester (1946) and Machlup (1946) debated the role of equilibrium and marginal analysis in labor economics. The local labor market studies of Reynolds (1951), Myers and Shultz (1951), and others critiqued the standard assumptions of mobility and perfect information.

By the mid-1960s these disputes seemed to have been settled with the rise of human capital theory and the integration of labor economics with mainstream economic theory. The institutionalists were not eliminated but they retreated into schools of Industrial Relations and, less commonly, into business schools. The empirical power of human capital theory as well as the creativity of theoretical work swept the field. For example, the apparent anomalies uncovered in the local labor market studies turned out to be explicable as modern theories of information and search emerged.

This outcome notwithstanding, the goal of this paper is to reconsider institutional labor economics and make a renewed case for it. Two recent developments motivate this effort. One of the last remaining strongholds of institutional thinking has been researching and explaining the personnel practices of firms and, in particular, how they organize the rules of their internal labor markets (ILMs). Understanding these practices is a fertile field for an institutional perspective and, indeed, there has been a rich literature. However, in recent years New Personnel Economics (NPE) has emerged as a significant subfield of labor economics. This line of research seeks to explain the personnel and internal labor market practices of organizations from an optimization

perspective. For example, NPE has addressed the general question of why internal labor markets exist, has studied optimal compensation and promotion practices, retirement policies, and many other human resource topics. Because NPE is congruent with most of standard economic theory it has gone unchallenged yet the older tradition of institutional labor economics, appropriately updated, takes a different perspective, has a great deal to say on the same topics, and is worth a serious reconsideration. This is particularly true because, somewhat below the radar screen, more institutionally oriented scholars, many of whom are sociologists but some of whom are more direct descendants of the older institutionalists, have enlarged and deepened their own analysis of organizations. Hence, as I will argue, the substance of institutional economics is deeper and more vital than has been understood.

The second justification for reconsidering institutional labor economics is that the current period is witnessing a remarkable number of changes in how firms organize work. Understanding what is driving these transformations is central to the intellectual agenda of the field and this project poses a substantial number of puzzles that are difficult to understand simply from the perspective of NPE. At the broadest level, many firms seem to be making efforts to dismantle parts of their ILM, as indicated by for example falling job tenure rates of managers (Osterman, 2009) even though much New Personnel Economics energy has gone into showing that those ILM arrangements were “optimal.” In addition, as we will see below, there is considerable diversity in ILM strategies even among firms that operate in similar product and labor markets. In some cases this diversity is puzzling because it flows from the failure of firms to adopt human resource practices that a good deal of research has shown leads to very much improved

results relative to the practices in place. In other cases the diversity reflects different choices that have been made about ILM practices in the face of similar factor and product markets as well as other external constraints. This diversity poses difficulties for NPE approaches. Another issue is that firms seem to vary considerably in their success in obtaining high levels of effort and commitment from their workforce and, in yet another challenge to NPE models, this variation is not related to differences in compensation and other reward systems. It is the contention of this paper that to understand these changing patterns of modern ILMs the static optimizing approach of mainstream New Personnel Economics should be supplemented with the more complex and historically contingent accounts of institutional economists.

Given these twin developments the stage may therefore be set for a reconsideration, albeit in more modern vernacular, of the older question of whether an institutional perspective has something important to add to our understanding of how work is organized. There have, of course, been a number of relatively recent important contributions that have sought to elaborate the meaning of institutional labor economics and to create space for this school of thought (Jacoby, 1990; Kaufman, 1994; Kaufman, 2004; Marsden, 1999). This paper aims to build on that literature and add to it a varied range of contemporary theory and empirical research.

In the next section of the paper I describe the approach that I will take to this topic and the boundaries and limits of my argument. I then describe and critique the New Personnel Economics and lay out what I regard as a viable institutional alternative. Subsequent sections of the paper illustrate the utility of institutional economics by reviewing evidence regarding features of Internal Labor Markets (ILMs) as well as

evidence of how these ILMs are changing in the current environment. I then turn to a possible NPE response to the argument developed here: that deviations from standard theory are merely transitory and will be eliminated by market discipline. To address this objection I draw on a substantial literature that casts doubt on the efficacy of the market in pushing organizations toward a single optimum solution. The final section draws together the argument and its implications and discusses its limitations and possible next steps.

The Argument, Its Boundaries, and Some Preliminaries

The conventional view regarding the debate between institutionalists and standard theorists is that the institutionalists argued from a list of empirical observations that appeared to be inconsistent with standard theory (McNulty (1980), Boyer and Smith,2001). This has led to the claim that early institutionalists were a-theoretical and simply “fact based and deductive (Boyer and Smith, 2001 p. 201), a claim that other scholars have rejected (Hodgson, 1998; , Kaufman, 2007). In any, case standard theorists succeeded in enriching their models by incorporating ideas such as search costs and incomplete information and this seemed to undermine the institutional critique. The weakness of the institutional strategy was that standard theory is sufficiently supple to develop reasonable explanations of seemingly deviant observations. Hence rather than starting with a laundry list of complaints it seems more helpful to distinguish among different levels of theory and to see where the core disagreement really lies. The argument developed in this paper emphasizes an understanding of the internal dynamics of the firm as it makes decisions regarding it’s personnel rules or ILM.

In making this argument it is important to be clear that the claim is not that mainstream labor economics does not pay attention to institutions. Whatever the merit of this claim might have been in the past when the dominate research stream was human capital theory and earnings regressions it is certainly no longer true. There is a rich “standard” literature that examines the impact of minimum wages, unions, employment security legislation, temporary help agencies, and a variety of other labor market institutions. However, in all of this literature the institutions are viewed as external constraints on the firm and the model of firm behavior, the model exemplified by NPE, remains one of optimizing a well defined objective function subject to external constraints be they supply and demand or institutions. By contrast, the goal of this paper is to introduce greater reality into our understanding of how firms make decisions regarding their employment rules.

This paper develops an argument about the importance of groups inside of organizations, the persistence of conflict of interest among these groups, and the role played by power and politics in working through these conflicts. It is this group level process that creates the employment practices that we are seeking to explain. In emphasizing these factors the argument shifts attention away from the optimizing models that NPE uses to explain employment practices while at the same time acknowledging that the impulses central to the NPE models are one of multiple factors at play and need to be given weight.

The NPE approach has not gone unchallenged and it is important to understand the perspective taken here and summarized in the foregoing paragraph differs from other critiques. In particular, I want to distinguish my argument from what might be termed

the socio-psychological perspective. The standard model typically sees economic actors as atomistic and selfish utility maximizers whereas social-psychologists emphasize interpersonal comparisons of utility and alternative sources of motivation such as gift-exchange. Several recent reviews of the literature (Pfeffer 2007; Baron and Kreps, forthcoming) provide well developed expressions of this perspective and by now it is easy to show that the behavioral assumptions inherent in NPE models are incomplete and shallow and lead to misunderstandings about how people actually behave at work and about what motivates them.

As useful as is this socio-psychological viewpoint it is also important to see that the discussion and examples used to support the argument center on such individual level behaviors as role of intrinsic motivation, the importance of reciprocity and gift-exchange, status inconsistency, the anchoring of expectations, and interpersonal comparisons of utility. The Baron and Kreps literature review exemplifies this point of view. They show that these considerations lead to substantial modification of agency models in predicting how individuals respond to incentives. What they do not emphasize, indeed spend virtually no time on, is the role of formal and informal groups in using power and bargaining to shape the ILM rules of the firm. That is, the entire discussion remains almost entirely at the level of individual actors. Other efforts to introduce “social” considerations into standard models are also similarly limited. For example, Robert Solow (1990) argues that the labor market is a “social institution” but his emphasis is basically upon variants of efficiency wage models of wage determination and the macro-economic consequence of the fact that individuals respond to fairness considerations and

salary norms. There is no discussion of groups, group conflict or competing visions of the objectives of the firm (Solow, 1990).

At the other extreme from individual behavioral foundations is a critique at the level of markets and society. The argument here is that the labor market (and other markets) are embedded in larger cultural, legal, and institutional systems. This perspective is exemplified in the substantial political science literature on “varieties of capitalism” and this research makes the fundamental point that alternative equilibria are possible and that there is no single “most efficient” outcome (Hall and Soskice, 2001; Katz and Darbishire, 1999, Thelen, 2004). For example, Japan, Germany, and the United States are all successful market systems but they show considerable variation in how they have responded to economic shocks and the impact technological change has had on the wage distribution. This stands in contrast not just with standard theory but also the older institutional view that industrial societies were converging towards a single model (Kerr et.al., 1960). One review of the varieties of capitalism literature concludes that the consensus among scholars that there is a persistent diversity across nations in how capitalism is organized is “truly striking.” (Thelen, 2004, p. 1).

The implication of these national effects is that in order to understand why a given ILM practice is adopted it may be important to pay close attention to the national context. For example, Acemoglu and Pischke (1999) argue that national wage setting practices that have led to compression in Germany but not in the United States affects the two nations’ practices with respect to the assignment of training responsibilities to firm based specific skills training or school based general training. Another example is research by Marsden and Belfield (2008) that shows that the use of performance pay differs between

Britain and France and the difference can be attributed to the impact of variation in employee protection laws across the two countries.

From the perspective of the argument developed in this paper national effects are important because, in addition to having a direct impact upon ILM practices, they also affect the relative power and resources of different groups within firms. Although in one sense national effects are a challenge to NPE—because their existence demonstrates that context matters and that ILM practices cannot be explained via timeless and spaceless optimization models—a more sophisticated version of NPE can deal with national effects by simply treating them as an additional constraint on firm decision making. From the NPE perspective firms choose their ILM practices in order to optimize efficiency subject to the constraints they face and some of those constraints may be national effects. It is also worth noting that a weakness in the national effects literature is its tendency to view nations as internally homogeneous in their practices but the reality, as I will show below, is that substantial diversity characterizes within countries in ILM rules. It is this diversity that I seek to better understand.

Divergent Observations

As noted above, the earlier style of institutional labor economics consisted of unearthing observations about how labor markets functioned that were not consistent with the framework of standard theory. It is, of course, still possible to proceed in this manner. An example is the role of groups in conditioning the rules, formal and informal, for promotions. The standard view is well captured by the following

statement by two leading economic theorists in the course of a presentation of their model of advancement, “[we assume] jobs are ranked in terms of ability, so it is efficient to assign higher ability workers to higher levels of the job ladder.(Gibbons and Waldman, 2006, p. 60)”

The real experience of organizations suggests that this assumption is quite naïve. One view along these lines is provided by Robert Jackell in his ethnography of a corporation. (1988, p. 45 and 193) He described promotion practices as follows:

For most managers, however, future chances in an organization, after the crucial break points in a career are reached, are seen to depend not on competence nor on performance as such. Instead, managers see success as depending principally on meeting social criteria established by the authority and political alignments—that is, by the fealty and alliance structure—and by the ethos and style of the corporation... What matters in the bureaucratic world is not what a person is but how well his many persona mesh with the organizational ideal; not his willingness to stand by his actions but his agility in avoiding blame... not his talents, abilities, or his hard work... not what he stands for but whom he stands with....

This emphasis on bureaucratic politics and personal fealty is obviously consistent with the idea of competing interests within an organization but this version of competition is rather personal and may feel too idiosyncratic for systematic social science theorizing. However, there is another version of the same point, network theory, that has become widespread in sociological analyses of organizations and whose implications have been elaborated with respect to advancement.

Networks can be used to identify social groups that operate on behalf of their members as a collective. One version of this is the “old boys club,” an idea that was developed more deeply several decades ago by Rosabeth Kanter in Men and Women of the Corporation (Kanter, 1977). An example of how network theory can be used to

make a similar point is provided by Emilio Castilla (2008) in his analysis of the behavior of supervisors in deciding whom to support for promotion. Castilla shows that social relationships among supervisors influence the evaluations that they give to employees who are common across them even after holding actual performance constant.

Furthermore, there are significant effects for race and gender commonalties between employees and groups of supervisors. The point, for the purposes of the present paper, is that the supervisors act as a coherent interest group affecting the HRM practices of the enterprise.

Although the standard model does seem out of touch with these observations it is possible, just as in the past, to add permutations that can, at least in theory, explain the deviant observations. Thus, for example, Prendergast and Topel (1996) have written about the optimal level of favoritism in organizations and Gibbons and Waldman (2004) have added a new kind of human capital, “task-specific” human capital, to the usual list of general and firm specific in order to rationalize observations in the data that are not consistent with standard models. These kind of theoretical amendments are very difficult to disconfirm since we almost always lack direct evidence on productivity and hence the research style is to see if patterns are “consistent” with theory. As Baker and Holmstrom note in their review of the NPE literature on Internal Labor Markets “At this point there is hardly any feature of internal labor markets that cannot be given some logical explanation using the right combination of uncertainty, asymmetric information, and opportunism.” (Baker and Holmstrom, 1995, p. 255). The problem with this, of course, is that the overall strategy is not subject to confirmation or disconfirmation. If a particular set of empirical facts appear inconsistent then the model can simply be tweaked

in the manner suggested by the quote. Because job tenure may be correlated with either deep contact networks and success at building a clique or else with acquisition of skilled human capital the empirical work is ambiguous and the presumption of standard theory is typically seen as validated by its adherents. Hence, although these amendments to standard theory can sometimes seem as if they are modern examples of Kuhn's epicycles, i.e. complicated additions to incorporate deviate observations rather than a search for a simpler and more convincing paradigm, nonetheless it is more fruitful to focus on the theoretically essential differences between institutional and standard theory rather than argue about deviant observations.

The Debate About Employment Rules

In this section I will describe the main lines of the debate and develop my core argument. The central theoretical idea that I wish to develop and contrast with NPE is an alternate perspective on how firms make decisions regarding how to organize work. Specifically I develop the argument that within organizations there are competing rationalities and that the economic outcomes that we that we observe and seek to explain are the result of a political and social process that blends these rationalities.

The New Personnel Economics (NPE), as summarized in a recent review by Edward Lazear and Katherine Shaw "is aimed at modeling firms' use of optimal management practices. (Lazear and Shaw, 2007, p. 92)." The prototypical research strategy in the NPE is to identify a personnel practice that is empirically prevalent and develop a model in which the practice in question emerges as the most efficient solution

to the problem posed in the model. In other words, practices are seen as flowing from the firm's effort to maximize efficiency. As a second step, NPE adopts the standard economics equilibrium assumption that if organizations err and adopt sub-optimal practices they will lose out in the competitive market. As a result natural selection will enforce the diffusion and dominance of practices that flow from the optimizing models. Kaufman (2004) calls this NPE approach "choice theory" and distinguishes it from price theory because it is about the firm and not the market. This is true, although NPE does use the market both as a constraint (an opportunity wage, for example, in models) and in terms of extinguishing sub-optimal behavior.

Effectively the New Personnel Economics is simply the creative application of micro-economic analysis to the human resource practices of the firm. As such it does not represent any break with the dominate economic perspective on how individuals and firms behave and Robert Hall some years ago prefigured this line of thought when he wrote that "The central argument of good economics in general and the theory of human capital in particular [is] that economic forces determine institutions and not the other way around (Hall, 1975)."

The New Personnel Economics assumptions regarding the optimizing behavior of the firm insists that organizations adhere to what March and Simon called the "machine model" of behavior (March and Simon, 1958, p. 37). This is the view that organizations can be seen as an algorithm that take inputs, e.g. data on prices and production processes, and spit out the optimal response which they then execute. This view assumes an organizational computational capacity doubts about which have long formed

the basis of critiques (Nelson and Winter, 1982, Cyert and March, 1963). However, in the present paper I take a different tack.

One general criticism of this machine model of organizational behavior which is relevant to the proposed paper is that it is excessively functional. Functionalism in social science is the tendency to confound the functions that an institution performs with an explanation for why it came into existence, i.e. the argument that “Institution X does so and so and therefore it was created in order to accomplish just that.” As Jacoby notes in his critique of standard theory, “There is a tendency to rationalize employment practices in functional or efficiency terms without regard to their historical-causal (how did the practice arise)...complexities (Jacoby, 1990, p. 317).” A similar comment, directed to economic modeling more generally, was made by Granovetter:

“...the main thrust of the ‘new institutional economists’ is to deflect the analysis of institutions from sociological, historical, and legal argumentation and show instead that they arise as the efficient solution to economic problems. This mission and pervasive functionalism it implies discourages detailed analysis of social structure that I argue here is the key to understanding how existing institutions arrived at their present state” (Granovetter, 1985 p. 505)

Indeed, there is a long tradition in political science and sociology of criticizing this style of argument but, because of the power of the modeling tradition in standard economics and the tendency to ignore history as a source of data, functionalism has persisted.

An Institutional Perspective

Although there is substantial truth to these criticisms of NPE it is hard to beat something with nothing and therefore to complain about excessive functionalism without an alternative is insufficient. However, the institutional perspective does offer such an alternative, i.e. a more complex view of organizational decision making and behavior. The interpretation of institutional thinking developed here is that within organizations there are competing rationales as well as competing factions with distinct interests. The decisions organizations make about their ILM practices flow from a complex interaction of rationales and interests that includes an important role for factors such as norms and customs, social structure, competing interests, search for legitimization, and power. Only by understanding this mixture can we explain why a given practice emerged and took the form it did and, more importantly, how it is likely to evolve and adapt to shifts in the environment.

The idea that organizational behavior/decision making is not of the optimizing “machine model” mode has certainly been put forward before in the literature by both economists and sociologists. Cyert and March (1963), in the Behavioral Theory Of The Firm note that organizations are coalitions and that “basic to the idea of a coalition is the expectation that the individual participants in the organization may have substantially different preference ordering (i.e. individual goals)...with the obvious potential for group conflict” (p. 31). However, the book itself emphasizes different goals and coalitions among functional units as they make business decisions (production, accounting, sales, etc.) and only pays the most passing attention to employment issues¹.

The view of organizations as an arena in which different visions and power configurations are played out also has a distinguished provenance in sociology and

political science.² Nearly a century ago John Commons wrote that “...economic conflicts are not merely conflicts between individuals...but are conflicts between classifications or even classes of individuals... (quoted in Parsons, 1963).” In his description of a French bureaucratic organization Crozier wrote of “opposing forms of rationality” (p. 298) and went on to observe a “complex equilibrium affecting the patterns of action, the power relationships, and the basic personality traits characteristic of the cultural and the institutional systems of a given society” (p. 294).

Gouldner took a similar position in his classic book Patterns of Industrial Bureaucracy (1954). He examined via a case study of one firm the origins and implementation of bureaucratic rules regarding issues such as attendance, safety, bidding for jobs, and effort. In modern language he explored how the firm created the rules of its internal labor market. He described how each rule came into being and argued that they were not based on a universal functional rationality but rather the result of competing interests. For example, he showed how the world view and interests of several distinct groups of employees as well as both incumbent managers and newly hired outside managers all differed from each other and how these differences varied depending on the topic at hand. The point was not just that they had different self interests but also that they had different views about the underlying rationale of the organization and about what was appropriate and inappropriate behavior. As a result the firm’s personnel practices, its ILM, reflected a political and social process that resolved these conflicts. Gouldner wrote that “Rather than assuming that bureaucracy possesses a Gilbrator-like stability, the perspective directs attention into the tensions and problems evoked by bureaucratization” (p. 11)

NPE scholars might want to claim that with the rise of principal-agent theory they have incorporated into their models the idea of competing self-interest within firms. But in general agency theory is about how one designs incentives for individuals. It is not about group behavior, competing conceptions of purpose, and collective interest in organizations. Furthermore agency theory implicitly assumes that there is a decision maker with power to impose an incentive compatible solution but in fact decisions in organizations are the outcome of a political bargaining process among the groups as described above. The so-called decision maker cannot act unilaterally. Once groups are introduced and bargaining among groups, implicit or explicit, becomes the explanation for how internal labor market rules are established we have departed from the standard world of principal-agent theory.³

To illustrate the foregoing arguments I will first discuss alternative explanations for the rise of the classic ILMs that were the focus of the literature coming out of World War II. Second, I will discuss how those ILMs are now changing and compare contributions of the NPE and institutional models to explaining these trends. Finally, I will demonstrate that there is a great deal of diversity across similarly situated firms in how they organize work and note that it is difficult for NPE models to explain this diversity.

The Rise of ILMs

The existence of formal administered job practices was highlighted by John Dunlop (1966) and Clark Kerr (1954) and these ideas were elaborated in Doeringer and

Piore (1972). The central empirical observation was that employment within firms is governed by a set of administrative rules that, at least at first glance, are only loosely connected to the external market. In other words, the bureaucratic procedures of the firm have at least as much weight as the market forces in determining wages and other economic outcomes. An extensive literature in both NPE and institutional traditions has documented these practices and sought to explain them.

The NPE perspective does offer insights into the emergence of ILMs since pressures for ILMs emerged in part from the efforts of firms to address turnover and incentives concerns. Turnover is costly because it entails a waste of human capital and because in a high turnover organization provision and investment in on-the-job training is problematic. In order to reduce turnover compensation is back loaded and this leads to a system in which people spend long periods of time with the same employer. This effect is intensified by the nature of human capital acquisition. The early investments in training need to be rewarded over time, from both the perspective of the employees and the firm, and again this implies long careers. In some versions of the human capital story there is also a process by which firms need time to learn about the abilities of their employees and this implies firm based careers (e.g. Farber and Gibbons, 1996). The incentive interpretation is somewhat different in that it is less about skills and more about behavior. In this line of thought ILMs help resolve agent-principal problems by creating long-term employment settings. In such settings opportunism can be minimized because there is always another round in the game (Williamson, 1975).

These economic forces pushing towards the establishment of ILMs are certainly plausible but what is the evidence that they in fact were important during the years in the

twentieth century when the standard ILM model took hold? Here NPE scholars, with their disinterest in history, have done themselves no favors because the scholarly record is much richer when it comes to understanding institutional considerations. Nonetheless there is some evidence that does support the underlying dynamics implicit in the NPE models

The emergence of ILMs can usefully be thought of as falling into two periods, the years prior to the Great Depression and the Great Depression/World War II era. The evidence supporting the NPE view rests largely on the first period while the institutional perspective has much greater traction in the second.

At the turn of the twentieth century American firms, even large ones, did not have well developed internal labor markets. Instead, they managed their workforce via the so-called “drive system” in which substantial discretionary (often arbitrary) power was put in the hands of the foreman (Jacoby, 2004). Turnover was high and was problematic during periods of growth and labor shortage and this led to efforts to stabilize the workforce via creation of job ladders personnel systems. Adoption of these practices was uneven but does seem to be correlated with NPE like considerations. Jacoby writes that “employers now found personnel management an attractive alternative, one that promised to simultaneously relieve labor shortages, improve productivity, and promote labor peace,” (Jacoby, 2004, p. 102). Furthermore, Jacoby relates the ebb and flow of adoption to shifting pressures of supply and demand in the external labor market (Jacoby, 2004, p. 129). Other correlates included firm size and stability of their product demand (Jacoby, 2004, p. 143).

With the onset of the Depression the storyline shifts. In sectors that were unionized pressures built to establish the formal job ladders and seniority systems that characterize industrial ILMs. Non-union firms imitated these systems in order to avoid unionization. The Federal Government, via the War Labor Board, imposed standardized personnel practices on Federal contractors in order to maintain labor peace. In addition personnel specialists within firms, were very active in pushing for the formalization of employment practices, a point of view that was clearly in their self-interest. Indeed, during the Depression and the World War II periods there was very little correlation between the standard optimizing correlates of ILMs—firms size and turnover rates—and the adoption of specific formal personnel practices. (Baron, Dobbin, and Jennings, 1986).

The core conclusion to be drawn from this material is that when it comes to understanding how the prototypical ILM of the post-war period emerged the story is considerably complex than that implied in NPE models and the complexity is consistent with the institutional perspective developed above. There is certainly considerable room for the play of market forces and efficiency maximizing considerations but to these were joined the actions of two important interest groups within firms, unions and personnel professionals, as well as the actions of an external institution, the government. Internal Labor Markets can only be understood as resulting from the interaction of these actors as they used their resources to pressure organizations in the directions that they preferred.

How ILMs are Changing

ILMs have not been static and indeed the current era has witnessed very substantial shifts in how work is structured. A sketch of recent developments would include the rhetoric and reality of “core-competencies” that has challenged the very notion of long term employment in large firms, the (halting) diffusion of so-called High Performance Work organizations, the changing rules for career development and advancement brought about by the equal employment opportunity revolution, and the growing diversity of ILM models across enterprises . Our understanding of these shifts is certainly advanced by the kinds of considerations emphasized by NPE models but by the same token these models are only partial. Institutional considerations of the kind emphasized in this paper figure strongly in any convincing story.

The most obvious of the NPE factors is that as competitive pressures on firms have ratcheted up (due to deregulation and increased penetration of overseas competitors) many older ILM practices increasing looked costly and hence the pressure to change them grew. A clear example is the automobile industry in which rigid job demarcations as well as the failure to involve employees in suggesting ideas and quality programs led to part of the cost disadvantage of the Big Three relative to competitors such as Toyota (Katz, 1985). A similar version of this story could be repeated in many sectors of the economy. In addition NPE scholars might also plausibly argue that underlying technologies have shifted in ways that affect optimal retention policies (for example in the direction of more general skills. See, for example Gould (2002)).

All of the above is certainly supportive of the idea that much of what we observe today as ILMs are transformed can be understood via standard models as shifting

constraints that led firms to implement new ideas about organizations, what Cappelli (1999) has characterized as “market-in,” such as new uses of on-site suppliers, increased utilization of contractors and out-sourcers, and innovations in pay-for-performance.

However, just as is the case with the earlier historical record, if analysis is limited to this mode of thinking our understanding will be incomplete. The particular ways in which the economic pressures are refracted through institutional considerations is essential for a full understanding of current developments. In particular, as the examples below will demonstrate, groups within organizations seek to redirect the pressures for change to their own liking and the actual ILMs rules which result reflect this institutional fact of life. In the sections that follow this point will be illustrated by five examples drawing from recent shifts in ILMs: the slow diffusion of High Performance Work Systems, the efforts of firms to obtain increased levels of effort and commitment from their workforce, the use of contingent employees, the spread of new promotion rules in response to equal employment opportunity pressures, and the growing diversity of ILM systems.

The Slow Diffusion of High Performance Work Systems

High Performance Work Systems, which involve the use of teams and various forms of quality programs, have been implemented in a range of firms (Osterman, 1994 Osterman, 2000; Handel and Gittleman, 2004) because there is considerable evidence that they lead to higher levels of quality and productivity (Pfeffer, 2007, MacDuffie, 1995,

Ichniowski, Shaw, and Prennushi, 1997, Kochan and Osterman, 1994). Yet despite this evidence adoption has been slow which implies, as Pfeffer has observed, that money has been left on the table

Survey based research on diffusion points to a set of institutional considerations. For example, in their survey of the adoption of HPWO practices across a sample of automobile firms Pil and MacDuffie (1996) find that a set of variable capturing the presence or absence of internal organizational barriers and resistance perform better than simple measures economic performance. In a cross-national survey, Bloom and Van Reenen (2007) show that ownership patterns play an important role in explaining differences in adoption of modern managerial practices, a finding that is consistent with explanations that emphasize balance of power considerations within firms. In his survey of establishments Osterman (1994) found that a variable capturing employee friendly values held by managers was significant in explaining HPWO diffusion. Erickson and Jacoby (2003) find ,for a sample of California firms, that managers who participate in external networks with managers of other firms are more likely to adopt HPWO practices, a pattern which points away from the “machine model” of organizations although it is also supportive of information and search arguments.

Case studies of adoption are also supportive of institutional arguments. Among the patterns in the literature are that first line supervisors resist because they feel threatened by the role of self-managed teams in taking over some of their functions (Coyle-Shapiro, 1999), unions can be oppositional when their adversary function is threatened by the more cooperative nature of HPWO systems (Walton, McKersie, and Cutcher-Gershenfeld, 1994), and, as Pfeffer (2007) also notes, the growing power of the

finance function within the firm puts heavy weight on immediately measurable costs and less weight on more abstract or hard to measure future benefits.

In short, both surveys and case studies support the view that adoption of HPWO systems is strongly affected by group pressures and politics within organizations. Whether and how a firm adopts these practices is due to much more than simply an optimizing decision by senior managers.

Effort and Commitment

Obtaining higher levels of employee commitment has emerged as very important in markets where quality and customer satisfaction are key to competitive success. As a consequence another recent development is new strategies by firms aimed at addressing this need.

The New Personnel Economics addresses employee effort and commitment from two perspectives: efficiency wages and incentive compensation models that are grounded in principal-agent incentive theory. These perspectives are somewhat different in that efficiency wage/shirking models are about level of effort whereas in principal-agent models the worry is that the effort may be in the wrong direction, i.e. for the self-interest of the agent rather than the principal. However, what both flavors of standard theory have in common is the view that effort is largely decided at the level of the individual and that the key to any solution is to get that individual's incentives correct.

An empirical illustration of this perspective and evidence that it has power, is Lazear's research on Safelite glass (Lazear, 2000). This paper, which is prominently cited in the standard literature, discusses the consequence of introducing piecework pay

systems for auto-glass installers. The research showed that the installers responded to these incentives and that there was a selection process in which the less able employees quit the organization. The point then is that people do indeed respond as predicted to financial incentives but it is also important to remember that the circumstances of Safelite were special. Output was easily measured and monitored and employees worked individually, not in teams or groups. Nonetheless, one can take the point that incentives are important but also recognize that there is a good deal more complexity to the issue of effort.

The institutional perspective on effort takes a different angle and focuses on group processes, organizational structure, and culture. At the core of the institutional perspective is the idea that the level of effort delivered by the workforce is at least partially determined at the group level, i.e. by considerations other than individual incentive schemes. Consider Toyota or Southwest Airlines, both of whom are probably taught in Human Resource courses even more frequently than Safelite. These firms are tremendously successful in their industries and both are widely known for obtaining high levels of effort from their workforce. They are also successful in obtaining organizational commitment, an idea that is basically foreign to New Personnel Economics thinking (Lincoln and Kalleberg, 1990). But, in contrast to NPE expectations, both are quite conventional in their incentive systems (and this is as true of Toyota of America as it is of Toyota of Japan) and in both organizations seniority (frequently seen in the NPE literature as the enemy of meritocracy) is important. Why is it that these organizations are able to obtain exceptional individual effort and organizational commitment while other firms with essentially the same compensation

arrangements are not? The answer lies in a set of factors that institutionalists emphasize: group norms and culture. In thinking about this it is important to recognize that norms and culture are group phenomena and not examples of the kind of individual level social-psychological exchange discussed earlier.

There is a long tradition in institutional research for recognizing that group culture and norms are important as, for example, in the literature on production norms and a “fair days work for a fair days pay.” In its more modern form organizational culture is a rapidly growing research field (Barley, Meyer, and Gash, 1988; Martin, 1992). In both Southwest Airlines and Toyota the employees have developed strong group commitments to the success of the organization (Womack, Jones, and Roos, 1997; Pfeffer, 1998; Gittell, 2003; Rubinstein and Kochan, 2001). In thinking about this it is important to avoid romanticism in that Southwest has had labor trouble on occasion with its pilots and Toyota has worked very hard to keep out the United Automobile Workers. Nonetheless it is clear to observers (see the citations above) that at the level of the workgroup each organization has succeeded in obtaining effort via broadly shared norms and not simply via individual incentives or individual gift-exchange.

Strategies For Using Contingent Employees

The use of temporary workers has surged in recent years and is an important element in the fraying of closed ILMs (Autor, 2003, Hausman and Osawa, 2003). Firms often use contingent work as a strategy for working around compensation rigidities that result from the persistence of fixed wage differentials based on work-group ideas of

fairness (Abraham and Taylor, 1996) and in this sense institutional factors play a role. However, institutional considerations are more than a backdrop against which contingent work is played out, they shape how precisely is contingent work used, i.e. the rules that govern its implementation.

The use of contingent employees changes the balance of power within the organization between line managers and human resource staff since line managers are often given authority to directly hire temps and hence bypass the HR function. This pattern was observed by Smith and Neuwirth (2008) in their ethnography of a West Coast staffing agency that provided highly skilled temps. They observed that “human resource managers were forced into a ‘partnership’ with the staffing industry which partially eroded the authority and power of the former [while] line managers gained greater authority to make decisions and policies about hiring..” (127-128).

In addition, when firms use temps they have to pay attention to the reactions of the regular workforce and the specifics of the ILM rules around temps are often shaped by the need to maintain status differentials. In her study of how a call center and a manufacturing firm, both in the Boston area, implemented temporary work Lautsch (2002) observed that the balance of relations between the two employee groups was a central concern of managers. She notes that “regular workers favored the maintenance of status differences between themselves and temporary workers” (Lautsch, p. 30). Management responded by “asserting that management would limit the scope of contingent work and its impact on regular jobs.” (Lautsch p. 32). She adds that “management learned...that regular workers would rebel if teams were set up so that temporary workers had majority membership, or so that temporary workers were in

supervisory roles over regular staff. Gradually these practices were eliminated.” (Lautch p. 34) In short, efficiency considerations were important and managers pressed forward with the use of temps as a source of cost savings but the manner in which they were used and rules governing their work were significantly shaped by institutional factors.

Due Process and Equal Opportunity

Although little remarked upon by NPE scholars, one of the most widespread shifts in ILMs—a shift certainly as important and as widespread as the diffusion of performance based pay—has been the implementation of a broad range of personnel practices associated with equal employment opportunity and with non-union due process and grievance procedures. These practices obviously have important implications for career pathways and promotions within firms

A large literature has emerged seeking to explain the origins of these practices within firms. Much of this literature is rooted in the “institutional” stream of thought in Organizational Sociology, a line of thinking that focuses on how organizations adopt practices in order to legitimize themselves in the eyes of other powerful actors or because the practices enhance the power of interest-groups within the organization (Selznick, 1949; DiMaggio and Powell, 1983). This latter perspective is clearly congruent with the argument developed in this paper. The challenge in this literature is to distinguish the institutional explanations from more efficiency based arguments that the adopted practices make economic sense for the organization.

Although it is not always possible to definitively prove that efficiency

considerations are unimportant, the body of research taken as a whole does convincingly demonstrate that institutional considerations played a central role in the diffusion of the new practices and in determining the specific forms that they have taken. In an early foray into this field Edelman (1990) studied the adoption of grievance procedures in non-union firms, specifically in a sample of 52 firms in the Bay Area. Her broad argument is that organizations adopted these practices not because of any specific legal mandate (there was none) nor because of unions (the firms were non-union and a variable measuring whether they faced a union threat was in-significant). Rather, the process appeared to be that the general normative environment coming out of the Civil Rights movement put heavy moral or societal weight on firms to build “fairness” into their procedures and that firms with personnel departments were more likely to respond to this pressure.

In later research Edelman, Abraham, and Erlanger (1992) put even more emphasis on the role of personnel departments in pushing for practices that were self-agrandizing. In this instance they studied the adoption of practices related to wrongful-dismissal charges. They show that the personnel profession as a whole systematically exaggerated the risks that firms faced in these law suits, in some cases using estimates that were “absurd” (p. 65) and in other cases simply misleading (by, for example, reporting data from California as if it applied to all states). As result, senior managers were convinced to implement personnel practices that enhanced the power and role of the personnel professionals.

In another set of studies Dobbin, Jennings, Scott, and Meyer (1993) and Dobbins and Sutton (1998) study the adoption of promotion policies in response to Equal

Employment Opportunity mandates from the Federal Government. There is certainly an underlying efficiency explanation in that firms faced the risks of lawsuits and contract loss if they did not respond in some way. However, in understanding what specific practices emerged there are important subtleties. First, Dobbins, Jennings, Scott, and Meyer (1993) show that the particular practices adopted “converged on a set of personnel practices that were isomorphic with the procedurally oriented, quasi-judicial administrative configuration of the federal government-formal, merit-based, employment and promotion conventions complete with an internal system of grievance adjudication.” In other words, the particular practices that were adopted were based upon imitation of those of the more powerful external organization, not upon an internal optimization logic. Of course, an NPE response to this might point to the search and information savings that such an approach might bring. However, Dobbins and Sutton (1998) demonstrate that even after Federal pressures sharply diminished in the Reagan years, and hence the costs of non-compliance sharply fell, personnel professionals continued to press for new practices and that they shifted their rhetoric from that of legal risk to the alleged internal benefits of diversity. Put differently, the personnel staff constructed (without any evidence) a new argument once the legal risk argument was no longer valid.

A fair reading of this literature is not that efficiency explanations were unimportant or irrelevant but that they are strikingly incomplete and perhaps even naive with respect to the forces that drove adoption of the wide range of personnel practices associated with equal employment opportunity and fairness in the workplace. The self-interest of a specific interest group within the firm, as it competed for resources and power, was a big part of the story.

Diversity of Employment Systems

Another characteristic of the current period is that dominant models have lost their hold and there is considerable variety in ILM systems among similarly situated organizations. Yet if firms that face similar external constraints have different ILM practices then this diversity poses a problem for NPE models, which would posit a single optimal response. By contrast, the diversity can be understood from an institutional perspective that emphasizes different internal political configurations across firms.

There is considerable empirical work that demonstrates diversity. At the case study level are examples such as the contrast in employment practices between Wal-Mart and Costco (Greenhouse, 2005), the divergence of Southwest Airlines from the practices of other large carriers, or the HRM practices of the software firm SAS compared to its competitors (Pfeffer, 1998). More systematic work within industries, such as automobiles and telecommunications, also points to the same conclusion. For example, in their study of telecommunications and automobiles Katz and Darbishire (1999, p. 4) report that “within both union and non-union sectors the extent of variation in wages, work practices, and other employment conditions has increased.”

A similar finding regarding substantial diversity emerges from research in a very different set of firms: small, young, non-union start-ups in the Silicon Valley (Baron, Burton, and Hannan, 1999; Burton, 2001). The study followed a sample of start-ups and collected data on their personnel practices with respect to hiring, promotion, compensation, and retention. Firms varied in their approach towards motivation and

retention and the researchers identified five HR models (which they termed Star, Bureaucratic, Commitment, Engineering, and Autocracy) each with a different set of personnel practices. As examples, a characteristic description of practices in a Star firm was “We recruit only top talent, pay them top wages, and give them the resources and autonomy they need to do their job” whereas an HR executive in a bureaucratic model said “We make sure things are documented, have job descriptions for people, project descriptions, and pretty rigorous project management techniques.”

Broader survey research also finds substantial diversity. Osterman (1994, 2000) surveyed roughly 700 establishments and, after holding constant a wide range of characteristics, found considerable variation in the adoption of teams, job rotation, and training practices. A similar pattern was observed by Bloom and Van Reenen (2007) in their survey of firms.

In short, there is considerable evidence of diversity in ILM practices across similarly situated firms. Of course, the evidence that the firms face exactly the same set of external constraints is not ironclad and if constraints are different then variation is not a problem for NPE models. The survey based research does hold constant a substantial number of variables as does the Silicon Valley work which is focused on a narrow and relatively homogenous sector within the same geographic area. The case study work is more subject to this concern. Nonetheless, when the wide range of evidence is considered it does seem reasonable to conclude that real diversity, holding constant constraints, is a fact of organizational life.

Because there is not a unified literature on diversity each of the different studies offers its own set of explanations. The Silicon Valley research focused upon the values of the founders of the firms and how those founders enforced their values and imprinted their organization. Bloom and Van-Reenen emphasize the importance of ownership patterns and in particular whether the firm is family controlled. The relative power of different internal constituencies—unions, personnel professionals, the finance function—show up as key variables in much of the literature. Taken as whole, while recognizing that the definitive test has not been undertaken, a fair reading of the literature would be that an important component of the very substantial observed diversity can only be understood as flowing from institutional considerations. It is also worth noting in passing that this diversity, and the fact that there is more than one way to achieve success, is reminiscent of the old institutional idea of a “zone of indeterminacy” an idea that was applied to wage setting (Pierson, 1957).

Objections And Responses

Two objections might be raised to the argument developed here. The first is to view the foregoing as a story about unions and to note that unions have long been recognized and incorporated into standard theory and that if “irrational” practices result from union behavior this is certainly no surprise. However, the paper’s argument is not a union story but rather unions are a specific example of a more general phenomenon, the fact that organizations are a coalition of competing interests and these interests compete not simply on a distributional basis (wages or which managerial clique gets ahead) but rather because they have different world views, different cultures, and

different definitions of rationality and organizational objectives. Indeed, I have taken care throughout this paper to use non-union examples.

The more significant counter-argument is to acknowledge some divergences from the predictions and expectations of the standard model but argue that they are only short term phenomena that will be swept away by market forces which inevitable, and quickly, select optimal behaviors and punish sub-optimal ones. However, while mainstream economics literature does assume convergence to optimal practice there is in fact an alternative vein of theory that points away from this view. Nelson and Winter (1982) argue that standard theory “cannot address such questions as the duration of the struggle or the durability of mistakes made in the course of it (Nelson and Winter, 1982, p. 32)” and they go on to describe what is essentially a search model for adoption of practices which is “groping, disorderly, and error ridden” with “general habits and strategic orientations coming from the firm’s past.” (pp. vii and viii). Their explanation is different than that of the current paper in that they focus on the nature of the managerial decision making process while this paper emphasize the importance of group conflict. Nonetheless the central point of importance here is the rejection of the view that market forces inevitably force out practices that seem sub-optimal from the standard perspective.

A similar conclusion regarding the persistence of “non optimal” practices is found in the literature on increasing returns. Arthur (1989) argues along these lines with the idea being that that with increasing returns a technology that is adopted gets advantages relative to a competing technology because it improves more quickly. Because of this, a random event or accident can set the adoption on a particular path whereas with a different event or accident a different path and different technology would win. As a

result he shows that while “Under constant and diminishing returns the evolution of the market reflects only a-priori endowments, preferences, and transformation possibilities...But while this is comforting it reduces history to the status of a mere carrier, the deliverer of the inevitable. Under increasing returns, by contrast, many outcomes are possible.” (p. 127) and “competition between economic objects...takes on an evolutionary character...with a ‘founder’ effect mechanism...history becomes important...” (p. 128)

This argument about “lock-in” has a parallel in the political science literature that examines the adoption of institutions as well as the sociology isomorphism literature. The general point is that another source of this lock-in is that existing institution takes on normative or customary legitimacy and thus are hard to change (Thelen, 2004; Mahoney, 2000, DiMaggio and Powell, 1983). In addition, Stinchcomb long ago argued that institutions are “imprinted” by the environment in which they are founded and are often unable to adapt to new conditions (Stinchcomb, 1965). The population ecology literature in sociology has taken off from this insight to argue that the source of change in response to environmental shifts is less the reconfiguration of existing institutions but rather the gradual rise of new organizations (Hannan and Freeman, 1984).

There is extensive empirical research in the literatures on technology, population ecology and political science that documents these arguments concerning persistence and lock-in. The literature in institutional labor economics has not been as systematic but there is a good deal of scattered observations that supports it. There is, for example, a long history of empirical work that demonstrates the power of customs and norms in the workplace and these customs and norms clearly serve to lock past practices into place

(Dunlop, 1958). The earlier observation about the slow diffusion of new high performance work systems is also evidence of how slow change can come. Numerous business school cases focus on firms that were slow to adapt due to the weight of past practice. It is not that the market has not had an impact, it certainly has, but one reasonable conclusion is that the discipline of the market, the pressures to eliminate “sub-optimal” forms, is considerably weaker than often assumed. In short, the problem, from the perspective of the NPE literature, is that the “death” of old institutions is very long in coming and the final result is best understood as the complex interaction of multiple pressures. Hence any effort to understand the current landscape is radically incomplete if viewed simply through an optimizing lens.

CONCLUSION

This paper has aimed to describe an approach towards institutional labor economics that recognizes the role of standard efficiency and market considerations yet brings to bear a deeper understanding of how organizations make decisions about how to organize work. One central characteristic of the argument developed here is that it does not aim to develop a universal model which is parallel to the universalistic tendencies of neo-classical economic theory.⁴ Rather this paper is pitched at the level of the firm or organization. It does not address the psychology of individuals (i.e whether or not they are utility maximizers) nor does it address the operation of external markets. The creation of employment rules within organizations is the terrain on which I think that

institutional ideas have the most purchase but the claim is not that these ideas should replace the entire apparatus of standard theory.

It is important in this context to understand that even at the level of the organization the approach proposed here does not reject market forces, this would be foolish indeed and particularly so in a period when established forms of work organization are under a great deal of pressure from competition. Rather the goal is to develop a more sophisticated understanding of what determines employment systems. The central proposition, one which as noted has a long tradition in the literature, is that these systems are the result of a political process in which competing objectives and rationalities play out a contest. Market or efficiency considerations are certainly one player in this contest and in the examples I presented I made an effort to give them their due. But they are not the only player. It is also important to recognize that the resources available to different positions in this contest will vary over time. It would not be unreasonable, for example, to argue that in the Depression and World War II period the external environment favored internal actors who opposed market models whereas today the efficiency advocates hold an advantage. But this ebb and flow does not alter the fundamental argument.

The emphasis on group processes and politics points to an important limitation of this paper: the question, which is not addressed, of how groups are formed and re-formed. This, of course, goes to the issue of how people and collectivities come to identify themselves as having commonalities and how they frame their self-interest. This is a topic of growing interest (Barley, 1989; Scully and Segal, 2002; Piore and Safford, 2006;) but it would take this paper too far afield to enter into it.

The goal of good social science should be to understand the determinants of the empirical realities that we observe, both at a point in time and as they change. Elegant theory is not an end in itself. This is important to understand because the arguments developed in this paper are certainly less clean and elegant than are NPE models. Furthermore they run the risk of devolving into what has been a weakness of institutional theory, namely a tendency to simply provide a long list of factors that should be taken into account without any strategy for assigning relative importance or for testing the arguments. However, to say that institutional theory runs this risk is not to say that it should be abandoned. Rather, advocates of institutional models have to be willing to be clear about their arguments and the strategies for testing them. The gains from such an effort should be a richer understanding of how employment systems are evolving and what drives this evolution.

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¹ The only discussion is two pages, pp 186-87.

² In a classification of sociological models of organizations Scott and Davis (2003, p. 30) lay out what they term a “natural systems” perspective in which “the analytical attention is devoted not to the appearance of consensus, but to the reality of underlying conflict.”

³ There is an NPE literature on organizational politics but it remains at the level of individuals and how they maximize their self interest rather than at the level of group political contests over rules. For example, Lazear (1989) examines whether wage compression is good or bad for efficiency given that it may enhance cooperation but perhaps also reduce incentives for the best employees. However, his analysis asks how individuals react with respect to their private self-interest to different wage distributions and he maintains the view that there is a decision maker within the firm who can set the wage structure based on which is the most optimal. In another effort along these lines Prendergast and Topel (1996) model the behavior of supervisors who exhibit favoritism towards particular employees. But, again, the modeling is purely at the individual level. Supervisors simply “like” some workers and not others, there is no sense of group action or interest.

⁴ I am grateful to Sandy Jacoby for clarifying this point for me.