The Handbook of Organizational Economics

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Employment as an Economic and a Social Relationship

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1. Introduction

Because employment is simultaneously an economic and a social relationship, one cannot profitably study it as one or the other in isolation. To understand employment relationships requires taking into account both economic and social-psychological dimensions of their content and context and, especially, how economic and social forces interact. This is true of many economic exchanges, but particularly of employment: Fraught with the complexities of time, uncertainty, and ambiguity, employment contracts are often massively incomplete. "Market discipline" is likely to become less and less acute the longer an employment relationship endures. Although supply-equals-demand may be informative in the aggregate, at the level of the relationships between an organization and its employees—the level of greatest interest to practitioners and of increasing interest to scholars—more nuanced and, to some extent, quite different ways of thinking should be employed. In particular, insights from social psychology and sociology about what drives employee behavior—about what employees value, what they expect, and how they assess their situations—are essential to a full and useful understanding of employment relationships. Economics by itself is far from sufficient.

Economic reasoning should not be abandoned in favor of these other disciplines. Instead, economics should be blended with social psychology and sociology. We have found it particularly helpful to use an economic skeleton derived from the theory of relational contracting within the broader framework of transaction cost economics and then to flesh out the skeleton with ideas from the other disciplines.

Economists are customarily schooled in the crisp, concise tradition of supply-equals-demand, in which sparse hypotheses generate broad conclusions. Accordingly, economists may be troubled by the complex animals we construct. If the skeletal structure is simple, the variety of muscle and flesh—and their complex dependence on the broader social environment—leaves one with an incredibly rich menagerie of employment relationships. This is not to say that useful

Authorship (and blame) is shared equally.
predictions are impossible. But they are more nuanced than might emerge from a purely economic perspective. And, in at least some cases, social forces can turn predictions derived from economics alone on their head.

We begin by describing the skeleton. Readers versed in the theory of relational contracts will find this description to be very familiar territory. Then, more by examples than anything else, we show how concepts from social psychology and sociology flesh out the skeleton in ways that a mainstream economist might not anticipate.

2. Employment as a Relational Contract

The economic skeleton for employment relationships is a standard version of relational contracting within the framework of transaction cost economics, mixing bilateral, hierarchical, and, in some cases, trilateral governance, and with more than a nod toward more mathematical theories of repeated games and reputation. We expect that this story is well known to most readers of this chapter, so we outline it succinctly.

We focus for the moment on the relationship between employer and employee:

1. The relationship endures for some length of time. This is not a theory of spot labor transactions.

2. Because it is too costly (or, more likely, impossible) to specify all contingencies in advance, the contract between employer and employee is massively incomplete, both at the outset and as it evolves. Among the many terms of the exchange that are specified only as time passes are: the precise tasks to be performed by the employee and how to assess performance; training that might be provided; decisions about reassignment, promotion, and changes in compensation; and the identities of co-workers, subordinates, and immediate hierarchical superiors.

3. Market forces working on both employer and employee might be acute at the start of the relationship (although institutional factors, such as “company towns” and collective bargaining, may work against even this). As time passes, however, both parties build relation-specific assets, which relax the discipline of the market. Each side gains the ability to hold up the other, albeit their powers may grow quite asymmetrically.

4. The relationship, and how it evolves in the face of contingencies that arise, is often best characterized by its terms of governance: who makes which decisions.

5. The precise design of the contractual relationship will tend to optimize the net benefits of the relationship, net (in particular) of the transaction costs of forming, (re-)negotiating, adapting, and enforcing the contract. (But see, in particular, our discussion below of reputation concerns and effects.)

How should decision rights be assigned? Efficiency considerations point us in two directions: decision rights should vest (1) in the party with superior information and ability to make a particular decision; and (2) in the party in whom greater trust can be reposed that the decision rights will not be abused.

In his classic article on the subject, Simon (1951) proposes that employment is typically a hierarchical relationship, with the employer or hierarchical superior making the vast majority
of decisions. In Simon's model, the employee retains (only) the privilege of quitting, if the employer's demands become too onerous or distasteful. One can see both considerations at work here:

1. The employer, in many cases, acts to coordinate the activities of a number of employees. Being a specialist in coordinating the actions of others, the employer has greater access to information vital to decisions about what must be done when.

2. Trust is more naturally reposed in the party who has more at stake reputationally if the relationship is sundered. In employment, both employer and employee have assets at risk, because both have developed relation-specific assets. The employee expends time and energy acquiring knowledge and skills useful only for this employer, builds up a network of friends on the job, puts down roots in the community which she might lose if forced to seek employment elsewhere, and so on.¹ A list of the employer's assets at risk include: the employee, through time, learns on the job and through training provided by the employer, all of which must be repeated when turnover occurs; employees form networks within the employer's organization that are useful; and so forth. And each party has the substantial ability to diminish the value of the other party's assets. Absent slavery and indenture, the employee always retains the right to quit (although she may be bound to some extent by contractual non-compete clauses). The employer retains the ability to fire the employee, within the constraints that may be imposed by employment law and collective bargaining.

Because both parties have assets at risk, either can conceivably be trusted by the other, based on a threat by the other to destroy those assets. Indeed, measured as a percentage of the party's overall assets, the employee probably has more at risk in the employment relationship than the employer does with any individual employee. This observation might argue, on reputational grounds, for assigning decision rights to the employee who, having relatively more at stake, is potentially more trustworthy and at the same time, less likely to resist a hold-up. (Bargaining theory does not provide us with absolutely firm grounds for this conclusion, but still it seems reasonable.) The information advantage of the employer could be sufficient to overcome this trustworthiness advantage, but another general force works to increase the potential trustworthiness of the employer: Because employers typically deal with more than one employee, they develop reputations among all employees and prospective hires for how they behave as employers. In the usual virtuous-cycle fashion of reputation constructions, a reputation that— if credible— would elicit desirable behavior from trading partners can become self-enforcing. A desire to protect the value of reputation makes the reputation credible; this credibility enhances the value of the reputation, making it worthy of protection through adherence. Therefore, to the extent that an employer deals with multiple employees, if maltreatment of

¹. Even in a pure transaction cost economics account, social forces are clearly at work here. Many of the job- or relation-specific assets an employee develops on the job are social in character, such as friendships made. The employer can influence the extent to which these assets develop—for instance, by promoting social exchange on the job, encouraging after-work fraternization, or (in the other direction) by a policy of frequently breaking up teams, moving people from one location to another, and so forth. In general, the more assets the employee has at risk, the stronger is the employer's bargaining position, and so actions that promote the formation of these social assets, at this level, are good for the employer. But as we discuss later, social comparison processes and group dynamics can present nontrivial trade-offs along this dimension.
a single employee would harm the employer’s reputation with other employees, the reputational cost of such maltreatment increases enormously, which dramatically increases the employer’s trustworthiness. This gives a further rationale for assigning to employers the bulk of the decision rights.

To be clear, specific decision rights are in many cases vested in employees. (More rarely, the two parties resort to tripartite governance, utilizing third-party arbitrators.) Employers probably have superior information about the coordination of activities among different employees; with highly interdependent jobs, they may also have an advantage in deciding what is done and how. But, to take a contrary example, academic deans may often have an advantage in scheduling when certain courses will be taught and even what general material should be covered; yet individual professors are nonetheless typically left with substantial—if not total—discretion about the specifics of how the material will be taught.

It is also worth noting that worker collectives—work councils, labor unions, and the like—can turn this picture on its side, if not its head. Worker collectives provide employees with representatives who can specialize in collecting and processing information valuable for coordinating activities, as well as a collective reputation stake in the relationship between employer(s) and the collectivized employees. Political considerations (e.g., American traditions of bread-and-butter unionism) aside, worker collectives can render it quite efficient to reassign decision rights to employees collectively or, at least, to require in the governance structure a measure of consensus before a decision is made.

3. Behavior: Beliefs and Tastes?

To flesh out this skeleton, we have to specify how the parties involved will behave in various situations in which they find themselves.

For a formal and mathematically inclined economist, behavior is purposeful, driven to achieve specific aims as encoded by the individual’s unchanging and unchangeable utility function. That same economist views purposeful behavior as reflecting two distinct influences: tastes or utility, the primitives of value to the individual; and beliefs, predictions concerning how others will behave, particularly in response to one’s own actions. But after acknowledging the importance of tastes and beliefs, economists do not have a lot more to say about either:

- Economists, by and large, forswear any competence in specifying tastes: De gustibus non disputandum est is perhaps economists’ second favorite bit of Latin (after ceteris paribus). Having disavowed any competence to specify tastes, economists do so anyway, traditionally populating their models with individuals whose tastes are a function solely of their own consumption. Nothing in economic theory precludes homo economicus from having in her utility function a taste for justice, a competitive streak, a masochistic bent, or a desire to see her friends prosper and her rivals suffer. But one rarely finds these traits in economic models.2

2. For a recent attempt to infuse agency theory with more behavioral realism by invoking social and psychological forces, see Rebiter and Taylor (2011).
Beliefs are a more complex matter. In the repeated interaction and reputation stories that form the basic architecture of the skeleton we have proposed, equilibria are manifestly a matter of each party's beliefs. In more mathematical renditions of these stories, the Folk Theorem tells us that many equilibria are possible, depending on the equilibrium beliefs held by the parties. The importance of specific beliefs is clearly recognized, but little is said about where those beliefs come from, how they evolve, and so forth.

Our thesis is that social psychology and sociology provide substantial insight regarding individual tastes and beliefs in employment settings, especially the social nature of those tastes and beliefs. Accordingly, those disciplines may help illuminate which particular equilibria we might expect to see among the many possible options. But the insights provided by social psychology and organizational sociology generate a stronger challenge to the economists' way of thinking, sometimes blurring the line between beliefs and tastes and calling into question the economist's standard assumption that tastes are unchanging and unchangeable. A more accurate rendition of our thesis is that social psychology and sociology teach us much about individual behavior in employment settings, with special emphasis on social factors that affect behavior. In the next few sections, we provide some specific examples.

4. Agency and Consummulate Effort

More attention in the economics literature on organizations is paid to problems of agency and incentives than perhaps to any other issue. Designing robust and well-functioning tangible incentives can be particularly difficult where (1) employees must tend to multiple tasks; (2) tasks are dynamic, interdependent among employees, and ambiguous (the links between employee inputs and observable outputs are noisy or, worse, subject to unforeseen contingencies); and (3) employees' levels of risk and effort aversion are not well known by employers.

Non-economics-based approaches sometimes "solve" the problem of agency in a manner that economists tend to regard as cheating; they appeal to social and psychological processes that lead employees to choose to act in the best interests of employers or some other constituency. Using the terminology of economics to express these social-psychological processes, they include:

- an appeal to motivation on the part of employees to do a good job because the task is inherently interesting, out of pride in the task itself, or because doing a good job is a general social norm;
- an appeal to the employee's sense of obligation (gift exchange); or
- an appeal to the employee internalizing (perhaps endogenously) the welfare of the employer or some other constituency.

All three of these work at the level of employee tastes; the idea is that, contrary to the assumptions of simple agency models, employees are not motivated solely by income received and the desire to avoid effort. Because one can incorporate these additional motivations in an employee's utility function, they are easily accommodated in the standard utility-maximization models of economists (but see the discussion in Section 4.4). Social psychology provides us with a number of interesting and even provocative hypotheses in this regard.
4.1. Explicit Extrinsic Rewards or Control Mechanisms Can Drive Out Intrinsic Motivation

When workers are intrinsically motivated to do a good job, emphasizing "supporting" explicit extrinsic rewards can dull or even reverse intrinsic motivation (see, e.g., Deci 1971, 1975; Lepper et al. 1973; Lepper and Greene 1975; Deci et al. 1999). Several psychological accounts are offered for this effect. Deci and colleagues associate intrinsic motivation with feelings of autonomy: imposing extrinsic rewards or external control mechanisms, such as surveillance, tends to increase the employee's sense of being controlled, diminishing the level of intrinsic motivation. (Why are individual faculty members given autonomy over what they teach and how? A partial explanation may lie in this direction: The freedom enhances the intrinsic motivation of the faculty member, which is an essential piece of motivation for this complex task.) A different psychological account involves self-perception theory (Bem 1967): An employee who works hard at some task, without explicit extrinsic rewards, is insufficiently justified cognitively and will tend to rationalize to herself that her efforts at doing a good job must stem from her own pride in or love of the job itself. Having so rationalized her prior efforts, she subsequently acts in accordance with these values; her pride in doing a good job or intrinsic interest in the task rises. When extrinsic rewards or explicit controls are made salient, the individual may become over-sufficiently justified: Now she can attribute effort to a desire to earn the specific reward or avoid punishment. If she comes to believe that that is what motivates her, then she may do what is required, but only just what is required. She is less likely to attribute her effort to pride or love and, the story goes, is less likely to provide consummate effort subsequently. 3

This is not to say that, by reducing the salary of an intrinsically motivated employee, an employer would perform intensify that intrinsic motivation. These effects have more to do with the extent to which extrinsic rationales are made cognitively salient than with the provision of extrinsic rewards per se. Moreover, demotivation may ensue if compensation levels are not fair and equitable, especially based on social comparisons, or are inconsistent with status (see Section 5). The point is, instead, that highlighting explicit extrinsic incentives—emphasizing an explicit quid pro quo—can dull intrinsic motivation, which in turn may either lower performance or raise the cost to the employer of achieving the optimal level of performance.

This is also not to say that focusing on extrinsic incentives is always a bad idea. In some settings, intrinsic motivation to perform is scarce and of limited relevance to individual or organizational performance. But intrinsic motivation can be a very powerful and inexpensive control mechanism in a wide variety of settings: where work has social meaning, such as nursing; where it involves the use of a skill or craft acquired through a process involving strong normative socialization, such as a crafts union or professional school; where the individual employee is better equipped than the employer to make real-time judgments about what actions to take and in what sequence; where the difference between adequate and superlative performance is highly valuable to the enterprise; and where individuals work interdependently, so that spillovers in attitudes and outputs are possible among members of the employee group.

3. A somewhat different account of the self-fulfilling nature of extrinsic controls emphasizes the dynamics of performance sampling or what psychologists term "asymmetric disconfirmation." Employers who underestimate the extent of employee opportunism will observe their errors and restructure accordingly, producing a self-fulfilling cycle; in contrast, employers who overestimate the extent of employee opportunism are unlikely to structure jobs in such a way as to allow their priors to be disconfirmed (e.g., Denrell 2003; Larrick and Wu 2007).

4.2. Prices and Wages

In a competitive market with perfect information, wages, like prices, are the result of a process of supply and demand. But wages are not prices: They determine the cost of labor, not the cost of goods. The cost of labor depends on the demand for labor and the supply of labor and the going wage rate. This, the market clears: If market conditions change, wages rise or fall to clear the market. If the demand for labor increases or the supply of labor decreases, wages rise; if the opposite happens, wages fall. The market is also efficient: It allocates resources among industries so as to maximize the sum of consumer and producer surplus.

A similar logic applies to wages. Wages are reciprocated for work performed and are determined by the interaction of demand and supply. When the demand for labor increases, wages rise; when the supply of labor decreases, wages rise. The market is also efficient: It allocates resources among industries so as to maximize the sum of consumer and producer surplus.
4.2. Process (Language and Symbolism) Affects Gift Exchange

In a competitive labor market, profit-maximizing employers are meant to pay employees their market wages. Nonetheless, one sometimes observes employees being treated better—in terms of wages, benefits, or other perquisites—than their market alternatives. The typical economic explanation is that these are so-called “efficiency wages” (see, e.g., Campbell 1993): By paying above the market, the employer reduces the chances of the employee leaving the job for another opportunity or for personal concerns (e.g., one’s spouse has found a better job elsewhere). This, the story goes, economizes on turnover, supervision, and training costs. Moreover, above-market compensation induces employees to take particular care not to be fired. To protect their privileged job (in an environment where they might be terminated unexpectedly), employees reciprocate with above-market diligence, they forebear from dysfunctional rent seeking, and so forth. These considerations suggest that efficiency wages are expected when it is difficult or costly to exercise direct managerial oversight; tasks are interdependent among employees; turnover, monitoring, and training are costly; and hold-up problems are intensified by virtue of scale, technology, worker organization, or skill monopolies among star employees with external opportunities. And empirical evidence is at least partially supportive; in particular, premium wages are often associated in a given labor market with larger firms, which complement premium wages with premium benefits.

An alternative and somewhat noneconomic view is that above-market wages and benefits actuate a reciprocal pattern of gift exchange. The employer is providing gifts to employees; employees are then motivated to reciprocate with gifts of commensurate effort. Employees do not precisely calculate the monetary value of the gifts they are given or what it would cost them monetarily to lose the gifts by losing the job. Instead, employees feel a more basic social obligation to reciprocate gift for gift. In this story, the character of the gift from employer to employee can powerfully affect how the employee responds. Gifts are more likely to engender reciprocation the more personal the gift is, the more it seems to have been personally costly to the gift giver, and the more it seems to be a gift and not simply extra compensation. To reduce this idea to something of a caricature, a gift basket of books or music CDs at the holidays, particularly if the composition of the basket reflects the individual tastes of the recipient, is more effective than is the equivalent amount of cash, especially if the cash amount is determined by a specific formula that depends objectively on the employee’s base salary. (Compare with the standard economic point of view: Except for their tax-favored status or economies due to large-scale purchases or the solution of adverse selection problems, specific benefits are less valuable to employees than is the equivalent amount of cash.)

A gift is more clearly and obviously a gift—and therefore more likely to trigger reciprocal gifts—the more clearly it is “unnecessary.” Efficiency wage stories imply that employers should utilize efficiency wage regimes to mollify employees having the highest expectations, the most abundant external opportunities, and the greatest ability to impose costs on the employer. Yet these may well be the employees among whom it is most difficult to cultivate feelings of obligation by providing treatment that exceeds what is customary in a given occupation, industry, or locale. The relative affluence and clout of these employees makes it more likely that they will frame the above-market compensation simply as their due. In contrast, above-market rewards paid to those lower in the employment pecking order are, for that reason
alone, more likely to be framed as gifts. It may be employees with lower expectations regarding compensation and treatment who are affected most profoundly by receiving a gift of a specific value.4

This insight has been leveraged to great effect by George Zimmer, founder of Men's Wearhouse, a retailer selling low-priced menswear in conveniently located establishments that minimize the travel and shopping time men must spend when purchasing clothing. In an industry characterized by astronomical turnover rates, low wages, minimal benefits, and reliance on technological surveillance and controls to deter employee misconduct, Zimmer has adopted a contrarian approach. He invests heavily in employee training and development, in providing short- and long-term benefits, and in making the workplace fun (O'Reilly and Pfeffer 2000). Many individuals he hires are passed over by competitors who do not see in the resume the indicia of trustworthiness and business acumen. For Zimmer, a lack of experience or a string of past travails creates opportunities to engender more intense feelings of obligation and gratitude. Zimmer offers these disadvantaged individuals not simply a job and a paycheck but also a chance for self-esteem and a new life.

There is evidence in support of the economic benefits realized through this regime. According to the 2005 National Retail Security Survey (NRSS) of 156 retail chains (Hollinger and Langron 2006), shrinkage in retail averaged 1.59% of total annual sales in 2005, slightly higher (1.62%) in the men's and women's apparel sector.5 A Stanford Business School case on Men's Wearhouse reports a shrink rate of "roughly 0.5%" (Pfeffer 1997). At the time of the NRSS survey (2005), the company reported revenues of $1.725 billion. If its shrinkage rate was 1.62% − 0.50% = 1.12% lower than its competitors, this represents a savings of about $19.3 million. According to the 2005 NRSS, on average 5% of theft was due to vendors, 15% to administrative and paperwork errors, 33% reflected shoplifting, and 47% was due to employee theft. Even if one assumes that Men's Wearhouse human resource (HR) practices only affect shrinkage from employee theft and shoplifting (80% of the total), the savings still add up to about $15.5 million for the year or about $1,120 per employee. And these rough estimates may well understimate the savings from reduced shrinkage: the NRSS reports considerably higher shrinkage rates in retail establishments with high turnover and heavy reliance on part-time personnel (Hollinger and Langron 2006; figures 25 and 26), and Men's Wearhouse is far below the industry average on both dimensions.

On the expenditure side, it is difficult to calculate the magnitude of the efficiency wages being paid, but the Stanford case reports that training expenses (which include many social activities having team-building effects) average roughly 2% of payroll. In FY2005, selling, general, and administrative expenses for the entire company totaled $531.8 million, so an upper bound on the entire training tab is 2% of that amount or $10,637,000, which works out to $771 per employee. In short, the goodwill Zimmer creates by investing in a workforce whom others have shunned pays for itself handsomely simply due to reduced employee theft and increased employee attention to customer theft. This estimate ignores any benefits obtained through greater sales productivity, less turnover, or lower administrative overhead.

4. For some field-based and experimental evidence consistent with this speculation, see Baron (2011).

5. More recent annual versions of the NRSS yield very fairly similar estimates but warrant less confidence due to much lower response rates among firms in men's apparel.
### I. M. SPICE CORPORATION
Confidential (for Herb Spice only)

<table>
<thead>
<tr>
<th>Last Name</th>
<th>First Name</th>
<th>2009–10 Performance (1 = horrible, 4 = star)</th>
<th>Whining Index (5 = non-stop complainer, 1 = like a kitten)</th>
<th>Probability Quit in Next Year</th>
<th>Comments</th>
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</thead>
<tbody>
<tr>
<td>Anise</td>
<td>Al</td>
<td>3</td>
<td>1</td>
<td>0.05</td>
<td>Caring for sick parent</td>
</tr>
<tr>
<td>Bass</td>
<td>Brian</td>
<td>2</td>
<td>5</td>
<td>0.50</td>
<td>Engaged to army officer</td>
</tr>
<tr>
<td>Caraway</td>
<td>Carl</td>
<td>4</td>
<td>4</td>
<td>0.10</td>
<td>Takes night classes at Tech</td>
</tr>
<tr>
<td>Dill</td>
<td>Dave</td>
<td>1</td>
<td>5</td>
<td>0.10</td>
<td>Let’s hope his wife gets that job in Europe she’s applied for!</td>
</tr>
<tr>
<td>Elder-Berry</td>
<td>Ellen</td>
<td>1</td>
<td>3</td>
<td>0.10</td>
<td>No talk of leaving lately</td>
</tr>
<tr>
<td>Fennel</td>
<td>Fiona</td>
<td>2</td>
<td>3</td>
<td>0.01</td>
<td>Joint custody of kids</td>
</tr>
<tr>
<td>Garlic</td>
<td>Greta</td>
<td>3</td>
<td>5</td>
<td>0.20</td>
<td>Always threatening to leave, but...</td>
</tr>
<tr>
<td>Herbes</td>
<td>Finis</td>
<td>4</td>
<td>2</td>
<td>0.80</td>
<td>Recently won lottery</td>
</tr>
<tr>
<td>Juniper-Berry</td>
<td>Jill</td>
<td>3</td>
<td>1</td>
<td>0.75</td>
<td>Two close friends just quit</td>
</tr>
<tr>
<td>Kaffir</td>
<td>Kris</td>
<td>2</td>
<td>3</td>
<td>0.50</td>
<td>Applied to grad school</td>
</tr>
<tr>
<td>Licorice</td>
<td>Linda</td>
<td>1</td>
<td>1</td>
<td>0.10</td>
<td>Coaches local youth sports</td>
</tr>
<tr>
<td>Marjoram</td>
<td>Marjorie</td>
<td>4</td>
<td>3</td>
<td>0.20</td>
<td>All her family members live locally</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td>2.5</td>
<td>3</td>
<td>0.28</td>
<td>21.425</td>
</tr>
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**Note:** D = 8 + (3.0 * A) + (2.5 * (5 - B)) + [10 * (0.5 - (C - 0.5))].

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**Figure 1.** Proposed Thanksgiving gifts for employees of the I. M. Spice Corporation.

Interestingly, Zimmer apparently resists appeals from his management team to quantify the return on investment for expenditures such as the annual companywide retreat at the beach in Pajaro Dunes, California, to which all employees are invited. In a videotaped conversation with a class of Stanford students about the company, Zimmer says that this is "the best money we spend" and that the expenses will only be curtailed "over my dead body, even if it is hard to quantify from a cost-benefit point of view" (Pfeffer, personal communication, 1998). Given the apparent magnitude of the return and Zimmer's shrewdness, one cannot help but wonder whether this posture is intended to preserve the gift-exchange properties of the company's training investments by not emphasizing any calculative logic involved in having made them.

Conversely, opportunities to leverage gift exchange can be squandered through words or actions that emphasize the calculative underpinnings of employers' actions. For an (admittedly fowl) example, imagine employees of the fictional I. M. Spice Company discovering the spreadsheet shown in Figure 1 on their boss's desk just before Thanksgiving. It is hard to imagine Spice's employees responding to their proposed Thanksgiving perk with unbridled displays of loyalty and corporate citizenship.

Cultural and social factors largely outside the firm's control can also affect if and how employer largesse triggers reciprocity, by affecting how the recipients frame the gift. These cultural and social factors may pertain to the recipients. For instance, it is not a great overstatement to
suggest that the educational experiences at elite business schools reduce mightily opportunities for engendering feelings of reciprocity and obligation among newly minted MBAs vis-à-vis the organizations that employ them. Throughout the business school experience, students are described and treated as the "best and brightest" and indoctrinated with the principles of neoclassical economics, a cocktail that encourages many students to presume (if not assert boldly) that they are worth whatever they are able to extract in the labor market. This, in turn, suggests that MBAs, especially those from elite programs, might be relatively more sought after by organizations that eschew gift-exchange processes in favor of greater reliance on extrinsic incentives.

Cultural and social factors may also relate to the gift itself. For instance, a gift that runs counter to the dominant local culture may be dysfunctional: Think of a very early provider of health benefits for same-sex domestic partners. This offering was more likely to have the desired effect in, say, San Francisco, than it might have in, say, Utah or the deep South. Moreover, the power of this gift was probably strongest in San Francisco for the early adopters: Whereas a gift that is utterly unusual or unprecedented may be misunderstood or misperceived, one that is utterly commonplace or has become an industry norm provides relatively little luster. The impact of a given HR system is likely to depend on the distribution of alternative systems being utilized within the relevant sphere(s) to which employees attend. Zimmer would presumably derive considerably less benefit if his approach to employment relationships were the norm in apparel retailing.

Evidence of similar effects is found in the high-tech sector. The Stanford Project on Emerging Companies examined how founders' early blueprints or mental maps regarding employment relations affected the evolution and performance of a large sample of Silicon Valley start-ups. The researchers found that companies founded with high-commitment HR systems displayed higher rates of survival and success from 1994 to 2001 than did most otherwise-comparable companies, even those founded with "star" models of the sort generally thought to promote technological excellence (see Baron and Hannan 2002). This was true in a locale (Silicon Valley) and time period (the Internet boom) in which "commitment" was generally regarded by the mid-1990s as an outdated construct that impaired organizations from being flexible and fast. The point here is that if the significance of an employee's offer to employees depends on the benchmark in terms of which it is assessed, then the returns to building a high-commitment culture may be greatest precisely when such cultures are uncommon and somewhat suspect: the significance of investing in employees and committing to their long-term development is greater when few rivals are doing so and when it is relatively more constraining or costly for employers to do so.

4.3. Internalizing the Welfare of Others

Sections 4.1 and 4.2 considered situations in which one party, the employee, takes actions that benefit a second party, the employer, without any apparent extrinsic incentive to do so and, presumably, at some personal cost in time or effort. By the principle of revealed preference, the observation of such behavior is explained by supposing that this behavior is, on net, utility enhancing: The benefits to the first party exceed the cost of the time or effort required. One possible explanation—what we mean to suggest in Section 4.1—is that the party finds the act inherent.
inherently enjoyable, takes pride in the act itself, or feels that the action per se is compelled by norms of proper behavior. We could test this idea by seeing whether the first party would take a similar action that benefits no one in particular or that benefits only unknown third parties. A second explanation—suggested by the language of gift exchange—is that the first party is discharging some perceived obligation to the second party; the action would not be taken for anonymous third parties, nor would it be taken on behalf of the specific second party once the original gift was adequately reciprocated. (This behavior can be rationalized as conformance to the norm of reciprocity, but it is reciprocation that is normative and not the specific behavior itself.) A third possibility, where the action would be taken for a specific second party (and not for an anonymous third party), is that the first party has (positively) internalized the welfare of the second party; roughly put, the first party’s utility depends positively on the welfare of the second party.

It is probably difficult to separate the second and third explanations of this pattern of behavior empirically, especially where the two parties interact repeatedly: Unrequited love notwithstanding, any persistence in my internalizing your welfare is likely to require that you demonstrably reciprocate. One might simply view a sequence of back-and-forth gift exchanges as a device, especially on the employer’s part, for increasing how much the employee internalizes the employer’s welfare, thereby efficiently solving agency problems. However, in the spirit of escalating commitment (Staw 1981), which psychologists have examined primarily in the context of ill-fated decisions, we suggest that virtuous cycles of internalization can occur. The two parties might begin by exchanging small and inexpensive gifts, but as time passes and the relationship matures, if it matures positively, the extent to which each side internalizes the other’s welfare will escalate.

Psychologists and others have documented a number of mechanisms by which this internalization occurs, aside from a generalized social norm of reciprocity. Studies of commitment in a variety of contexts (corporations, unions, voluntary associations, and long-term relationships) have documented that the time and effort associated with investment in a relationship itself tends to foster and deepen internalization of the other’s welfare (e.g., Sheldon 1971). Moreover, the diminution of alternatives that often accompanies investment in building long-term alliances can strengthen the tendency for each party to internalize the welfare of its other exchange partners. And numerous studies of escalating commitment to ill-fated courses of action have highlighted the role of self-justification in sustaining prior commitments, lest the decision-maker appear unwise in the eyes of others (Broockner 1992). Similar processes of self-justification, self-perception (Bem 1967), or social consistency (Festinger 1957) are presumably activated by taking actions that benefit another individual or entity without sufficient extrinsic rationality. In Section 4.1, we imagine an employee who exerts herself without the prospect of a contingent, extrinsic reward as rationalizing this effort, ex post, with “since I worked so hard on it, it must be because it was fun” or “because it is important to me personally to do a good job.” In the right social environment—such as in an organizational culture that emphasizes cooperation and loyalty—she might justify her efforts with “I did it because I want my co-worker [or team, boss, department, organization] to succeed” and, having so justified her past efforts, might adopt this attitude when choosing her subsequent levels of effort.

Such justifications are not merely attempts to rationalize or justify one’s actions to oneself or others. Behavioral scientists have documented an important moral dimension of commitment,
which seems distinct from other facets of commitment. For instance, studies of marital commitment and duration have identified personal, moral, and structural dimensions of commitment, corresponding (respectively) to a person's responses when asked how much he or she wants to stay married, should stay married, and has to stay married due to irretrievable investments, limited alternatives, or social approval (Johnson 1991; Johnson et al. 1999). Moreover, research in a variety of contexts suggests that the persistence of all sorts of relationships depends on the individual internalizing the welfare of specific parties. For instance, commitment to one's spouse as a person, and changes in that commitment, predict the level of self-reported love and marital discord experienced in Norwegian marriages (Swensen and Trauhaug 1985).

In sum, prior investments, structural constraints, social and moral prescriptions, cognitive consistency and self-justification motives, and the familiarity that develops over time can all drive individuals to internalize the welfare of those with whom they transact, in ways that go far beyond straightforward self-interest. The rub, however, is that researchers have found this blissful state of affairs to be very difficult to sustain over long periods of time. Consider, for example, how the authors of the just-mentioned Norwegian marriage study summarized their research findings:

Those [who developed] increased commitment to the spouse as a person over the course of marriage expressed significantly more love to their spouses and had significantly fewer marriage problems. However, commitment to the spouse as a person declined for most couples over the course of marriage. [Swensen and Trauhaug 1985: 939, emphasis added]

In a similar vein, Sheldon (1971) documented that the commitment of PhD scientists to their employer (a private laboratory) increased with their investments, captured by measures of age, length of service, and position level in the enterprise. But commitment to their profession also increased powerfully with work experience, beginning to undercut commitment to the organization after a moderate length of service. Sheldon found that social involvements—a high degree of involvement and identification with co-workers, on and off the job—mitigated the negative effects of professional commitment on organizational commitment. Put differently, as the scientists' commitments to the firm per se began to wane relative to their identification with the broader professional community, personal involvement and identification with their colleagues, on and off the job, became the focal mechanism for binding the scientists to the laboratory.6

In Section 4.1, we cited work that showed how (over)emphasizing extrinsic incentives can diminish intrinsic incentives. One explanation for this phenomenon is that emphasizing extrinsic rewards provides another rationale for the effort provided; an individual who is over-sufficiently justified (to use the language of social psychologists) need not resort to ex post rationalizations of how interesting the tasks are, or how important it was to her to do a good job. The same process, presumably, would dull the development of positive internalization; if I can rationalize help that I give you as being driven by extrinsic rewards, I am less likely to adopt the position that I do it because I care for you.

6. One cannot help but note an analogous pattern that sometimes occurs in long-term marriages, in which commitment to the spouse as a person wanes as a basis of marital attachment and is overtaken by a more vibrant commitment to the shared products of the marriage: the kids.
It is worth noting in this context that in all but the simplest of work technologies, employees must interact repeatedly with parties other than the “employer” (put in scare quotes because the employer is rarely a single individual but rather a conglomerate of hierarchical superiors, managers, etc.). In some work technologies, it is crucial that employees help one another. In some instances, strong and cooperative relationships between employees and clients are crucial to success. Our point is that internalizing others’ welfare—which would induce helping efforts or strong and cooperative relationships with clients—is a possibility in virtually any long-term relationship. Moreover, employers have levers with which to control the extent and nature of this internalization, such as job rotation policies, workplace architecture, workforce demographics, and job titles. Of course, before an employer can employ these levers, she must first analyze where internalization is desirable and where it might work against her own interests. An appreciation of this social psychological process, of both its impact on economic outcomes and on the ways and means of controlling it, can be very informative in the study of particular job designs.

4.4. These Phenomena in the Economics Literature—and the Issue of Changing Tastes

A few economists have written papers concerning the psychological phenomena described above, although this work is not always cast in the employment context. Three important streams in the literature are:

- Frey (see, e.g., 2008) stresses the sorts of explanations given by Deci; i.e., the importance of autonomy to intrinsic motivation.
- Fehr and his associates present a series of experimental papers that put particular emphasis on the norm of reciprocity and the role of gift exchange. A survey of this work is provided in Fehr and Falk (2002).
- Gneezy and Rustichini (2000) provide some field data that they interpret as an example of extrinsic incentives driving out intrinsic motivation in the context of picking up children at the end of the day from daycare.

In addition, two papers by Bénabou and Tirole (2003, 2007) concern these phenomena and, in particular, an important methodological issue. At the start of Section 4, we said that accommodating these phenomena was “simply” a matter of introducing into the utility function of employees such arguments as the enjoyment of a specific task (i.e., performing the task raises utility directly); a primitive desire to do a good job or to conform to a particular norm; a propensity to reciprocate, especially to reciprocate a gift; or the welfare of another party. But, in fact, things are a bit more complex than simply putting those arguments into the utility function, because the phenomena we have described involve interactions between those arguments and things like the degree and salience of extrinsic, contingent rewards; the degree to which the individual perceives herself to be autonomous; and the degree to which a reward is perceived to be a gift. To develop formal models of the phenomena described, one requires either a utility function with complex interactions among its many arguments or—more simply, but more controversially—a model of endogenously changing tastes, where what the employee wants today concerning her efforts tomorrow is not what she will want tomorrow concerning those efforts. Behavioral models along these lines, particularly models of economic behavior
with changing tastes, have become increasingly fashionable. But such forays into behavioral economics are still regarded with considerable suspicion by many mainstream economists.

Bénabou and Tirole, then, seek to explain the phenomena within a standard model, in which the economic actors have the standard sort of preferences. In Bénabou and Tirole (2003), a principal has private information about how onerous a particular task is for the agent. When and if the principal puts in place extrinsic rewards for good results, the agent (correctly) infers that the principal knows this task to be onerous, and she (the agent) is less intrinsically motivated to perform. In Bénabou and Tirole (2007), the agent has private information about how intrinsically motivated she is in general. Even if she is not intrinsically motivated, it is good for her to pretend to be, because of the treatment she will then receive from this principal or in other engagements, and she will therefore act as if she were intrinsically motivated, as long as doing so sends the “right” signal. But when and if the principal puts in place extrinsic rewards, consummate performance by the agent is no longer as powerful a signal; the agent might be responding (only) to the extrinsic incentives. The signal she wanted to send is jammed, and she acts as if she were less intrinsically motivated (closer to her true preferences) as a consequence.

These are very clever models, and Bénabou and Tirole argue that they fit well with specific phenomena observed in the field. Nonetheless, they involve a degree of calculativeness (each involves a complex signaling equilibrium) that we find somewhat implausible, especially in light of some of the experimental evidence, and they are not in accord with the psychological accounts of what is happening. So we continue to hold that understanding the psychological and sociological underpinnings of behavior is crucial to understanding incentives and motivation in employment, even at the cost of models in which utility functions sport arguments with which economists are largely unfamiliar and in which those utility functions—viewed as they should be, as modeling artifacts of revealed preference—may change according to the individual’s experiences and environment.

5. “How Am I Doing?”: Social Comparison, Procedural and Distributive Justice, and Status Consistency

In an ongoing employment relationship, participants continually must answer the question, Am I being treated appropriately? In a game-theoretic equilibrium, an objective, absolute standard must be met, but in real life, matters are not so simple. A host of social, psychological, and sociological factors play a pivotal role here.

For one thing, employees mix absolute standards with relative ones: They ask how they are being treated relative to others in the organization. These social comparisons can be with hierarchical subordinates or superiors, but perhaps most often they involve peers who are socially and/or demographically similar. Moreover, the social comparisons that are made are manipulable. Cognitive and social psychologists have demonstrated convincingly that the nature and extent of social comparisons can be influenced by such factors as formal categorical distinctions (e.g., job titles and subunit distinctions), physical propriety, frequency and intensity of contact among group members, group demography (how similar members are), and the purpose or motive being served. Organizations have control over all these factors, in some cases at little or no incremental cost.
Theories of procedural and distributive justice offer a somewhat more specific formulation of how comparisons and equity judgments are made and assessed. Having identified a referent that (by virtue of functional role, social standing, or demographic traits) is viewed as comparable, person A compares the perceived ratio between rewards and output or performance for himself to the equivalent ratio for the referent.\(^7\) Experimental and field research in a host of organizational settings has demonstrated that the process by which rewards are determined and distributed is also highly influential (Lind and Tyler 1988; Tyler 2010). One should not put too much weight on the prescriptions of simple agency theory, but it is easy to construct toy agency-theoretic models offering prescriptions that are utterly contraindicated by these social psychological considerations. Imagine, for instance, an agency problem in which persons A and B must each independently take an action. Independent outcomes for A and B are observed. If X is the desired action, agency theory says to reward A most highly when the observed outcome has a relatively high likelihood if X is taken, relative to the likelihood of X under other actions.\(^8\) If B operates independently, and the connection between B’s actions and outcomes are independent of those of A, then B faces similar incentives. And, without the appropriate monotone likelihood ratio properties (and more), this could result in a situation where A receives a greater reward, even if B’s outcome is “better” for the firm. This result is fine if A and B don’t engage in social comparisons or look for distributive justice. But, in real life, they often do, which complicates the agency problems facing the employer or, in some cases, even turns them on their head.

Status consistency can also play a role in these judgments. The idea underlying the notion of status consistency is quite simple: when an individual occupies multiple positions that differ markedly in their typical expectations and entitlements, he or she experiences a set of psychological stresses associated with this inconsistency. Some research (e.g., Jackson 1962; Hornung 1977; Bacharach et al. 1993) has documented emotional, psychosocial, and even physical strains associated with occupying multiple roles that vary markedly in their status or prestige (e.g., the CEO who is 20 years younger than everyone else on her leadership team or the London cabbie who received his doctorate in Classics from Oxford). However, the empirical results are far from conclusive or consistent, and this simple idea has proved astoundingly difficult to pin down theoretically or empirically. It raises all sorts of nagging questions about the referent against which to compare those in inconsistent situations; how to disentangle “inconsistency” effects from the main effects of the respective statuses; how to deal with change over the life course (if a person experiences upward mobility on one dimension but not on the others, does that have the same effect as experiencing “cross-sectional” inconsistency?); and so on.\(^9\)

Notwithstanding these difficulties and ambiguities, there is considerable intuitive appeal to the notion that the utility employees derive from a particular allocative regime at work may depend on their relative standing in status hierarchies outside the workplace. For example, numerous quantitative and ethnographic accounts of the feminization of occupations document

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7. The literature has identified a multiplicity of ways in which individuals respond to perceived equity, such as altering perceptions of rewards or performance for themselves or for the referent, altering their choice of referent, seeking to transform the allocative regime, or disinvesting psychologically in the activity or role at issue.

8. We are being very rough here, but readers versed in agency theory will know what this statement means.

the resentment and anger men often display, stemming from a perceived loss of status as their roles become "women's work." Conventional measures of males' satisfaction and organizational commitment decline as occupations become more gender integrated (Wharton and Baron 1987). Interestingly, however, there is some evidence that males working in integrated work settings are not particularly dissatisfied if they have a nonworking wife at home (Kessler and McRae 1982; Wharton and Baron 1987: 583–584). This finding suggests that among men working in previously male-dominated settings, those who retain the traditional role of sole breadwinner within their households are least troubled by the devaluation that occurs when the workplace becomes more gender integrated. Most economic models of employment and labor markets assume, explicitly or implicitly, that employers and employees compare the gains to trade against either their next-best alternative in the market or a no-trade state of affairs. But if employees are keenly attuned to their social standing relative to others and relative to how they rank in other social roles and settings, then two employees with observationally equivalent "next-best alternatives" might react very differently to identical offers or treatment from the same employer.

6. History Matters

In judgments made to answer the question "how am I doing?" and in the answers given by employees (and their employers) to such questions, history matters. There is now a massive literature documenting how anchoring and expectations mold judgments and decision making, suggesting that early experiences are particularly important in determining what referents workers employ and what norms they invoke in responding to their workplace experiences. Some recent empirical studies corroborate this point. For instance, analyses based on the Stanford Project on Emerging Companies have documented a menu of five basic HR blueprints from which most entrepreneurial founders seemed to choose (commitment, star, engineering, bureaucracy, and autocracy), with the initial choice having profound and enduring consequences for the enterprises they created. Attempts to alter the initial employment model or blueprint generally had deleterious consequences for organizational survival and performance and heightened employee turnover, especially when the firm sought to change from one of these five relatively "pure" or clearly understood blueprints to one that was less coherent or internally consistent (Baron et al. 2001).

Social psychologists have also documented a widespread preference for increasing consumption and reward levels over time, even when other sequences (such as declining wages coupled with savings) would produce superior returns over time (Loewenstein and Prelec 1991, 1992). In the employment context, such a preference is consistent with the notion that initial treatment of employees establishes anchors and expectations that govern how subsequent allocations are assessed (also see Baron 2011).

History can matter in other ways. Sorensen (2000) has demonstrated that employees' turnover propensities are affected not simply by current organizational demography—which presumably captures patterns of communication, cohesion, and the like—but also by the entire demographic history individuals have experienced while employed at their current place of work. In other words, it is not simply how well one fits in demographically with one's co-workers...
today that determines "fit" or what economists might be inclined to call "match quality": It is the entire demographic history an individual has experienced in the work setting that influences present-day propensities to stay or remain. One cannot think of a career simply as a succession of job titles, responsibilities, and assignments. It also involves a series of relationships and interpersonal experiences at work, which may have persistent effects long after the relationships themselves have withered.

7. Reputation

For organizations scholars whose background is game theoretic, the concept of reputation is often enlisted as a magic bullet when it comes to employer credibility. For instance, an employer can credibly promise to reward employees later for something done today because, if she fails to carry out her promise, she will damage her reputation for doing so, and employees in the future will disbelieve her promises. If the ongoing value of keeping her promises so that employees trust her exceeds what the employer could earn (in present-value terms) from defaulting once on her promise, it is an equilibrium for her to make and keep the promises, and for the promises to be believed.

The magic in this magic bullet comes from the Folk Theorem (and similar results). Many things are equilibria, in theory, and the model builder gets to pick the equilibrium and corresponding reputation that best suits the point to be made. More specifically:

1. The employer seemingly selects whichever equilibrium makes her best off.
2. Having selected her preferred reputation and/or equilibrium, it is in fact attained.

It is a nice story. It even makes sense within the confines of the typical model, where actions are simple and discrete and neither the population of employees nor the set of contingencies to be met varies much. Reputations are for things like "don't abuse employees" in a context where in each round the employer chooses between "abuse" and "don't abuse." In such a simple context, it makes sense that prospective employees will conclude that this is a valuable reputation for the employer, so she has instant credibility upon adopting it.

But this story does not match the complexities of the real world. Actions are not always discrete, and when they are, more than two or three options are usually available. Employees vary in their tastes and personal circumstances, and the employer must deal with a host of employees who vary along demographic, educational, and cultural lines, to say nothing of the types of work they do. The contingencies that must be met in specific situations vary enormously.

In real-world applications of this idea, reputations must be acquired, not announced. Assuming that the reputation inheres in the employer, it must be comprehensible to present and prospective employees. This is not simply a matter of learning what the reputation is. The core of a reputation construction is that the parties whose actions the reputation influences must be able, ex post, to verify that the reputation bore acted in conformance with her reputation. Otherwise, the reputation exerts no constraint on the actions of the reputation bearer ex ante and has no particular value (as far as endowing credibility is concerned). So comprehensibility here entails a measure of ex post verifiability.
All these considerations point to several conclusions that bring us into the domain of sociological and psychological concerns:

1. Reputations must be relatively easily understood, communicated, and verified. They should reflect relatively few clear, simple precepts that are psychologically powerful and inexpensive to communicate.

2. To aid in understanding, it is helpful if reputations (bearing on workplace relations) mimic or are consistent with norms and roles routinely encountered elsewhere in the society. “They treat you like family at that firm” or “that’s entirely a ‘best athlete’ culture” or “it’s ‘dog eat dog’ when you work there” are the sorts of themes we have in mind. The Stanford Project on Emerging Companies research mentioned earlier found that there was not one efficient design or blueprint for the HR management policies of a high-tech Silicon Valley start-up; rather, there were five, each reflecting a relative clear and consistent pattern that could be communicated parsimoniously (e.g., “autocracy” versus “star” culture). Moreover, altering the HR blueprint resulted in dislocation and diminished organizational performance, as employees struggled to understand the new pattern of expectations. But the disruptions were less severe when firms shifted from an aberrant or incoherent blueprint (i.e., one not fitting into any of the five basic types) to one of the more prevalent and consistent types.\(^\text{10}\)

3. Efficiency is enhanced by hiring individuals who commence employment with a superior understanding of the firm’s informal practices and culture and whose background enhances their prospects for understanding those practices and internalizing the culture. For instance, notwithstanding its pernicious aspects, hiring through alumni networks or on the basis of internal referrals not only enables employers to get more and richer information on applicants, it also increases the likelihood that those hired will have expectations that are closely aligned with those of their superiors. Firms that mimic the military in management practices are inclined to hire from the military, and so forth.

7.1. Consistency of Practice in an Organization

Reputation comprehensibility and credibility require that “similar” employees in an organization must be treated with sufficient uniformity that a coherent picture of how the organization does business emerges. This requirement can limit the activities of the firm or specific subunits in the firm. For instance, a firm claiming to “treat employees like family” might expect to confront more difficulty and cost in outsourcing some of its activities, unless those outsourced activities involve employees who are conspicuously different socially from core employees. And, in such cases, it helps to minimize contact between the outsourced labor and the core employees—the

\(^{10}\) The exception to this pattern involved shifts to pure bureaucracy or pure autocracy. These invariably were destabilizing (inducing high turnover), irrespective of the initial HR blueprint being supplanted. Bureaucratic and autocratic cultures are universally revisited among scientific, technical, and engineering talent in Silicon Valley; hence, even when companies replaced an incoherent employment blueprint with a coherent bureaucratic or autocratic one, employees responded negatively. Put somewhat differently, when diners hate the dish, calling attention to it, making it easier to recognize, or serving larger portions only makes things worse.
archetypal example here is the custodial crew, which (only) comes in at night after core employees have left. But this family-culture firm is likely to find outsourcing mental tasks superior to insourcing them, if the employees performing these tasks are going to be treated menially.

To be sure, developing a consistent reputation does not require that all employees be treated the same in all respects. Almost every enterprise of any scale and complexity is vexed by the issue of how much uniformity to impose across subunits and localities in rewards, organizational structures and practices, and workplace cultures. It is self-evident that uniformity will be most problematic when the tasks involved are highly disparate among subunits or localities and when the labor markets in which tasks are carried out vary markedly. But we can offer some other conjectures and guidance by drawing on relevant psychological and sociological scholarship. Intra-organizational variation in HR practices across subunits and locales is likely to be most problematic when it is imposed

- on organizational units or locales whose employees share strong social connections,
- in organizations whose business strategy necessitates significant cooperative effort across units or locales,
- across geographical locales with similar regional or national cultures (Hofstede 2001), and
- across units or locales whose employees are in frequent contact and/or share abundant information.

Because of what might be thought of as psychological and sociological complementarities, differentiation among units or locales is also likely to be most contentious for organizations that knowingly or unknowingly foster uniformity among their employees in other ways. Examples might include extensive reliance on company-wide jargon and centrally issued corporate communications, mandated stints at corporate headquarters by field personnel to soak up “HQ culture,” or frequently rotating personnel geographically. Organizations may also foster uniformity of thought and behavior among employees by virtue of their linkages with particular sources of personnel, such as hiring heavily from the military, American schools worldwide, or religious schools; all institutions that themselves foster a certain degree of uniformity. And uniformity is likely to emerge when Organization X faces the same key supplier(s) or customer(s) across its divisions or locales, and those partner organizations themselves have very distinctive and uniform cultures and practices. The exigencies of collaborating with such partners will mandate a degree of cultural and behavioral uniformity across X’s different divisions or locales, which complicates efforts to diversify local compensation systems, organizational practices, or cultural edicts.

7.2. Dynamics: Acquisition and Change

To maintain a reputation for behaving in some manner, it is manifestly important to behave in that manner. But to acquire a specific reputation, one must convince the intended audience that one will behave in that way. In some situations, the opportunity to demonstrate the desired behavior occurs naturally. For instance, a party seeking to dissuade others from challenging it—in the fashion of the chain-store paradox—fights when challenged and, it is hoped, slowly dissuades challenges. In cases where the reputation is specific behavior that elicits trust from
others, bootstrapping the reputation is harder to imagine. In the simple situations of game-theoretic models, no one will trust someone who lacks a reputation for being trustworthy, and if no one trusts that party, the party never gets the opportunity to verify its trustworthiness. Either a leap of faith is made at the outset or, seemingly, it is not.

Bootstrapping this sort of reputation and equilibrium may be informed by social-psychological considerations. One might induce one party to make the necessary leap of faith and then, by treating that party well, slowly convince others to do likewise. One might begin with members of one’s family or social acquaintances, individuals with a predisposition to trust. Trustworthiness might be “borrowed”—for example, by forging an alliance with a central, highly respected member of the local union or professional association, convincing that individual of your good intentions, and enlisting that individual to recruit others. Or a reputation for trustworthiness might be built in small steps: a party induces others to trust her in little things, again perhaps relying on related social exchanges, and then moves to bigger, and then even bigger, items. Whatever the means, it is clear how important founding circumstances and conditions are when it comes to establishing a reputation. Initial impressions are powerful anchors for subsequent expectations; stories about “the early days” can be used as vivid tools of acculturation, and changing a reputation, once it is established, can be a very difficult endeavor.

There is clear evidence that this sort of change in premises and expectations—and reputation in general—is regarded by managers as being of the utmost importance. For example, a study of 765 CEOs by IBM Global Business Services (2006) found that chief executives across diverse firms, industries, and nations were increasingly seeking innovation by transforming their organizations’ underlying business model, rather than focusing simply on changes in operations or products and markets. The most frequent focus of such change initiatives was organizational structure, mentioned by roughly two-thirds of CEOs who were seeking to transform the business model for their enterprises. And when asked to identify the main obstacles to innovation they confront, “unsupportive culture and climate” topped the list, with “workforce issues” also represented among the most frequent responses. A survey of leaders in 365 companies in Europe, Asia, and North America by Bain & Company highlights the difficulty of transforming organizational cultures: 68% of leaders responded that culture provides the greatest source of competitive advantage; 81% stated that an organization lacking a “high-performance culture” is doomed to mediocrity; 75% said that culture can be changed; and 65% admitted that cultural change was necessary in their own organization (Rogers et al. 2006). Yet, according to the study, fewer than 10% of firms actually succeed at achieving this cultural transformation.

The fact that cultures and HR systems are difficult to change should come as no surprise. Organizational cultures, reward systems, and control structures would have little value were they not difficult and costly to change. Or, to put it more in the language of competitive strategy, they would confer little competitive advantage if the currently most efficient system were easily imitated. But why is this so? If one accepts the game-theoretic constructions of reputation, it ought to be bad agreements.

We believe that bootstrapping with the employer. To do with the distance and, in the employer. To do with the distance and, in the employer. To do with the distance and, in the employer. To do with the distance and, in the employer. To do with the distance and, in the employer. To do with the distance and, in the employer. To do with the distance and, in

11. Among internal obstacles, roughly 35% of CEOs mentioned unsupportive culture; 34% cited “limited funding for investment,” and about 27% cited workforce issues. Only one external obstacle was cited by more than a fifth of the CEOs: “government and other legal restrictions,” cited by about 31% of chief executives.
ought to be possible, when a superior alternative comes along, to tear up the old (implicit) agreements and initiate the new ones.\textsuperscript{12}

We believe that an important sociological and psychological effect is at work here, having to do with the almost unconscious legitimacy of a given system in the minds of the employees and employer. To give a (psychological) analogy, people have internalized norms about interpersonal distance and turn-taking in conversations, which vary in rather subtle ways across contexts. We do not pay conscious attention to these norms unless or until we happen to observe them being substantially violated (e.g., you "can't get a word in edgewise" or someone is literally "in your face"). And the lack of conscious attention can promote efficient interpersonal interactions. Of course, individuals do pay some conscious attention to these things—for instance, by asking whether they themselves are talking too much.\textsuperscript{13} But it is in the most relaxed and "natural" social settings that the least conscious attention is paid to them.

Similarly, we believe that much of the force and value of organizational control systems stems from their tacit and taken-for-granted character. Making controls explicit and salient generally entails costs—not only the costs of formulating and implementing explicit rules and controls, but also the costs of monitoring adherence to them. As we have argued, intense, formal, and explicit controls can also undermine intrinsic motivation and commitment processes, which often can provide more powerful and less expensive means for aligning employees' perceived interests with those of the enterprise. And, as Baker et al. (1994) have noted with regard to subjective performance criteria, tacit rules and controls may be more difficult for employees to circumvent; they also have the potential to broaden and generalize, subsuming a wide variety of contingencies for which no explicit provisions have been made.

It should be clear how all these considerations relate to changing a firm's reputation or organizational culture: Attempts to make changes will raise the level of salience of matters that have heretofore been tacit and implicit. This calls into question longstanding norms and expectations, often altering the categorizations and social comparisons to which employees have become accustomed and acclimated. And by opening up one set of issues, it raises the possibility that everything should be put on the table. Having started this chapter by recounting standard transaction cost economics, we cannot resist the opportunity to cast our argument in those terms: Attempts to change a piece of a firm's reputation will raise enormously the costs of adaptation and renegotiation, because it potentially takes a very efficient adaptation or renegotiation mechanism that resides somewhere beneath the full calculative consciousness

\textsuperscript{12} Mathematical economic and game-theoretic analyses are at a disadvantage on this point, because their agents are never so surprised by evolving circumstances that it makes sense to abrogate an old implicit contract and initiate a new one. In all but a handful of formal analyses, the economic actors anticipate the possibility of the specific contingency arising that would call for the new implicit arrangement, and the original arrangement includes an understanding of what will happen when and if the contingency arises. Formal and explicit contracts may be renegotiated, and old formal contracts may be important points of departure for the new agreements that are reached. But at the outset, everyone understands that if the specific contingency arises, this is what will happen next. So essentially, the old equilibrium, in the full sense of the term, is never modified. In that sense, the question being asked here is entirely outside the realm of economics or, at least, of standard economics.

\textsuperscript{13} Though it is seldom those who are talking too much who ask the question.
of employees and replaces it with some very conscious calculations about the overall legitimacy of the firm's employment transactions.

7.3. The Economizing Principle

These considerations bring us full circle to one of the basic premises of transaction cost economics, at least as presented by Williamson (1985). Williamson argues that the basic unit of analysis should be the individual transaction and, further, that one should expect that transaction to adopt whatever form of governance maximizes benefits from the transaction, net of transaction costs. The social and psychological effects we have discussed in this chapter suggest that his argument should be amended to some extent. First, individual transactions are important, but transactions are embedded in a social environment that cannot be disregarded. Furthermore, transactions are linked together—how firm A transacts with employee X powerfully constrains and is powerfully constrained by firm A's dealings with employees Y and Z. The individual transaction is, of course, important. But, especially in the intense social environment of employment, the constellation of transactions firm A has with all its (diverse) employees, situated within the particular society in which those transactions take place, may be the more appropriate unit of analysis.

And although a firm's constellation of transactions may tend toward the structures that maximize efficiency net of transaction costs, history—particularly the history of a firm's past management practices and relations with its employees—makes this only a tendency, not an indomitable economizing force. When confronted with secular changes in market conditions, we should expect to see firms, especially larger and more established ones, trapped in employment practices that no longer appear as fit as they once did. If employment were only an economic relationship, this might not be so. But employment's social character means that any economizing has to take into account the costs arising from the social and psychological processes we have discussed, as well as the economics of the situation.

8. Conclusion

In after-dinner remarks celebrating Oliver Williamson and his book *Markets and Hierarchies*, Jim March developed the simile that economists were well-regulated and orderly Methodists, who crave order and simplicity and know very well to stay away from what March termed "the saloons of sociology." Economists reading this chapter may be forgiven for thinking they have been touring one such saloon. Thinking of employment relationships as both economic and social relationships and, in particular, culling useful insights from social psychology and sociology, is not especially edifying if one craves the order and simplicity of Debreu's (1959) *Theory of Value*. For at least one of the two authors (Kreps), who masquerades as an economist and who has those cravings, writing this chapter was a frustrating exercise in trying to impose neat and tidy order on a messy collection of important ideas.

Yet when it comes to employment—and probably other forms of long-term economic exchange—that is the nature of the beast. It may not be pretty, at least to an economist's aesthetic sense, but incorporating psychological and sociological influences into economic models of employment relationships is useful for scholarship and managerial practice. And although
these influences may not be as neat and tidy as economists like, they present important specific and generalizable insights:

- Knowledge about the psychological and sociological factors that foster commitment, promote organizational citizenship behaviors, build and maintain cohesive groups, and sustain adherence to norms (especially the norm of reciprocity) can be marshaled to identify where and when solutions inspired by agency theory are inefficient and even dysfunctional. The need for incentives or controls diminishes when employees are intrinsically motivated, can be motivated to reciprocate what they perceive as gifts, or internalize the welfare of co-workers and the firm generally. Especially when explicit incentives and controls are most difficult to get right—when employees must work innovatively, autonomously, and interdependently, and when they must deal with ambiguous and unanticipated contingencies without explicit control or oversight—high-powered incentives and controls may not only be less efficient; they may become dysfunctional, if they dull the more efficient motivations employees already have to “do the right thing.”

- The processes by which individuals perceive and judge their own situations are rarely as straightforward and objective as is assumed in economic models. Anchoring and recency effects, social comparisons, and status consistency all play their roles, and perceptions and judgments can be profoundly influenced by what (to many economists) seem to be irrelevant facets of the social environment beyond the workplace.

- History powerfully shapes the behavior of individuals and organizations; to understand current patterns, one does well to study the course of past experiences. Reputation concerns can powerfully shape what a firm can and cannot do with its employment practices. Indeed, they can lead firms to decide not to alter their cultures or HR policies, even in the face of powerful environmental pressures.14

- Attending to differences in the psychological and sociological resonance of different incentive and control systems is also likely to prompt a re-ranking of various alternatives for rewards and organizational designs, relative to an ordering based solely on the direct and transactional costs and benefits associated with the production process. Approaches

14. An example that comes to mind concerns AES Corporation, a global power company founded in 1980 by two former government energy officials with strong moral and religious convictions, convinced that an energy company free from the bureaucratic constraints, functional specialization, and disempowering practices commonplace in the industry could produce extraordinary results. They built their culture around four core values: integrity, fairness, social responsibility, and having fun. In mid-June 1992, nine technicians at a new AES plant in Oklahoma conspired to falsify water test data required by state and federal regulators. Following these revelations, the firm’s share price dropped by nearly 40%. The plant management, under intense pressure from lawyers, abandoned most of the company’s distinctive HR practices. According to one of the firm’s founders:

I mean, they just went for a total control kind of mentality, because they were scared to death . . . They basically fired me. They said “Please do not come back to the plant.” . . . [It] was a real test of whether we were going backwards toward centralization . . . And we went along with it. I wouldn’t go there for a whole year, and they finally called back and said, “We’d like you to come back again, we’d like to rejoin the company.” . . . [It] illustrated a couple of things. One was that we did mean it when we were talking about decentralization and autonomy. And second, it proved . . . [that] support for AES principles was surprisingly strong.” [Pfeffer 2004: 15–16; also see Bakke 2005]
that mimic or leverage values, attitudes, and behaviors that employees embrace frequently and fervently outside the workplace are likely to be easier and less costly to implement and sustain. This is true as well for approaches that leverage personal bonds and reputational concerns among employees outside the workplace, which is why firms and labor unions have sometimes embraced nepotistic practices. It is also one reason firms often take steps to get their employees deeply engaged in activities and institutions in their local communities.

Stated simply, what traditional models of economic exchange miss in the employment context is that many of the tasks for which employees are being compensated involve interaction with other human beings, inside and outside the organization. Those interactions occur in a social and cultural context from which employees cannot escape, and they manifest cognitive and social psychological processes that employees cannot put on hold (at least entirely) simply because the exchange is work related.

Having preached this message to incredulous economists over the years, we know that there will be objections. A standard rejoinder is that behavior is not as complex as we have claimed. And those making this rejoinder will point to organizations run according to a basic design right out of an agency theory primer, in which employees act just as agency theory predicts they will.

We do not doubt that such organizations can be found; they are part of the organizational menagerie. But they are only part, and their existence is entirely consistent with our view of things. One of our messages, after all, is that the style of on-the-job interactions can have a profound impact on their content. For the principals of agency theory to be able to carry out their prescribed role effectively would seem to require considerable detachment from the agents, lest a clever and cohesive band of agents manage to co-opt a vulnerable principal and play him or her against the remaining principals. (There are strict rules in prisons limiting fraternization between inmates and the guards whose job it is to control them.) Yet a firm in which owners and managers adopt such a stance toward employees is a very different kind of firm simply by virtue of that stance, particularly in the employment context, where the inmates often have some role in determining who becomes their guard. Certainly, an HR blueprint will tend to attract and retain employees who are comfortable in enterprises run in that fashion. But the blueprint chosen for the firm will influence much more than that: the kinds of productive activities at which the firm's employees are likely to have an advantage; the intensity of social bonds that are likely to form among the labor force; and, perhaps most importantly, how both agents and principals come to think about their own and one another's roles. This endogeneity can produce among employees precisely the attitudes and orientations that the principals initially believed justified the incentives and controls put in place (e.g., effort aversion, lack of trustworthiness, lack of loyalty), creating a self-fulfilling prophecy.

Let us put it this way. Economists are sometimes demonized for creating their own (demonic, self-interested) reality. Much has been made of the fact that in a variety of experimental situations, economists and economics majors pursue more self-interested strategies than their counterparts in other professions or academic majors. They also contribute less to charities and public television than equally wealthy individuals in other occupations. And longitudinal studies indicate that these propensities increase with exposure to microeconomic theory (see Frank et al. 1993). Regardless of how one feels about economists' self-interest, it is precisely this sort
of effect that we assert will take place in the context of employment. Different approaches to pay and control systems foster different ways of thinking, believing, and acting, which in turn shape the way that principals and agents think about the roles of each.

Economic models of employment should be tested not simply by asking, "do employees at firms that are run the way economic orthodoxy says firms should be run behave the way orthodoxy would expect them to?" One should also ask, "do employees at firms run on wholly different principles and blueprints behave in different ways? And when it comes to performance (the measurement of which is likely to become the next point of contention), is one way of managing human resources superior?"

Our answer is clear. Looking at a broad spectrum of employment situations, blending social insights into economics will increase the $R^2$ in analyses of organizational designs and incentive systems. But we believe it will do much more than that. It will illuminate the diversity of management regimes that can flourish in a given setting. It will clarify the complexity and fragility of those regimes and the challenges of trying to optimize employment relationships dynamically. And, in the process, it will produce insights that not only invigorate the scholarly study of organizational economics but also prove managerially useful.

REFERENCES


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