Chapter Two

Literature Review

This section begins with discussions encircling around competitiveness, its definition and measurement. The study revolves around studying firm competitiveness and cost cutting becomes an important tool in the agenda. A discussion is also undertaken that covers aspects of wages in relation to the Classical, Marxian and Neoclassical paradigms. Trade unions also find mention in this section and are seen as an important agency in organisations.

Further, this section also introduces the institutional analysis lens of viewing transactions within organisations. More specifically, it looks into aspects of relational contracting that emanates from a more mundane and recurrent nature of labour transactions.

2.1 Competitiveness: A primer

One of the vital questions in the current global economic environment revolves around questions regarding competitiveness. Competitiveness as an attribute can be measured for a variety of agencies, throwing light on the prospects for future growth. In the current cut throat competitive economy, maintaining competitiveness is not only desired but also essential for survival.

Porter (1990) defines competitiveness in terms of a mix of both internal and external factors to the firm. They are a) factor conditions, which speaks of the factor inputs like infrastructure or skilled labour, b) demand conditions i.e. existence of demand for the products that the firm manufactures, c) related and supporting industries which refers to the product ancillary industries that takes care of the supply chain aspects and finally d) firm strategy, structure and rivalry which refers to the nature of existing rivalry in a particular industry or country. The fulfillment of these parameters is what results in the creation of competitive advantage for firms.

Chaudhuri and Ray (1997) bring out that although competitiveness has been one of the main themes of economics, business and management studies alike, there has been little
effort towards synthesis amongst different academic leanings. Scholars belonging to various disciplines, applying various methodologies have studied competitiveness in its myriad forms. The unit of analysis also differed in these cases, ranging from firms, industries to even economies. Table 1 below showcases a glimpse of various studies in this direction.

Table 1: Categorising literature on competitiveness

<table>
<thead>
<tr>
<th>Category</th>
<th>Level of analysis</th>
<th>Variable pertaining to</th>
<th>Notable contributors</th>
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Narrowing down to firm level competitiveness, Basu (2011) defines it in terms of having efficient structures in place with producing superior quality products. He outlays six different perspectives of studying firm competitiveness in terms of business strategies employed. These are
a) Neoclassical Economics theory  
b) Industrial Organisation (IO) Economics perspectives  
c) Schumpeterian perspective  
d) Chicago school or productive efficiency perspective  
e) Transaction Cost economics theory  
f) Resources and Dynamic capabilities perspective  

The neoclassical economics theory which looks at firms as being self reliant on harnessing a technological determined production function. The Industrial Organisation economics perspective or the Chicago school perspective looks at the efficiency parameters with respect to industries or firms respectively. Transaction cost economics perspective looks into managing vertical integration as according to market fluctuations. The resource based and the Schumpeterian perspective looks at firms as dynamic organizations which can bring about change, both through adaptation from inside and disruptive innovation from outside. The vital thing for Basu (ibid.) has been that all these varying perspectives looks at firms as being self-sufficient in their business.

Kumar and Chadee (2002) while focusing on Asian firms build a model of international competitiveness that looks at both internal and external factors. Internal factors in this model concerns with three things namely, technology and ICT (information and communications technology), human resources and organisational structure, while the external factors looks at role of government in the process and the role of finance and capital. While there can be no doubt about the importance of technology and having appropriate organisation structure for a firm, the human resources aspect of the firm forms the most important part of the project and one that provides a strategic edge to the business of the firm.

In studying firm competitiveness, human resources of the firm form an important part of the system. Other factors like technological upgradation or organisational restructuring would only be effective as long as it is in tandem with the employees of the firm. Issues of training, development and talent management become important in this respect. On the cost side, however, firm also needs to strike a balance between having the right people and the right amount of them. Thereby, human resources management is also concerned
with restructuring and dressing down tactics in order to carry out operations at minimal costs. In this respect, a look into the aspect of wages would be essential.

2.2 Wage distribution: A matter of utility

The discussion on wage distribution is also a discussion on the distribution of wealth and income. Unprecedented growth point to growing inequality thereby creating tension in the fabric of the society. The growing interest in the analysis of such a phenomenon is not new and has been undertaken by various political and social thinkers from Malthus, Ricardo, Marx and so on.

Wage distribution or income distribution has been one of the central areas of policy discussions in all times. The importance of this distribution is also key in analysing socio-economic growth of any society. The analysis of wages provided in the classical and neoclassical framework of distribution theory is preoccupied between costs of production and marginalism respectively.

Workers viewed as value producing agents, in combination with capital and land; produce value that ultimately lay to the distribution between these various factors of production. As Classical economist Ricardo (1951) puts it in his chapter “on Profits” that “the whole value of their [labour] commodities is divided into two portions only: one constitutes the profits of stock, the other the wages of labour” (p. 110). After having allowed for the wages of the labourers, the residual that was left amounted to the profit of the capitalist. This kind of analysis implied a zero sum game- an increase in the proportion of share to one factor of production would decrease the share of the other. Bentham (2000) in his Introduction to the Principles of Morals and Legislation brings out utility as a moral code to derive the greatest happiness towards moral and social rectification. For Bentham, utility did not only mean the usefulness of any item or thing but also to the extent that it augments the happiness derived from that item. This is presupposed by the idea of equality where one man is worth the same as any other without discrimination. Combining Bentham’s idea of utility with the classical

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18 In later sections we shall see what determines this share of profits from production.
framework of Ricardo shifts the balance of power greatly towards the large pool of workers.

On the other hand, neoclassical economics bases its design on the ‘marginal revolution’ largely dependent on the demand and supply aspects. The wages of the workers are in direct relation with the marginal productivity of their labour i.e. an increase in the total output on account of an increase of a worker by one unit. The law of diminishing returns restricts the rise in wages with increases in the marginal productivity. Hence the action of raising wages beyond a certain point is seen to be non rational and which thereby might enhance economic inefficiency. In this case Pareto comparison dominated economic thought and utility of all parties mattered more than utility of any one.

This shift from the traditional Benthamite utilitarian allocation of resources is directly confronted by the Pareto distribution. However, both these positions suffer from the distributional issues where wages become one of the most prominently discussed.

2.3 The Concept of Wages

2.3.1 Ricardian Classical view

Ricardo\textsuperscript{19} adhered to the subsistence theory of wages congruent to Malthus and his Theory of population. According to Ricardo, labour bore a natural price as well as a market price. While the natural price of labour would include the necessary items essential to perpetuate their living and reproduction, the market price was more random and depended on the demand and supply operations of the market. The remuneration which applied to the labour was that dependent on the market price of it and there can exist a considerable difference between them. Therefore, in so movement of the wages, when the market price of labour tended to increase as compared to the natural price of labour, labourers would be in a better stage than vice versa. This high wages would spur an increase in the supply side of the labourers and hence the wages would again slump downwards, sometimes even to the extent of going below the natural price. Unless there

has been a reduction in the supply of labourers or a hike in the demand for them, their privations would remain unaltered.

The natural price of labour also mattered from the perspective of the stage in which the society had been. Food\textsuperscript{20} being a motive of subsistence of the labour and thereby in the determination in the natural price of labour has a propensity to get dearer with time. Technological improvements among other factors to some extent may help subsume the effects of this price rise for some time. However in the long run, it would be difficult to contain it.

### 2.3.2 Marxian view- the immorality of the price system

In Marxian terms\textsuperscript{21}, the analysis of value of labour begins by the analysis of the product of its labour i.e. a commodity. Following the classical labour theory of value\textsuperscript{22}, the value of a commodity lies in the amount of labour necessary for its production. In the same fashion, if this logic is applied to value of labour, which is presented in the market by the labourer, it would denote to be the amount of labour time embodied in it which itself is meaningless.

The value of labour is one such image and Marx explains this through the statement: “In the expression ‘the value of labour’, the idea of value is not only completely obliterated, but actually reversed. . . . These imaginary expressions, arise, however, from the relations of production themselves” (Marx, 2011, p. 571). Further that apart from the fact that the labourer actually through his labour creates value, there is no inherent value of labour as such. The methodology of the classical political economy, however, maintains this value.

In a classical paradigm, labour possessed a very unique and distinguishable quality; the process of creating value when combined with any other object. The labourer in its

\textsuperscript{20} Ricardo writes “The power of the labourer to support himself . . . does not depend on the quantity of money which he may receive for wages, but on the quantity of food, necessaries, and conveniences become essential to him from habit, which that money will purchase” (p. 93). Note here that Ricardo does not directly equate money that the labourer receives with the items that can be bought from them. This points towards two directions, one determining the concept of nominal and real wages and the other towards the stage of society wherein the labourer apart from his employment had other sources of earning his living. The latter part was sufficiently given attention to by Marx in his chapter on primitive accumulation, as we shall see in the subsequent sections here.

\textsuperscript{21} See Marx’s \textit{Capital} (2011).

\textsuperscript{22} Labour theory of value has reference in the works of Adam Smith and David Ricardo.
pursuit of selling his labour counters the issue of non expendability of it. That although labour forms the value of any commodity created, it intrinsically carries no value itself to be measured as wages. It is actually the labour power that is sold and expended by the labourer. This quality is unmatched by any other commodity in the bourgeois process of production. The worker in selling his labour- labour power gets remunerated with wages. Wage is a phenomenon of the price and it would be erroneous to equate value of labour power to the price of it. However, this system of analysis provides an advantage to the market mechanisms where the price of any item is calculated through the demand and supply mechanisms. For Marx this demand and supply misrepresented that what was bearing on the labour. This was also a critique of the bourgeois society where appearances are delusional and in which the ontological relations are oblivious to the people.

Once the labour is measured in the manner under prices, it can get into varied wage systems and comfortably hide the surplus value generated out of it. In this way Marx explains that capital had these different ways to garb the exploitative systems of extraction of labour. Extraction of labour power also varies from place to place. Although Marx points out towards differences in wages between different economies it is also made clear that even economies with comparable standards of living also differ in value of labour power as it is dependent on the prices of those product.

3.2.1 Surplus value and means of exploitation

The concept of surplus value forms a basic tenet of the bourgeois mode of production. Surplus value as presented derives its origins as all other values, in the labour power that is sold in the market. The labour process employing the means of production which brings about the products of labour are ultimately the property of the owners of the means of production i.e. the bourgeoisie. The valorisation process of labour induces in the time period of its employment more value than what is being bought by the capitalist and this results in the creation of surplus value. Marx brings this argument succinctly by explaining

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23 Labour power is the productive capacity of the labourer.
the circumstance, that on the one hand the daily sustenance of labour-power costs only half a day’s labour, while on the other hand the very same labour-power can work during a whole day, that consequently the value which its use during one day creates, is double what he pays for that use, this circumstance is, without doubt, a piece of good luck for the buyer, but by no means an injury to the seller (ibid., p. 182).

The proposition in which the capitalists extracts the surplus is the blurring of the meaning of value of labour power, which for good reasons however represent the habitual necessities of reproducing that labour and not the value of the product for which the labour is used. This becomes “the cause of his [capitalist] laughter\(^24\) and therefore of surplus value.

The rate of surplus value is given by the formula

\[
\text{Surplus value(s)/Variable capital}^{25} (v) = \frac{\text{Surplus value}}{\text{Value of labour power}} = \frac{\text{Surplus labour/necessary labour}}{\text{unpaid labour/paid labour}} \tag{1}
\]

\[\text{3.2.2 Means of subsistence}\]

Capitalism in its modus operandi requires the abolishment of all previous modes of production. Marx likewise bases his thesis on the historical process of primitive accumulation which brings out a duality in the freedom of the workers. In one capacity where the producer of goods ceases to remain a slave or an indentured labourer, it also provides for the seizure of all the means of production from him/her. Left with no choice but to sell his labour in the market, the worker gets a minimum value of subsistence with regard to the services provided for the sale of his labour power\(^27\).

The means of subsistence provided to the labourer proves as a way of maintaining his labour through procreation for future use. Upon other things, it also depends on the

\[^24\] Marx (2011, p. 182).
\[^25\] It denotes the new value produced by the labour power only.
\[^26\] In so far as using this term “unpaid”, Marx (2011) relates this to the over and above work that is extracted from the value of the labour-power which goes to the capitalist gratis.
\[^27\] See Ramakumar (2011, p. 53) in Marx’s Capital: An Introductory Reader.
habitual comforts that the labourer as a class has enjoyed. As Marx (ibid.) puts it that “the value of labour-power resolves itself into the value of a definite quantity of the means of subsistence” (p. 154). The reproduction of this social labour constitutes food, fuel, clothes among other basic stuffs. The inadequacy to provide this to the labourer would be debilitating.

This kind of analysis is peculiar to the kind of critique that Marx presented to the typical bourgeois mode of production. Marx presumes a different approach to the problem of wages which can be gauged from his philosophy of dialectical materialism. Wages in that sense is nothing more than an ideological nuance devoid of any real meaning and which ultimately becomes a source of exploitation of labour.

2.3.3 A Neoclassical understanding

Marginalism formed an essential tool in the hands of economists and in it concepts of total utility and marginal utility gained prominence. Parallel to it was the spreading of industrial revolution that tumultuously changed the production process of society. Concepts of ‘value in use’ and ‘value in exchange’ of goods attained a new tool of analysis. It debunked the labour theory of value and instead attributed prices of goods based on the marginal utility rather than on the amount of labour necessary for its production. It was here that prices and utility were seen in the same manner. Wages, therefore also meant to be understood in terms of its marginal productivity to the output. Here, labour is divorced from the human and neoclassical lens treats it as a mere factor of production that which significantly contributes towards the total output. Demand and supply mechanisms further dictate the movements in these prices of labour.

The classical understanding of any commodity also made comparisons between labour and capital, after all capital had its origins in labour itself at some point of time. Neoclassical steered clear of these dichotomy and assigned greater role of proportions of

Marx throughout his works follows the line of analysis of historical and dialectical materialism. This lens lies rooted in understanding reality as a mixture of both appearance and essence. The diversion of not able to comprehend the actual value of labour is thus marked in only having a half understanding of the substance of reality i.e. mainly lying within the realms of appearance only.

See Smith’s The Wealth of Nations (2003, p. 41). The classical diamond-water paradox of Adam Smith also finds its explanation in the marginal utility theory.

the factors than the rank\textsuperscript{31}. Therefore, the question was not so much in asking which among labour and capital ranked (or valued) better but on asking what were the proportion of their contributions towards the output. This approach shifts the balance of power towards capital which in the long run with greater technological improvements would increase their proportion in the output.

This output driven analysis linked to production gathered focus on rational choice and information in making decisions. Although having a few loopholes, neoclassical economics dictates present day economics.

2.4 A Note on Wages: Concept and its Distribution

In all the aforementioned discussion on the concept and distribution of wages, the analysis revolves around an individual worker. Classical economics posits the labour theory of value and the nature of the subsistence wages for the workers. Neoclassical lens views the marginal contribution with each worker added to the final output. Although trade unions had been a recognised phenomenon, the analysis of wages did not find scope for collective bargaining of the trade unions.

2.5 Trade Unions

Trade union gathers an intriguing mix of interest from economists, sociologists, practitioners and industrial relations expert. Modeling trade union behaviour confronts a basic question regarding objectives of the union (termed as preferences) subject to certain constraints. Historically trade unions have been concerned with an array of issues however wage bargaining is considered as the raison d'être of trade unions. Although, this does has some constraint and raising wages to a certain level jeopardises the employment scenario. The challenge is reaching a delicate position in which high wages coupled with moderate employment would be reconciliatory. The utility of the union therefore lies in

\[ U = U(w,n) \]

where, $U$ is the utility of the union and $w$ and $n$ are the wage and employment respectively. In the microeconomic setting, such kind of bargaining occurs in the hope of a division of the surplus that is earned through the production activity of a firm. The firm also pitches in strongly when faced with these preferences and alternatively decides on employment figures and the union and the firm collectively decided on the wages, alternatively known as the right-to-manage model. On the other hand, a union monopoly model signifies unilateral power to the union.

Bargaining models of bilateral monopoly where a firm as a monopsony demands labour from the monopoly trade union are archetypal. In general, two approaches to represent the bargaining behaviour must be mentioned. Firstly, the axiomatic approach which presumes certain axioms along which solution to the bargain process must be obtained. The Nash bargaining solution with its four axioms of invariance, efficiency, independence of irrelevant alternatives and symmetry (anonymity) exemplifies this axiomatic approach (Nash, 1953). In a bargaining problem $(S, s^0)$, if $s_i$ denotes the payoff to bargainer $i$ and $s_i^0$ denotes the payoff to bargainer $i$ in case of a break down in bargaining then $\max (s_1 - s_1^0, s_2 - s_2^0)$ denotes the unique solution to the problem. The utility representations $u_i$ also encapsulate the risk aversion behaviour and also time preferences of the parties. However, the interpretation of $s^0$ i.e. the case of a breakdown in negotiations, maybe unclear and it may variously represent payoff accrued during strikes or in the case of a complete breakdown of relation, the payoffs subsumed in the period of the search for an alternative relation. To answer some of these defects in the model, secondly, a game-theoretic approach is also used. This approach is used in both finite and infinite time horizons which tend to make it more realistic. The finite horizon approach uses backward induction process and looks for a subgame perfect equilibrium at all sub games. Effective discounting is done owing to the length of the period of bargain. However, both the above approaches happen to produce the same solution.

Trade unions also pose interest in a sociological inquiry. After all, trade unions as they exist are democratic political organisations imbued with the task in nation building.

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32 See Booth’s *The Economics of the Trade Union* (1995) and also Oswald (1985).
33 See Binmore, Rubinstein and Wolinsky (1986) and Booth (1995).
through collective action and mobilisation. Their due however in the wake of bettering the conditions of work and other employment opportunities are gauged only upto the point that they “bring home the bacon” (Ramaswamy, 1977, p. 466; 1983, p. 976). However, sociology has never tried to limit itself in the narrow confines of wage only. Indeed wages form a minuscule of the large variants of analysis in this domain. Here, one of the main focus has been on the relationship between the union leaders and the rank and file workers and enablers towards a greater participation of the rank and file. In a country like India, this generates even more interest where unions are dictated most often by their political affiliations. Ramaswamy (1984) in *Power and Justice: The State in Industrial Relations* analysed the role of the State as being a neutral party to the settlements reached. Questions related to just and fair settlement is abandoned when the State comes in as a power wielding agency. In the manifestation of power in getting across settlement for maintenance of peaceful industrial relations, justice takes a back seat. The political economy of the study of the union in the broader confines of a nation state then becomes imperative. It is also a matter of concern when most of the union leadership comes outside the category of the so called *working class*. A parallel assessment to this in economics is what is termed as the principal-agent problem.

### 2.6 The brunt of bargaining

In a seminal work, Axelrod (1984) analyses the problem of cooperation, without a central authority to monitor their behaviour. He finds representation of this cooperative behaviour and analyses it through the game of Prisoner’s dilemma. The Prisoner’s dilemma game presents a situation where in two parties have option to either cooperate or defect. The pay off for defection is more than the pay off for cooperation. Hedonistic behaviour of this kind is explained premised with the *rational* attitude of the players.

Haber (2006) draws analogy of the two players in Prisoner’s dilemma with two parties in an industrial organisation i.e. management and labour that can either choose to be conciliatory (cooperate) or aggressive (uncooperative). Any party attempting to pursue its

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36 Prisoner’s Dilemma game actually involves the decision making capacity of two prisoners who are incarcerated in separate prison cells and are unaware of each other’s decision choices.
own self-interest risking on others gains would essentially be Pareto-inferior. Increased communication would also not guarantee a better outcome, until both parties agree to trust each other and cooperate. However, “cooperation and trust between the parties are difficult to create and to maintain” (ibid., p. 23).

Conflicts are an irrepessible part of bargaining and any disagreement leads to some amount of confrontation (Sánchez-Pagés, 2009). Strikes in industrial organisations arise out of the differences in the viewpoints of the bargaining agents and as Becker and Olson (1986) avers that “perhaps a more compelling consideration is that work stoppages are the most visible manifestation of any inefficiency associated with collective bargaining” (p. 425). Thus, strikes form an integral part of the functioning of any industrial organisation. It may be borne out of conflict of interest as enumerated by Axelrod (ibid.). Hart (1989) expresses dismay that however strikes are ubiquitous, proper theoretical explanations for them remains missing, for rational parties resorting to violent methods of distribution of profits is difficult to comprehend. On the same lines, Fernandez and Glazer (1991) point out the difficulty of economic theory in explaining strike as a phenomenon.

Amid bargaining situations of bilateral monopoly referred to in the earlier section, Ashenfelter and Johnson (1969) take a departure from this view and include a third party i.e. union rank and file also in their analysis which shapes interactions between parties in a significant manner. Although this analysis seems to be quite simplified it nevertheless provides useful insights in the analysis of strike activities. Another somewhat accepted view of the explanation of strikes can be attributed to the asymmetric information between management and union (Fernandez & Glazer, 1991). Also the cases of one-sided asymmetric information where the workers are completely unaware of the firm’s profitability have proved to be useful in terms of finding its empirical implications (Card, 1988).

On a different note, Ramaswamy (1978) points out that “strikes have to be understood in their context instead of the context being deduced from strike incidence . . .” (p. 15). It is this aspect which showcases the unreliability of data on strikes. Also, strike as an instance of industrial bargaining processes is too complex to be analysed within a single frame of
reasons. There might be cases wherein the underlying dynamics of having a strike might be different from the purpose for which the strike is taken. The strike outcome is also perceived differently by different bargaining agents.

Also, Banaji and Hensman (1990) in their study of industrial plants in and around Bombay reject the theory of determinism in industrial conflicts and confer it as being phenomenological rather than objective in nature. The given choices available in addition to the experience of the workers correctly capture the industrial relations scenario in the firm. Also, the characterisation of the plant specific to any particular industry is deemed irrelevant for drawing any meaningful conclusions about the industry.

Owing to the fallibility of deriving meaningful conclusions on rational parties engaging in strikes and lockouts, Institutional economics provides humongous scope for having a multi-disciplinary approach towards the problem.

### 2.7 Institutional Analysis- Study of ‘transactions’

‘Institutional economics’ strives to address the intricacies of the complexity of institutions. An interest in the study of institutions, essentially native to America, found appeal in the late 1910s and early 1920s. Hutchison (1984) distinguishes institutional economics with attempting to reduce the undue abstraction of the classical and neoclassical theories. Although the works in this direction has been taken up by a variety of scholars, the intellectual impetus to the subject is credited to the works of Thorstein Veblen\(^{37}\). Veblen (1899, 1904) explains that, institutions having their habitual ways of shaping and influencing behaviour of individuals pronounced ‘conspicuous consumption’ by growing affluence, which lies in direct tension with the greater societal welfare function. Further, he criticised the hedonistic assumptions of economics and called for an alternative in ‘habit’ psychology\(^{38}\), for it lay to him, that the product of this self-indulgent attitudes of monopoly business that essentially led to the surge in social problems\(^{39}\).

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\(^{38}\) See Veblen (1898).

\(^{39}\) One might discuss, over the similarities of the pecuniary characteristics of the social theories of Veblen and Marx. Although, by and large, Veblen agreed with the thesis of Marx, he was not a ‘Marxist’. On one
A different strand of institutionalists in the line of John R Commons, J.M. Clark etc. showed interests in combining economics with law (Rutherford, 2001). Commons (1924) in his work *Legal Foundations of Capitalism* developed “transaction” involving a minimum of five persons as the basic unit of analysis of economics, law and ethics. Transaction, as he called to be the “social electrolysis” which defined the minimum basic of all social and economic relations (ibid., p. 67–69). Parties doing the transaction are open to the set of choices available to them, of choosing the rivals- actual, potential, possible or impossible and also of the degree of power that can be exerted in the transaction. Any transaction, in the history of human origins, holds an implicit causality to disputes and these in turn warrant the rise of the class of judges, priests, arbitrators etc. acting in congruence to the working rules of the law defined. Commons (1931) also specifies three different kinds of transactions or economic activities namely bargaining transactions, managerial transactions and rationing transactions. Of which managerial transactions is one in which the assumption of equality of parties is foregone and shifted to one where the management is the one that dictates activities and workers, in this case plays a servile role taking orders. The impetus here is on maintaining efficiency. This league of institutionalists took interests in the legal domain of transactions involving bargaining and power. Assertions of them can be found in various markets- goods, labour and property.

Yet another line of thinkers combined Veblenian ideas of capitalist economy with statistical and quantitative tools. Institutionalism, in its bid to understanding institutions and its supposed implications on the behaviour of organisations and work culture, generated parallels with the methods used in the exact sciences. In many ways this posed a serious challenge to neo classical economics, as a discipline that had been defunct of its applicability to real life problems due to its largely non-credible assumptions. The main proponent of this line of analysis was Wesley Clair Mitchell, who made a detailed study on the business cycles using quantitative techniques. The idea was further taken by several others particularly F C Mills and Willard Thorp (Rutherford, 2001). Neo classical economist and Nobel Laureate Milton Friedman (1950) in a sharp attack relegated hand when Marx based his idea upon Hegelian rationalism, Veblen lay on the idea of Darwinian evolutionary perspective (Rosenberg, 1948; Edgell & Townshend, 1993).
Mitchell to the position of an “empirical scientist rather than a theorist” and positioned research and analyses on the line that “the ultimate goal of science in any field is a theory” (p. 465). Sherman (2001) draws a line between neo classical economics and Mitchell’s institutionalism in the way that while the former is based on the study of economic shocks as an externality, the latter provides a more endogenous nature of capitalist development focusing on institutions.

Despite the initial success in establishing itself as a movement during the interwar period and having contributed greatly towards empiricism and amalgamative adjustments, institutional economics slowly waned out of popular support post World War II in 1945. There can be a number of reasons for this, and but as Rutherford (2001) avers, there were few important ones for it. Firstly, it took a position of methodological holism and thereby lacked a proper grounding in individual behaviour40. Institutionalists reneged on their proposition of ‘habit’ psychology approach, and it became unclear as to what elements of modern psychology it was to take from. Secondly, it received much criticism on account of its failure to provide any theories that could be readily testable or be used in making useful predictions for future course. Thirdly, Keynesian economics took over the prospects of being the exciting new avenue and influenced much of the economic thought.

It is to be remembered here that the debate on institutionalism, its growth, decline or even revival during the later stages were all centered around the methods and presumptions of neo classical economics. If old institutional economics posed a serious threat to displacing neo classical economics during the early 1920s till the mid 1940s, the new institutional economics maintained a more subtle reinstatement of the debates circling around the importance of institutions. In a break from the past, new institutional economics chartered a domain of peaceful co-existence with the neo classical views (ibid.).

New institutional economics began its ascent during the 1970s. If Veblen had been the thrust for old institutional economics, Ronald Coase had been the inspiration behind new

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40 See also Koopmans (1947).
institutional economics. In ways in which neo classical economics failed, new institutional economics came to haunt it back by bringing in the “institutional content” again to the fore that was necessary in its expedition (Rutherford, 2001, p. 186). Coase (1937) notes the limits of the firm by bringing transactions costs that explain the nature and workings of the firm and as North (1992) puts it that this formed an essential connect between institutions and neo-classical theory\(^{41}\). In another array, game theory, in its rationalistic assumptions, also has strived to go beyond the perfunctory and molded it to encapsulate detailed descriptions of institutions\(^{42}\).

Oliver Williamson is also regarded as one of the major proponents of this body of work. In his work he has highlighted the methodical impetus which Commons work on ‘transaction’ had provided, that formed the backbone of the newly formed transaction cost economics (Williamson, 2000). Indeed, transaction cost economics delves deep into the dynamics of any exchanges within the organisation of any economic activity. Williamson (2000) believes in the complexity of institutions and as a result confesses to the ignorance with which institutions are dealt with. He also draws four levels of social analysis that explain the origin and workings of institutional mechanisms. A look into these levels, as shown in figure 2, would help make the picture clearer.

\(^{41}\) Rutherford (2001) avers that recent works on game theory also incorporated the twin dimensions of institutional arrangements on the one hand and the evolution of social conventions on the other. Tools of game theory have been widely used to analyse labour negotiations in various studies where employers and the workers are seen as collectively bargaining for various aspects.

\(^{42}\) See Camerer (1997).
Now let us look at each of these levels, as presented by Williamson (2000),

**Level 1: Embeddedness:** Embeddedness is deeply rooted in the social customs and norms of the society. These can be of the form of taboos, rituals, code of conduct. This forms

**Level 2: Institutional Environment:**formal rules of the game-esp. property (polity, judiciary, bureaucracy)

**Level 3: Governance:** play of the game- esp. contract (aligning governance structures with transactions)

**Level 4: Resource allocation and employment (prices and quantities); incentive alignment**

**Source:** Williamson (2000, p. 597)

**Figure 2: Economics of Institutions**
the canvas on which the interplay of institutions persists. There is spontaneity in their origin and deliberate insistence of installing these mechanisms is a distant possibility. Due to their nature of ingrained societal constructs it is difficult to comprehend them in relation to the actions they project. However, this is a much recognised fact and economic sociologists have presented them in different hues. Change in these institutions takes place at a very slow pace.

**Level 2: Institutional environment:** These basically form the formal rules of the game. The possibility of deliberate designing is not non-existent. The designing of the code of conduct here requires merger with the existent social norms laid out in level one which often acts as constraints on it. Enforcement mechanisms protecting property rights, constitutions and contract law are part of the arrangement. This forms the arena for first order economising. Changes in the system are also difficult to bring about however it takes time in the manner of decades or even centuries unless a handbrake turn of the form of crises erupts. Positive political theory in the manner of social choice theory and other statistical analysis is applied.

**Level 3: Governance:** This level directly spurs from the need of tightening the enforcement mechanisms of the previous level. The goal of governance ultimately would be to establish order in the various transactions that take place. This level also goes past the ex ante stage elucidated in the agency theory literature and realises that complex contracts inherently being incomplete shifts its focus on the ex post stage. Incentive alignment lies at the core of second order economising here. Any contractual arrangements can hence be unduly assessed in terms of a transaction costs economising fashion. Subsequent contract alterations hence take place between periods much less than in the previous lower levels.

**Level 4: Resource allocation and employment:** This is purely the domain of the neoclassical economics. Here, the firm depicted as a production function continuously maintains output relative to prices owing to the marginal analysis.

New institutional economics has been concerned primarily with the two intermediate levels 2 and 3 of analysis. These two levels are which specify the associated transaction
costs in any economic exchanges and where it deals with setting the ‘formal rules as well as the play of the game’ in the sense of specifying power distribution and also the governance mechanisms of dealing with it. This framework essentially follows a path dependency approach. Owing to the constraining allocative-efficiency models of neo-classical economies, new institutional economics has a lot to contribute to the field of economics (North, 1992). The role of transaction costs plays major role in explaining institutions and in this case as Dau-Schmidt (1992) confirms that the costs of collective bargaining are simply transaction costs that are associated with it.

Kaufman (2012) agrees that institutionalism recollects various strands of economics, history, sociology, political science and management. It extends the scope of traditional economics encapsulating the socio-legal aspects underlying any economic phenomenon.

2.8 Relational contracting

Coase (1937) in his seminal work “The Nature of the Firm” posed an existential question for a firm. Firms having exchanges and contracts synonymous to the markets are rather viewed as a more structured alternative to the latter. The realms of price mechanisms realised under the ‘invisible hands’ of the market are replaced by a more ordered objective function acting as constraints in the production activity. However, intertemporally firms also have less number of contracts to be formed as compared to markets which would thereby reduce the transaction costs associated with making these economic exchanges.

Spot contracting specifying exchanges worked out in the market, hence was somehow not compatible with such ‘hierarchy’ of a firm. A more controlled exchange owing to institutional specifications is central to the functioning of the hierarchy. Contracts arranged within internal labour markets thus become ‘idiosyncratic’. In these aspects relational contracts develops supplanting the old classical contract and neoclassical contract laws (Williamson, 1979).

Relational contracting as a governance structure applies to a more recurrent, mundane form of exchanges. Williamson (ibid.) further distinguishes it under two sub headings, namely obligational contracting of bilateral governance and internal organisation of
unified governance. While the latter represent more resolute transaction specific interactions which requiring highly dedicated physical and human assets, economies of scale can be fully realised\textsuperscript{43} thereby promoting vertical integration. The former obligational contracting deals with a mixed set of investment characteristics, which however involving specialised physical and human assets, outside procurement may be favoured. The obvious difference between these two governance patterns, of course lies in the autonomy of the parties involved in the transactions. Vertical integration prohibits any second party interference, while bilateral contracting by fiat contains autonomous structures realising their individual profits from the exchange.

Uncertainty is another dimension which has important implications on the governance infrastructures. The figure 3 below explicates the metamorphosis. As uncertainty increases, bilateral governance patterns shifts towards trilateral governance necessitating an arbitrator to settle disputes arisen over the course of time. Gradually the governance becomes more integrative as uncertainty further increases. This position is not unidirectional but can reverse itself as uncertainty in the future eases.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure3.png}
\caption{Governance in uncertainty}
\end{figure}

\textbf{2.8.1 Labour relational contracting}

The recurrent transactions taking place within firms forms the crux of labour relational contracting. The collective bargaining agreements of the firms governing employer-employee relationship form the basis of analysis. The relational approach as presented by

\textsuperscript{43} This is subject that the factor prices remunerated is the same for the buyer as for any other outside seller.
Williamson (ibid.) would lay a greater emphasis on the relational factors developed over a period of time rather than on a strict deference to the original contract. This relationship would go unaccounted for in a neoclassical system. All transactions are defined under the lens of three conditions namely, asset specificity, uncertainty and frequency of transactions (Williamson, 1979). The issue of asset specificity arises intertemporally where the higher the asset specificity, the more idiosyncratic its transactions and vice versa. Of the four different segregations of asset specificity in the manner of site specificity, human asset specificity, physical asset specificity and dedicated assets, here the study concentrates only on the human aspect of it. Uncertainty as a distinguishing feature has been focused above. Frequency of transactions becomes important when the costs associated with particular relations come in question with the recurring nature of it (Williamson, 1985).

Four modalities of arrangements of the internal labour market are looked into, intermixing degree of human asset specificity along with non-separability (ibid.). Two kinds of human asset specificity, \( k_0 \) for weak specificity and \( k_1 \) for high specificity, also \( S_0 \) for separable and \( S_1 \) for non-separable then

- \( k_0 S_0 \) wherein there would be no incentive to continue the existing employment relationship and moving between jobs would be fluid having no bearing at all. An internal spot market arrangement would be most suitable for such.
- \( k_0 S_1 \) wherein individual output cannot be segregated with ease. The coupling of supervisors or contractors as a medium between the workers and management makes this possible. Union formation would have a weak probability.
- \( k_1 S_0 \) wherein policies would be made so as to sustain the employment relation. This kind of arrangement would depict the obligational market.

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44 Commons (1924) saw this relationship in terms of opportunity, maintenance of it in terms of goodwill for both parties and privilege if it remains the only alternative. Seldom did Commons analysis go beyond the framework of maintaining the contract within the established law/order of the day.

45 See also Williamson’s *The Economic Institutions of Capitalism* (1985).

46 Adam Smith’s theorem ‘the division of labour is limited by the extent of the market’ is connoted here by Williamson (1985) to explain frequency.

47 See also Chakravarty (2002).
\[ k_1S_1 \] wherein relational teams are formed which would be interested in maintaining long term employment relation. Unions are also likely to emerge in such cases and would not be perceived as a hindrance by the management.

Idiosyncratic jobs presuppose certain basic level skills of the workers involved in production. Quantity manipulations in terms of employment figures then are resisted only up till the point where market forces do not make it didactic. Lay-offs are done only to maintain the human capital during later periods.

Prices in terms of labour remuneration or wages however, remain constant and only touched upon during periods of contract renewal. Insistence on price haggling would point to opportunism from the employers. During severe market conditions which promote change in price levels already fixed, tend to be antagonistic towards such relations.

2.9 Summary

In this chapter the concept of wages has been analysed using different frameworks of analysis- initiating from the basic concept of wages as value of labour or remuneration of labour in the classical fervour to the neoclassical marginal understanding of wages. Then the discussion shifted to the focus to decipher trade unions and their actions as legitimate bargaining agents in the system. In the shift from wages of an individual to the wages provided by the trade unions as collective bodies has been presented. In such cases issues relating to principal-agent problem have been pointed out. Bargaining also ensues chances of severing to the point of strikes or lockouts which would be hampering for both parties involved in bargaining.

In another dimension, the new institutional economics views firms beyond the scope of production function and introduce the subtleties of transactions to its operations. These transactions take place in a cost economising manner. Oliver Williamson’s economics of institutions has been employed to understand the institutional environment and governance structures which encompass the matter of the new institutional economics framework. Contracts as governance structures have been assessed with specifically dealing with relational contracts that forms a part of bilateral governance. Special
emphasis in terms of understanding the human asset specificity has been made. Uncertainty as one of the factors defining transactions has been given particular emphasis which dictates the trajectory of the contractual relations. In this given lens of analysis, how are wages to be assessed remains to be the central question.