

CAPABILITIES, SPONTANEOUS ORDER, AND SOCIAL RIGHTS

ESRC Centre for Business Research, University of Cambridge
Working Paper No. 174

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September 2000

This Working Paper relates to the CBR Research Programme on Corporate Governance, Contracts and Incentives

Abstract

This paper explores the legal and normative implications of the idea that the labour market is a spontaneous order or self-organising system which rests on set of mutually-reinforcing conventions which are themselves the outcome of an evolutionary process. It is suggested that the role of self-enforcing norms and conventions cannot be separated from that of more formal mechanisms of legal regulation and intervention (judicial decisions, legislation, collective self-regulation). These formal mechanisms can operate to change the ‘architecture’ or parameters within which the conventions of the market evolve, and in so doing can influence the path of social and economic development. In this vein, it is suggested social rights, far from being inimical to the effective functioning of the labour market, are actually at the core of a labour market in which the resources available to society, in the form of the potential labour power of its members, are fully realised. Social rights should be understood as institutionalised forms of capabilities which provide individuals with the means to realise the potential of their resource endowments and thereby achieve a higher level of economic functioning.

JEL Codes: J38, K31

Keywords: capabilities, spontaneous order, employment legislation

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1. Introduction

The premise of policies of labour market ‘deregulation’ was that the removal of regulatory ‘rigidities’ would free up the labour market to operate in such a way as to maximise efficiency. In the case of the European economies to which these policies were above all addressed, the results have been disappointing. High unemployment (by historical standards) persists at the same time as inequality has grown as a consequence of deregulation. For some, this simply means that the deregulatory agenda has not gone far enough. The goal of a fully flexible labour market will finally be realised once systems ‘cross the river’ to complete liberalisation (Bertola and Ichino, 1995). For others, the lesson of two decades of neoliberalism is that a fundamental reappraisal of the model underlying deregulatory policies is required. A large body of theory and evidence now attests to the presence within ‘unregulated’ markets of structural imperfections which impede the process of market clearing, quite independently of the effects of regulation. From this perspective, many of the regulatory ‘rigidities’ which were (and are) condemned by neoliberal critics can be seen as a response to imperfections such as those which the ‘new institutional economics’ describes in terms of ‘asymmetries of information’ and ‘strategic action’ (Deakin and Wilkinson, 1999).

Perceptive critics argued, early on in the flexibility debate, that deregulation would not put an end to the role of the state. Rather, the task of putting in place the conditions for a well-functioning labour market would require the state to assume new and potentially far-reaching forms of intervention (McCormick, 1986; Simitis, 1987). Experience in one of the first countries to set off on the deregulatory path, Britain, has shown that attempts to make the labour market operate as the economic textbooks say it should have led over time to a significant increase in the body of regulation, much of it devoted to controlling the power of labour market actors in the name of

competition policy (Brown, Deakin and Ryan, 1997). The promise of a lighter regulatory burden has not been met; the question of whether Britain's comparative economic performance has been improved is, to say the least, highly contested (Deakin and Reed, 2000).

Britain is often held out as a model for the European Community as a whole to follow in the pursuit of labour market efficiency. In our view, the true lesson of the British experience is that it is not possible to achieve efficiency simply by removing regulation. The question which we should be addressing is: exactly what kind of normative or regulatory framework is needed in order for labour markets to function in the interests of a range of societal goals, of which efficiency is one? One way into this debate is to consider more closely the nature of market processes and the role within them of norms, conventions and legal rules. We wish to explore the idea that the labour market, like other markets, is a spontaneous order or self-organising system which ultimately rests on set of mutually-reinforcing conventions which are themselves the outcome of an evolutionary process. In contrast, however, to adherents of a completely voluntarist conception of norms, we argue below that the role of self-enforcing norms and conventions cannot be separated from that of more formal mechanisms of legal regulation and intervention (judicial decisions, legislation, collective self-regulation). These formal mechanisms can operate to change the 'architecture' or parameters within which the conventions of the market evolve, and in so doing can influence the path of social and economic development. Understanding the possibilities but also the limits of this technique of 'reflexive regulation' is, we suggest, the key to the developing 'law of the labour market'.

In this vein, we will also argue that social rights, far from being inimical to the effective functioning of the labour market, are actually at the core of a labour market in which the resources available to society, in the form of the potential labour power of its members, are fully realised. For this to occur, certain institutional conditions which are prior to the market must be satisfied. In particular, individuals

should be provided with the means to achieve economic self-sufficiency. The social rights which we have in mind are therefore those which would empower individuals with the means needed to realise their potential in a sustainable way, thereby enhancing the wealth of well-being of society as a whole. We use here the idea of ‘capabilities’ which has been developed by Sen (1985, 1999) and recently formed an important dimension of the Supiot report to the European Commission (Supiot, 1999; Salais, 1999).

The argument is developed as follows. Section 2 outlines the theory of spontaneous order as it relates to markets. Section 3 considers how efficiency and regulation fit into the theory of spontaneous order. Section 4 then considers the preconditions for a well-functioning market and introduces the idea of capabilities into the analysis. Section 5 offers a stylised analysis of sources of inefficiency and inequality within labour markets. Section 6 discusses how the economic idea of capabilities can be operationalised through the legal-institutional idea of fundamental social rights in the context of the current debate over the future of European social policy. Section 7 concludes.

2. The market as a form of spontaneous order

For many critics of regulation, the search for labour market efficiency involves an attempt to recreate the general equilibrium framework of neoclassical labour economics. Under conditions of perfect competition, the fundamental theorems of welfare economics tell us that resources will gravitate, through voluntary exchange, to their most efficient use. Specifying the role of law in the general equilibrium model, however, is inherently problematic. In a world of zero transaction costs, there would be no need for either norms or law, as new institutional economics recognises (Coase, 1988: ch. 1). This makes conventional neoclassical theory singularly unhelpful for telling us about the relationship between law and the market system.

Some progress is made by approaches which accept the existence, in the real world, of positive transaction costs, and see a role for the law in seeking to reproduce the outcomes which a competitive market would have achieved, had it been able to operate as the model predicts. This ‘market perfecting’ agenda is superficially attractive since it holds out the promise that the legal system can enhance efficiency by selective interventions which address particular issues of market failure. However, it faces the formidable theoretical objection made by Hayek, namely that courts and legislators alike are unlikely to have the information which they require to make these interventions effective. Economic systems are too complex to be easily amenable to centralised legal direction (Hayek, 1973, 1976, 1979). The power of this critique, and the problem which it poses for those who wish to defend market regulation, are now widely recognised (Hodgson, 1998).

The theory of the market as a spontaneous order seeks to address the problem of complexity. Information and knowledge (or applied information) are privately held and cannot be mobilised through centralised direction or command. Under these circumstances, the contribution of the market is to operate as a mode of coordination which enables each individual to benefit from the possession and use of information *by others* (Hayek, 1973: 10-17). Competition operates as *a process of discovery*, generating information which is transmitted through the price mechanism. By mobilising the resources available to a society in this way, the market enhances the total wealth (or well being) of its members.

Hayek’s definition of a system or ‘order’ is ‘a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct’ (ibid: 36). Hayek’s definition implies a certain type of relationship between the overall properties of the system and its constituent parts. Sugden (1998: 487) offers the following definition:

‘[a]n order is a regularity among a set of elements. To say that the order is spontaneous is to say that in some sense the elements have *arranged themselves* into that order... For the elements to be able to arrange themselves, each must act on its own principles of behaviour or laws of motion; the regularity among the set of elements must be capable of being explained by the individual actions of the elements. This requires that each element have its own motive power, or be acted on by its own set of forces.’

A spontaneous order therefore rests on the symbiotic relationship between what Sugden calls ‘general’ and ‘particular’ mechanisms. In the case of the market, it is through *general mechanisms*, such as the price mechanism, that the transmission of detailed knowledge from one part of the system to another takes place. The price system is itself the product of interactions among a large number of individual economic actors. It both results from, and operates through, the *particular mechanism* of the self-interested behaviour of each actor.

The price mechanism is just one of the means by which coordination problems are overcome through the market. The market rests on numerous inter-locking *conventions* which guarantee the conditions under which it operates. Conventions or social norms¹ can be thought of as forms of shared information which enable parties to coordinate their behaviour on the basis of mutual expectations of each other’s conduct (Lewis, 1969). Another way of putting this is to say that the value of the information contained in conventions and norms is equivalent to the sum total of the transaction costs which prevent actors from knowing what the strategies of others are going to be (Warneryd, 1998). The price mechanism, for example, encodes knowledge about scarcity in a way that saves on transaction costs, in the sense that consumers do not need to know the reason for a particular shift in prices (such as a disruption to supply); the price signal is enough for them to adjust their behaviour. Social norms, and also the legal system, also operate as ‘information transmission systems’ to overcome coordination problems.

The existence of norms in a general sense is a source of efficiency, since it enables those who follow the norm to save on the transaction costs of endlessly searching for the solution to commonly recurring coordination problems. The returns to following a particular norm increase the larger the number of people who can be expected to adhere to it. The institution of money is an example of this: its use enhances efficiency by saving on the transaction costs which would otherwise arise in a system reliant on barter. Its effectiveness rests on a widely-shared convention to the effect that coins or notes, which may have little or no inherent worth, have value when used as a medium of exchange in the context of commercial transactions (Aglietta and Orléan, 1998).

Other norms which operate to sustain market activity include property rules which serve to identify the subject-matter of exchange. Property rules can be thought of as conventions which, in the terminology of evolutionary game theory, solve coordination failures which would otherwise arise from individually self-interested behaviour (Sugden, 1989: 85; Costabile, 1998: 12-14, 24-27). Repeated disputes over ownership result in socially-wasteful conflicts. The emergence of rules for settling these disputes is therefore a precondition of an extended system of exchange. Norms favouring the enforcement of contracts and respect for the security of commercial undertakings can be seen in the same light. In Hayek's terms, the function of these 'abstract rules of just conduct' is that 'by defining a protected domain of each [individual], [they] enable an order of actions to form itself wherein the individuals can make feasible plans' (Hayek, 1973: 85-86). In other words, these norms supply institutional support for the 'motive power' of individual economic actors, without which there would be no basis for the decentralised action upon which the spontaneous order depends for its effectiveness.

So far we have been discussing self-enforcing conventions which appear to operate independently of any centralised enforcement mechanism. Sugden (1989: 86) suggests that '[m]any of the

institutions of a market economy are conventions that no one has designed, but that have simply evolved’, and that ‘[a]lthough markets may work more smoothly when property rights are defined by formal laws and enforced by the state, they can come into existence and persist without any such external support’. The basis for this claim is the argument that self-enforcing conventions emerge through a process of social learning. In a world characterised by complexity and ‘bounded rationality’, actors have an interest in following those strategies which have proved to be successful in overcoming coordination problems. Norms, in the sense of regularities, can therefore emerge on the basis of repeated interactions between individuals (see Costabile, 1998).

However, those who argue for the spontaneous character of many of the conventions which are characteristic of market exchange do not seek to deny that, in a wide range of contexts, these norms are supported by legal mechanisms of various kinds. In suggesting that markets may work ‘more smoothly’ when legal enforcement is present, Sugden echoes Hayek, who argues that social norms are not sufficient for the preservation of the spontaneous order of the market: ‘in most circumstances the organisation which we call government becomes indispensable to assure that those rules are obeyed’ (1973: 47). Hence, for Hayek, the exercise of ‘coercion’ or legal enforcement of norms is justified within a spontaneous order ‘where this is necessary to secure the private domain of the individual against interference by others’ (ibid: 57). While a given rule of just conduct may have had a spontaneous origin, in the sense that ‘individuals followed rules which had not been deliberately made but had arisen spontaneously’ (ibid: 45), such rules do not lose their essential character merely by virtue of being put into legal form: ‘[t]he spontaneous character of the resulting order must therefore be distinguished from the spontaneous origin of the rules on which it rests, and it is possible that an order which would still have to be described as spontaneous rests on rules which are entirely the result of deliberate design’ (ibid.: 45-46). In this perspective, it is the particular function of private law – what Hayek quoting Hume, refers to as ‘the three

fundamental laws of nature’, *that of stability of possession, of its transference by consent, and of the performance of promises*’ (Hayek, 1976: 140) – to underpin the spontaneous order of the market.

3. Regulation and efficiency in a spontaneous order

Legal norms may therefore have a role to play in establishing the conditions for the effective operation of the market. Neither Hayek nor Sugden go into much detail on why this might be so. One reason could be the fragility of many social norms, that is to say, their tendency to be destabilised by changing environmental conditions. Legal enforcement of social norms could provide some degree of protection against this kind of effect. If this were the case, legal enforcement would have the important but somewhat limited role of crystallising in juridical form practices which were widely followed in practice.

A much broader role for law as an instrument for changing, rather than confirming, norms arises from the tendency for spontaneously-emerging norms to give rise to inefficient solutions over time through lock-in effects and other features of *path dependence* (Roe, 1996: 641). Although, as we have seen, a normative foundation of some kind is essential if a market order is to operate at all, it does not follow that norms evolve and adapt in such a way as to supply solutions which are optimal. In the case of conventions which emerge on the basis of social learning, the usefulness of a particular norm is a function of its adaptiveness in the *past*; hence ‘evolution will tend to favour versatile but inefficient conventions relative to ones that are less versatile but more efficient’ (Sugden, 1989: 94). The adaptation of existing concepts and ideas to new ends means that ‘features of existing conventions and institutions may often have arisen for one reason, but now serve very different functions and purposes’ (Balkin, 1999: 72).

The notion of efficiency in a spontaneous order is therefore a highly qualified one. Norms which emerge spontaneously are unlikely to be optimal in the Paretian sense of producing situations in which no further gains from trade can be made except by making at least one

party worse off (Costabile, 1998: 27-30). However, the configuration of incentives which emerges from the accumulation of conventions may be the best that is available. The costs of attempting to shift the system to a notional optimum through ‘market perfecting’ laws may outweigh the resulting gains (the so-called ‘irremediability’ principle (Williamson, 1996: ch. 9)).

The use of intervention to achieve Pareto improvements may be undesirable for other reasons. This is because spontaneous orders may be *self-correcting*. It is precisely because of so-called imperfections – such as imperfect transmission of information – that opportunities for profit from entrepreneurial activity or, more generally, from innovation in organisation and design of goods and services, exist. In the general-equilibrium world of pure competition, in which information and resources moved perfectly freely in response to the price mechanism, such opportunities would be instantly competed away. In the real world of positive transaction costs, by contrast, it is the possibility of capturing ‘supra-competitive rents’ or surpluses representing a competitive advantage over their rivals which motivates potential entrepreneurs or innovators and which, as a result, ensures long-run technological and organisational progress (Kirzner, 1997).

In this account, the appropriate role for the law, then, is to support private property rights, ensure that returns accrue to those who make investments in the process of discovery, and guarantee freedom of access to markets. The inequalities and concentrations of power and wealth which arise from the unbridled operation of market forces produce their own solution by incentivising those who, by misfortune or otherwise, fail to profit from the system. Even if certain gains and losses accrue by chance, leaving some with ‘undeserved disappointments’ (Hayek, 1996: 127), *ex-post* redistribution of resources blunts incentives for individuals to invest in their own skills and efforts. This and similar interventions which might be justified from a ‘market perfecting’ point of view merely block the *process* of competition as discovery which provides the means by which dispersed

knowledge and information are put to use: hence, ‘attempts to “correct” the market order lead to its destruction’ (ibid: 142).

The precise claim being made here needs to be carefully identified. It is not being suggested that markets, if left to their own devices, will tend towards an optimally efficient state. The market never ‘clears’ in the sense used by conventional economic theory. Rather, the market is useful because it generates a process of discovery which makes the best available use of society’s resources. It is accepted that the process of economic change which this account implies is one which is dynamic and non-linear. It is therefore the *dynamic efficiency* of the market system – in other words, its capacity to generate new knowledge and information in a way which will ensure the system’s long run survival in a changing environment – which justifies institutional support for individual property and contract rights, but which, at the same time, allows for only a very limited degree of market regulation, and rules out redistribution carried out in the name of ‘social justice’ (Hayek, 1973: 140-142).

4. The limits of market ordering

On closer inspection, this ‘minimalist’ approach to the regulation of the market is hard to sustain, even taking as given the assumptions underlying the spontaneous order approach. Indeed, one of the virtues of the theory of spontaneous order is that, in addition to explaining the many benefits of markets, it also helps us to understand their limits. Sugden (1998) acknowledges the limits of market ordering when he accepts that the market is good at meeting one particular type of objective, namely satisfying those wants or preferences which can be encapsulated in property rights. The market will not provide well in relation to those wants or preferences for goods for which no property rights exist. It therefore fails to work well in relation to non-excludable public goods or indivisible commodities (see also Sen, 1999: 127-129).

Moreover, the spontaneous order argument for markets is based on the power of individuals to make mutually-agreed exchanges with others; but this only satisfies wants *in general* if each transaction affects only those who are party to it. If there are externalities, then transactions between some parties affect the opportunities of others to satisfy their wants. As the Coase theorem recognises (see Coase, 1988), the state has a role in dealing with externalities in situations where negotiation is unduly costly. But this opens up another arena for policy intervention in an area where the market is not self-correcting.

Nor is this point simply related to limits to the spillover effects of exchange. Sugden argues that for the market to operate effectively, it is necessary not simply to have a system of property rights, but for individuals to have *endowments* in the sense of items of value which are tradable – ‘the market has a strong tendency to supply each person with those things he wants, *provided that he owns things that other people want, and provided that the things he wants are things that other people own*’ (Sugden, 1998: 492). Another way of putting this is to say that the market has no inbuilt tendency to satisfy the wants of those who do not have things that other people want.

This leads us to pose the question: can a market order function effectively in a situation in which there are large and enduring disparities in the wealth and resources of market participants? For neoclassical theory, the answer is clearly that it can; supply and demand can still be brought into equilibrium and resources will flow to their most highly valued use, value being measured by willingness to pay (Posner, 1999: ch. 1). From the point of view of the theory of spontaneous order, however, the answer is not so clear. Extremes of inequality exclude certain groups from the market altogether. The result is not just that these individuals no longer have access to the goods which the market can supply; the rest of society also suffers a loss from their inability to take part in the system of exchange. Resources remain unutilised. The logic of this position, as Sugden makes clear (Sugden, 1998: 493), is that redistribution is needed not

to reverse the unpleasant results of the market, but rather to provide the preconditions for the market working in the first place. From this perspective, we would suggest, many of the redistributive and protective rules of labour law have a market-creating function.

The argument for redistribution, and for regulation, can be taken a step further. The market itself may be a cause of inequality; inequality, in other words, may be *endogenous*. Neoclassical theory simply denies this on a priori grounds; the causes of inequality are assumed to be *exogenous*, in the sense that different individuals have different capacities and propensities to work. The market itself tends towards proportionality of effort and reward, by setting wages in proportion to the contribution which particular individuals bring to the employment relationship.

However, an implication of the path dependent nature of norms and conventions within labour markets is that forces are at work which disrupt this assumed correspondence of efforts and rewards. Unregulated markets contain within them the seeds of their own destruction. In the terms of spontaneous order, the symbiotic relationship between the general and particular mechanisms can break down. The market loses its capacity for self-correction. Externalities causing losses beyond the exchange which cannot be internalised because of high transaction costs to diminish economic value. Persistent inequalities mean that groups and individuals may lack the resource endowments to enter the market in a meaningful way. In an extreme case, the market will destroy itself unless these negative effects are counter-acted by non-market institutions in the form of regulation and redistribution. In a less extreme case, the market order will continue to function, but will fail to provide adequate economic opportunities for an increasingly large segment of the population.

5. The sources of inequality in labour markets

The suggestion that labour markets tend towards a fundamental lack of correspondence between endowments and efforts, on the one hand,

and rewards on the other, can be understood by considering the role of norms and conventions which structure both the demand-side and supply-sides of the exchange. Norms operate, firstly, to structure the conditions under which labour is supplied. The traditional household division of labour, is one example of this (Humphries, 1977), as are notions of what constitutes a minimum 'fair wage' for which the non-employed are prepared to work (Solow, 1992). Secondly, at the level of the organisation of production, what might be termed the 'managerial prerogative' norm expresses the practice of allowing to management an area of discretion within which to direct the pace and nature of production. Norms about fair treatment and equity in the treatment of employees also undoubtedly affect the practice of many organisations. The form and content of these norms may be (and very often will be) highly contested. Moreover, the degree to which they find concrete legal expression differs considerably across systems (for contrasting analyses of the contract of employment and social norms in American and English law, respectively, see Rock and Wachter, 1996; Deakin, 1999).

The proposition which we wish to investigate here is the idea that *conventions operate to structure the capabilities and hence the opportunities of individuals within in the labour market*. These conventions are the product of the strategies of labour market actors, and may be more or less institutionalised in legal and/or contractual form. Their cumulative effect is to induce dynamic processes which lead to the segmentation of the labour market and, as a result, to mismatches (or imperfections) in the process of pricing labour power. As a result, inequality becomes endogenous to the economic system.²

An initial distinction may be drawn between the endowments of individuals, their capabilities, and their economic functioning. The *resource endowments* of individuals include their labour power, their accumulated assets, and their entitlements (net of contributions) to private and public transfers. Resource endowments vary widely in both levels and composition between individuals and over an individual's lifetime. For example, the resource endowments of

children consist mainly of their claim to intra-household transfers based on their family affiliation and public transfers in the form of child benefits, education, health and other social provisions. In early adult life the most important part of individuals' resource endowment is usually their labour power and they have probably become net contributors, at this stage, to the tax/benefit system and possibly to private transfers. The importance of labour power and net contributions to public and private transfers increase with cohabitation and the formation of families but as individuals grow older their net contribution to private transfers can be expected to decline as their children leave the household, and when they retire their resource endowments become mainly state transfers, accumulated private assets (including private pension rights) and, possibly, private transfers.

There are, however, wide variations between individuals around this stylised lifetime profile of resource endowment. These variations are related to time spent in education, age at cohabitation and family formation, types of household, participation in the labour market, and other socially and economically determined factors.

Given their resource endowments, the *economic functioning* of individuals is determined by what can be described as their *capabilities*. For present purposes, the concepts of capability and functioning will be developed within the framework of a discussion of the effective mobilisation by individuals of the resources at their disposal as the means of becoming and remaining self sufficient. According to Sen (1999: 75),

'the concept of "functionings"... reflects the various things a person may value doing or being. The valued functionings may vary from elementary ones, such as being adequately nourished and being free from avoidable disease, to very complex activities or personal states, such as being able to take part in the life of the community and having self-respect'.

Within this context, a ‘capability’ is ‘a kind of freedom: the substantive freedom to achieve alternative functioning combinations’ (ibid.).

Capabilities are a consequence not simply of the endowments and motivations of individuals but also of the access they have to the processes of socialisation, education and training which enable them to exploit their resource endowments. Inter-community and inter-family differences in wealth, expectations and information provide individuals with variable degrees of access to these processes and hence to opportunities for more highly rewarded employment. The ‘traditional’ division of labour and household organisation, on the other hand, serves to reduce the capabilities of women in the labour market. Unequally distributed responsibility for domestic labour inhibits the labour market activities of women in varying degrees, depending on the collective resource endowment of household members and the willingness of other members to use their resources (either labour or capital) to provide substitutes for the cooking, cleaning, child care and other domestic services traditionally provided by women. The greater the domestic responsibility of a woman (and hence the greater her transfer to others in her household) the less favourable are likely to be her labour market opportunities. At one extreme, in resource-poor households which are highly dependent on the domestic services of female members (female-headed, single-parent households for example), women will find it extremely difficult to realise their full capability on the labour market whatever skills they might have. At the other extreme, in households with access to ample resources to replace female domestic labour, women members will be strongly placed to exploit fully their labour market assets.

The norms associated with the division of labour are affected by the state in a number of ways. The state influences the economic functioning of individuals by reference to social security and labour legislation and through direct provision of health and education services. The growth of the welfare state can therefore be regarded as

counteracting social, economic and other disadvantages and therefore breaking down the barriers to effective labour market participation. However, the extent to which individuals can take advantage of education and training to enhance their resource endowment will still depend on the willingness and ability of households to support non-economically functioning members and their experience, expectations and information about education, training and labour market opportunities.

At the same time, the impact of state intervention may be ambivalent in its effects. The resource endowments of the better-off can be expected to be enhanced by many forms of state provision of education and training as well as through access to health care and social security (state subsidies for occupational social security are a major source of wealth for higher-income groups). Those elements of state expenditure to which the worse-off have greatest recourse, on the other hand, often work to impair their economic functioning. For example, the capabilities of social welfare recipients are *reduced* by social security systems which rely on means-tested benefits which are reduced as incomes rise. This effectively imposes high marginal taxes on the low income households who find themselves in the 'poverty trap' (Parker, 1995).

Within the labour market, professional associations, sectional trade unions and other formal and informal organisations and networks exercise control over entry to particular labour market segments and to training, as well as to other forms of in-market advancement. In this way, they restrict access to and use of human capital. Labour market disadvantages such as sex, race, age, low social status and poor educational achievement are exacerbated by the difficulties particular groups experience in forming or joining effective in-market organisations. The hiring, training and labour management policies of firms interrelate with supply side factors in further differentiating job opportunities. Hiring rules adopted by firms rest on signals transmitted by social characteristics (age, sex, race, education and training qualification, dress, deportment etc.) which are only partially

objectively based but which are taken to measure the relative worth of job applicants.

The technical and organisational structure of the firm, the related systems of labour management, and collective bargaining (or its absence) all structure job opportunities within firms, while training and promotion policies regulate the allocation of workers within internal labour markets. Firms with a range of abilities to pay offer widely different levels of wages for comparable jobs so that differential promotion prospects - in terms of job content and/or pay - exist both within and between firms (Horrell, Burchell and Rubery, 1989). Successful progression within job structures enhances the labour market status of individuals whereas redundancy and other involuntary quits, periods out of the labour market for domestic reasons, and spells of unemployment have the opposite effect. Thus job prospects of individuals can be continuously modified from the supply side by their own employment experience and from the demand side by such factors as plant closures, industrial restructuring and changes in hiring and training rules adopted by employers³.

The structuring of job opportunities and related differences in the terms and conditions of employment are further reinforced by variations in the incidence and effectiveness of collective bargaining and protection afforded by the law. Collective agreements reflect the bargaining power of labour and the ability of firms and industries to pay and so their benefits can vary widely. The employees of small firms, part-timers, workers on temporary and other non-standard contracts and others whose employment status is ambiguous are frequently excluded from the scope of both collective bargaining and protective legislation (Pedrazzoli, 1988).

The general characteristics of labour markets are, therefore, that access to jobs is carefully controlled, and that the higher the pay and status of a particular occupation, the more restrictive the rules of entry. Rules of exclusion operate on all groups at all levels and are mutually re-enforcing in the sense that workers in each labour market

group, excluded from better jobs, more carefully protect those within their control. However, the ability to exclude others can be expected to decline at successively lower levels in the labour market hierarchy. At the bottom end of the labour market, jobs tend to be classified as unskilled whatever their job content, trade unionism is weak or non-existent, and the law offers little, if any, protection. As a result, terms and conditions of employment are poor, work is often casualised and non-standard forms of employment contracts are common. Individuals are trapped in this segment by their lack of transferable and/or socially recognised and credentialised skills, by the many forms discrimination takes, and by the priority which they are obliged to give to domestic and other responsibilities. At this level, jobs tend to be much more open to anyone, and therefore regular employees are thrown into competition with students and others who want temporary jobs to top up their income from other sources, and who are therefore prepared to accept wages below that necessary for self sufficiency.

Cumulative effects are built into the interaction between the resource endowment of individuals, their capabilities and their economic functioning. A virtuous cycle is in operation through which ample resource endowment leads to labour market advantage which enhances capability and economic functioning, which in turn enables increases resource endowment. By contrast, paucity of resource endowment interacts with reduced capabilities in reinforcing poor economic functioning, leading to a vicious cycle of disadvantage. This defines what we may refer to as the *out-market* undervaluation of the labour. This is compounded by *in-market* undervaluation which results from the structuring of labour markets by social, organisational and legal forces which relegate the socially disadvantaged to labour market segments where their capabilities are further reduced because wages are low relative to the real value of labour input.

The segmentation of labour markets and the social and economic deprivation which it engenders therefore have significant macroeconomic and microeconomic implications. The *out-market* undervaluation of labour reduces the overall productive potential of

an economy, while *in-market* undervaluation leads to further waste to the extent that it permits the continued existence of outmoded techniques and inefficient managerial practices. *In-market* undervaluation of labour also leads to a more unequal distribution of income than would be warranted by the distribution of what Marshall called *efficiency* earnings – ‘earnings measured with reference to the exertion of ability and efficiency required of the workers’ (Marshall, 1949: 549). The beneficiaries of this unequal distribution of income may be either those in receipt of profits or more advantaged groups in the labour market depending on whether, and the extent to which, the cost advantage of employing undervalued labour is passed on to the customer. There are a wide range of direct and indirect ways by which the wage share is distributed unequally in which both relative wages, prices and the system of taxation act together to enhance the resources, endowments and capabilities of some while reducing those of others.

To sum up this part of the argument: the operation of spontaneous order within labour markets is a complex process, involving the interaction of a number of forces on the supply-side and demand-sides of the exchange. Conventions structure both the demand and supply for labour in such a way as to produce persistent inefficiencies, or structural inequalities. Because of the path-dependent nature of conventions, these effects may become locked in, with the result that they influence the direction of economic change independently of the forces of supply and demand. The trajectory of economic development is determined by cumulative, feedback effects, which can produce a ‘pathology of the labour market’ in which inefficiencies, and hence inequalities, become endogenous.

Under these circumstances, there can be no assumption that a self-correcting mechanism will undo these effects. A role for policy is opened up, in terms of redressing what may be seen as effects which are undesirable not just for particular groups, but for society as a whole, given the waste and under-utilisation of resources which they

produce. We now turn to consider the nature of the policy responses which this perspective implies.

6. Fundamental social rights as institutionalised capabilities

We have already suggested that certain mechanisms of redistribution may be not just compatible with, but a precondition to, the operation of the labour market. Some more specific examples may help to illustrate this point. Consider laws protecting workers against dismissal on the grounds of pregnancy. A conventional economic view of such laws would be as follows. From the viewpoint of enterprises which would otherwise dismiss pregnant employees once they become unable to carry on working as normally, such laws impose a private cost. These enterprises may respond by declining to hire women of child-bearing age who will, as a result, find it more difficult to get jobs. If this happens, there may be an overall loss to society in terms of efficiency, because resources are misallocated and under-utilised, as well as a disadvantage to the women who are unemployed as a result.

An alternative way of thinking about discrimination against pregnant workers is as follows. In the absence of legal protection against this type of discrimination, women of child-bearing age will not expect to continue in employment once (or shortly after) they become pregnant. It is not necessary for all market participants to make a precise calculation along these lines; rather, a norm or convention will emerge, according to which pregnant women expect to lose their jobs and their employers expect to be able to dismiss them without any harm attaching to their reputation. The overall effect is that investments in skills and training are not undertaken, making society worse off as a result. Women workers will have an incentive not to make relation-specific investments in the jobs which they undertake. In an extreme situation, they may withdraw from active participation from the labour market altogether, and norms may encourage this too – as in the case of the ‘marriage bar’ norm, according to which any woman who married was expected thereupon to resign her position.

This norm was widely observed in the British public sector up to the 1950s and, in the case of some local authorities, was actually enshrined in regulations.

What is the effect of the introduction of a prohibition on the dismissal of pregnant women under these circumstances? In addition to remedying the injustice which would otherwise affect individuals who are dismissed for this reason, a law of this kind has the potential to alter incentive structures in such a way as to encourage women employees to seek out, and employer to provide training for, jobs involving relation-specific skills. The demonstration effect of damages awards against employers may over time lead to a situation in which the norm of automatic dismissal is replaced by its opposite. Stigma attaches to those employers who are flout the law. As more employers observe the new norm as a matter of course, it will tend to become self-enforcing, in a way which is independent of the law itself. Conversely, more women will expect, as a matter of course, to carry on working while raising families, in a way which may have a wider destabilising effect on the set of conventions which together make up the ‘traditional’ household division of labour between men and women.

Pregnancy protection laws, therefore, can be seen a form of institutionalised capability. In other words, they provide the conditions under which, for women workers, the freedom to enter the labour market becomes more than merely formal; it becomes a substantive freedom. This effect is not confined to laws in the area of equality of treatment. Consider laws which set minimum wages or which otherwise establish legally-binding wage floors (such as the principle of ‘inderogability’ in Italian labour law). These laws have been the subject of severe criticisms from economic and legal commentators (Ichino and Ichino, 1998). The objection made against them is that they artificially raise wages above the market clearing level, thereby reducing demand for labour and excluding the less able from access to the labour market. By doing so, they potentially

infringe the basic constitutional right to work in systems which recognise that concept.

This argument assumes that a 'free' labour market more or less accurately allocates wages to workers according to their relative productivity. As explained above, there are spontaneous forces at work in the labour market which make this unlikely. In an unregulated or 'free' labour market without effective labour standards, wage rates are only weakly linked, at best, to the comparative productivity of workers (Craig et al., 1982). The effect of segmentation is that workers with comparable skills and efficiencies are undervalued to varying degrees because they receive different wages per 'efficiency unit'. The persistence of structural inequality opens up the possibility of 'predatory' strategies by firms which seek to tap sources of undervalued labour. Individual employers adjust their wage costs to their ability to pay by either shifting their demand for labour to a more disadvantaged segment or because their workers, trapped in their respective segment, are unable to resist a decline in their relative wage (Wilkinson, 1991). By being in a position to increase the degree of undervaluation of the workers they employ, firms can avoid more radical remedies such as the restructuring of production, managerial reorganization and the replacing of obsolete equipment with new technology. The direct relationship between wage rates and the ability of the firm to pay in a structured labor market also has the effect of discouraging innovation by more creative entrepreneurs, who find it difficult to expand their share of the market because of the difficulties of dislodging technically and managerially inefficient firms which can remain profitable in the short term by employing undervalued labour. The overall result is a lower average level of productivity in the economy, both because managerial practices and obsolete equipment which should be scrapped remain in existence, and because of slow rate of introduction of new techniques.

By contrast, legislation setting a floor to wages and terms and conditions of employment in effect requires firms to adopt strategies based on enhancing the quality of labour inputs through improvements

to health and safety protection, training and skills development. This form of labour regulation may therefore be expected to have a positive impact on incentives for training. Minimum wage laws are therefore another form of institutional capability, improving the substantive labour market freedoms of workers.

By removing protective legislation which has a general or 'universal' effect, protecting all labour market entrants, deregulation directly undermines the capabilities of those individuals who are at most risk of social exclusion through discrimination and the undervaluation of their labour. The de-motivation of those who find themselves excluded from access to productive employment is met by ever-increasing pressure on them to take jobs at any cost. This takes the form of measures within social security law which discipline the 'voluntarily' unemployed by, for example, withdrawing benefits from individuals who refuse to accept jobs offering low-standard terms and conditions of employment. On the demand side, employers are encouraged to take on the unemployed by subsidy schemes which top up low wages. This exacerbates the effect of removing the incentives for training and investment in human capital which flow from a legal requirement for employers to pay a minimum wage. All these developments are well documented in the case of the British experience of deregulation which reached its high point in the early 1990s (Deakin and Wilkinson, 1991).

The perspective put forward here does not mean that all existing forms of labour regulation, at whatever level they operate, are efficient and must be retained. The general case for labour regulation which we have made would not translate into uncritical support for all aspects of existing labour law systems. The search for a system of labour regulation which enhances dynamic efficiency while also reflecting other, widely-held democratic values is one which must respond to a variety of diverse local conditions. Path dependence implies that solutions which work well in one context may not be readily supplanted into others. Finding the 'right' form of regulation is a process of discovery, in the case of the labour market as elsewhere. However, it is precisely in this context that fundamental

social rights have a vital role to play. Fundamental social rights should be seen as setting the ‘rules of the game’, or the architectural framework, within which the European social model, in its many forms, evolves. In this sense, social rights should form part of the wider move towards ‘reflexive’ regulation within labour law, that is to say, regulation which seeks to operate by inducing ‘second-order’ changes in the conduct and strategies of labour market actors.⁴

This implies a particular role for social rights in the context of the debate over harmonisation and subsidiarity. The purpose of harmonisation should not be to substitute for state-level regulation; hence, the transnational standard would not operate to ‘occupy the field’ in the manner of a ‘monopoly regulator’ as is often the case with federal regulation in the United States (and is often mistakenly thought to be the only option for the European Union as well). Rather, transnational standards would seek to promote diverse, local-level approaches to regulatory problems by creating a space for autonomous solutions to emerge. This may involve what some regard as a restriction of competition, in the sense of ruling out certain options which could be associated with a ‘race to the bottom’, while leaving others open. This is now a familiar technique within the European Union; in contrast to the US version of pre-emption, directives in the areas of labour law, consumer protection and environmental law are mostly interpreted as setting basic standards in the form of a ‘floor of rights’. Although ‘downwards’ derogation is prohibited, member states are allowed, and implicitly encouraged, to improve on the standards set centrally (Deakin and Wilkinson, 1994; Deakin, 2000). Far from being a ‘straightjacket’, then, which restricts local autonomy (Paqué, 1997), centralised intervention may be the precondition for local-level experimentation, in the field of social law as elsewhere.

Within the framework of a Europe-wide ‘reflexive harmonisation’ which we have just described, fundamental social rights would have a paramount role since they would essentially operate to set limits to the process of regulatory competition between systems. For this reason

above all, the formulation of a core of social rights which are given equivalent constitutional force to basic economic rights (rights of free movement and access to markets) must be an absolute priority for the European Union, as is the continuation of institutional support for the process of social dialogue which is proving to be a highly innovative mechanism for the operationalisation of social rights.⁵

The formulation of fundamental social rights within the legal framework of the European Union also has an important bearing on the debate over the changing nature of work and the response of labour law to these changes. In the words of the Supiot report (1999: 271), the increasing flexibilisation and individualisation of work necessitates the establishment of a 'convention of trust' as the basis for the governance of the employment relationship. The importance of trust in this context lies precisely in the growing importance of flexibility both in production and in the movement of individuals between jobs and careers across the life cycle. Radical uncertainty creates a set of conditions in which the effectiveness of the employment relationship depends upon the presence of goodwill trust, in the sense of both parties being willing to perform over and above the express terms of their contract (Sako, 1992; Marsden, 1996). At the same time, this is a high-risk strategy which exposes each side to the risk of exploitation or 'opportunism'. The question is, given the high-risk strategy which is implicit in the pursuit of goodwill trust, how is it achieved? The role of goodwill trust extends, in Fox's terms (1974), 'beyond contract', to encompass a degree of open-ended cooperation with expected returns only being realised over a long period. As a result, 'in the context of flexibility, the governance of employment amounts to more than just the management of opportunism; it must provide room for creative action on the part of the social partners, a space for the exercise of freedom' (Supiot, 1999: 270-271).

Factors which are important in creating positive expectations of future performance may be expected to include fairness of treatment, job satisfaction, high quality of work environment and, particularly, income and job security. The scope for determining these factors depends both

on the conditions within a given enterprise, but also on those within the wider environment consisting of the firm, its supply chains, the markets in which the firm operates, and the wider economy of which it forms a part. From this perspective, the issue is not simply whether regulatory intervention can cure particular market failures, but rather how successful the regulatory framework is in creating an environment which is favourable to the emergence of high-trust employment relationships. More specifically, the question is how far labour standards, by providing the conditions for investments in labour quality, may contribute to dynamic efficiency in the sense of the capacity of a firm or other productive system to respond effectively to changes in its trading environment, and in particular in the sense of its capacity for innovation.

The trust between economic actors which is necessary for developing and maintaining a dynamic European economy vitally depends on how performance and distributional disputes are resolved. Mechanisms of governance have the dual and potentially conflicting roles of securing cooperation in the process of production and agreement over distribution of the rents which are generated through cooperation. They can be thought of as emerging in response to coordination failures which are endemic within complex, long-term relations of exchange. However, this is not to suggest that the fit between institutions and market failures is a straightforward one. The evolution of particular mechanisms is shaped by the regulatory framework which sets the conditions for bargaining between groups and for competition between systems. In this sense, 'the endogenisation of social and technical change is not so much a matter of showing that societal institutions and the organisation of innovation arise as solutions to cognitive and economic constraints, but of analysing the political bargaining process underlying the emergence of particular social or technical arrangements or settlements in production' (Blankenburg, 1998).

The adoption of a broad theoretical perspective, which recognises the importance of both dynamic cognitive-technological and social and

political developments, widens the agenda for social policy just as it does for industrial and competition policy. Policy has to be adaptive to the challenge of new technological, organisational and market forms spawned by the pressure of scientific discovery and intensified competition. Such policy objectives include the adaptation and upgrading of technical and social support infrastructures to accommodate change by encouraging the development, and when necessary the reconfiguration, of co-operative networks, to enhance their innovative capacity. The effectiveness of these policies and their effect on the speed and direction of technical change and on competitive performance will also depend upon the devising of effective competition, industrial, regional and labour market policies. But an equally important objective here should be the development of a regulatory framework which is designed to restrict the exploitation of bargaining advantage and the negative consequences of this for the diffusion of new technology and the collaborative effort necessary to deploy it to its fullest advantage.

7. Conclusion

This paper has argued that fundamental social rights, far from being hostile to market relations, should be seen to be at the very core of a European labour market which is becoming increasingly flexible and individualised over time. This perspective draws on theories of spontaneous order and recognises the important contribution which they have made to our understanding of how markets work, but rejects the minimalist Hayekian position that the law should be confined to protecting private rights and ensuring formal freedom of entry to markets. It is necessary to go further, and examine the need for mechanisms which actively counter the exclusion of groups from labour market participation as a consequence of structural inequalities which are endogenous to market processes.

The idea of capabilities as substantive economic freedoms provides a way into this debate. Social rights, in our view, should be understood as institutionalised forms of capabilities which provide individuals

with the means to realise the potential of their resource endowments and thereby achieve a higher level of economic functioning. Social rights are therefore part of a wider set of institutional preconditions for individual economic self-sufficiency and sustainability of forms of production in the modern European economy.

There is sure to be a continuing debate over the nature of complementarities, on the one hand, and trade-offs, on the other, between market mechanisms and fundamental rights. What is clear, though, is that the terms of this debate are shifting away from the simple association of regulation with inefficiency and inflexibility. This will open up new possibilities for empirical and applied research, and fresh insights on the role of law in shaping the continuing process of discovery within European social policy.

Notes

- ¹ The terms ‘norms’ and ‘conventions’ are subject to many different definitions in the rapidly-growing literature on this subject, a full consideration of which lies outside the scope of the present paper. See the symposia held in (1996) 144 *University of Pennsylvania Law Review* and (1998) 27 *Journal of Legal Studies*.
- ² The arguments in the following sections of the paper are developed at greater length, and references to supporting empirical studies are given, in earlier works of the authors and their colleagues. See in particular Craig et al., 1982; Deakin and Wilkinson, 1991; Tarling and Wilkinson, 1997.
- ³ For detailed analyses of the dynamic effects of industrial restructuring and changes in hiring, training and other aspects of labour management on the supply and demand side structuring of the labour market see the collection of articles in *Labour and Society*, October 1988.
- ⁴ See Rogowski and Wilthagen, 1994; Collins, 1999. This ‘reflexive turn’ has much in common with the US debate about the role of the legal framework or ‘architecture’ in shaping market outcomes. See Picker, 1997; Lessig, 1998.
- ⁵ From this point of view, an important step was the decision of the European Court of Justice in the *Albany International* case (Case C-67/96, 21 September 1999), recognising that existing social rights in the EC Treaty have a separate standing from the economic rights of free movement and open competition and are therefore protected to some degree against erosion by market-based arguments for negative harmonisation. The further strengthening of the EC Treaty’s Title on Social Policy (Title XI) should, however, be a priority.

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