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## Working Paper No. 779

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### **Hierarchy of Ideals in Market Interactions: An Application to the Labor Market\***

by

**Aurélie Charles**

Centre for Development Studies, University of Bath, UK

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Levy Economics Institute  
P.O. Box 5000  
Annandale-on-Hudson, NY 12504-5000  
<http://www.levyinstitute.org>

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## **ABSTRACT**

This paper argues that a hierarchy of ideals exists in market interactions that sets the benchmark on the norm of fairness associated with these interactions, thus affecting pricing decisions associated with market exchange. As norms emerge, an ideal determines the criteria of optimal behavior and serves as a basis for market exchange. Norms homogenize the diversity of commodities in market interactions according to a hierarchy of norms and values. The paper then goes on to illustrate how this hierarchy of ideals works in the labor market, leading to inequality of access to jobs and wages between groups of individuals. Groups socially perceived to be diverging from the context-dependent dominant ideal are likely to suffer most in market interactions.

Keywords: Market Exchange, Norms, Optimality, Labour Market

JEL Classifications: B00, D1, E31, J31, J71, P00

## 1. INTRODUCTION

In a recent contribution, Jan Kregel (2012) elegantly demonstrates that the choices made by individuals in market exchange rely on their different perception of the desirability of commodities, and that this diversity is somehow homogenised by the price of the commodity. Here, our interest is to present the process through which this diversity is homogenised, and especially to show how norms play a central role in this homogenisation process. Norms, broadly defined as tacitly agreed upon rules of behaviour observed amongst groups of individuals, are set according to certain standards and ideals shared by groups of individuals regarding the perceived value of the object of exchange. The object of exchange has several characteristics to which one may attach more or less value. For the exchange to take place, two market players need to agree on the commodity characteristics that are perceived to be sufficiently valuable. Hence, in a particular historical, geographical and cultural context, a dominant hierarchy of values may become the norm and thus somehow homogenise the diversity of commodities in market exchange.

In the labour market, this homogenisation process is easily observable since it often results in discriminatory practices and pay gaps between different groups in the labour force. Beliefs and ideals draw a picture in individuals' imagination of what a perfect being should be in a particular context. Unconsciously, this picture sets the benchmark of behavioural expectations for people sharing these ideals. In turn, norms of behaviour related to these ideals affect their perception of themselves and others, thus engendering a sense of belonging to particular groups, what can be referred to as social identities such as culture, race, gender, age, occupation, and so on<sup>1</sup>.

The discussion here shows how these ideals influence market interactions and ultimately pricing decisions in the context of labour markets. In effect, the argument is that a hierarchy of ideals exists in market interactions which set the benchmark for the norms of fairness associated with these interactions and pricing decisions. The first part of this paper shows theoretically how, as norms emerge, a dominant ideal sets the criteria of optimal pricing and behaviour, and serves as a basis for market exchange in a particular context. The paper then goes on to illustrate

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<sup>1</sup> The literature on identity argues that individuals have multiple social identities and behave according to identity-related ideals, as much as they expect others sharing a common identity to behave according to these ideals (Akerlof and Kranton 2010, Davis 2010).

this hierarchy of ideals in the US and European labour markets; the outcome of this process being occupational and wage discrimination for groups of individuals who are perceived by decision-makers to diverge from the context-dependent dominant ideal.

## **2. FROM DIVERSITY TO HOMOGENEITY IN MARKET INTERACTIONS**

### **2.1. Perceived Utility and Relativity**

First-year economics classes teach that market interactions lead to market exchange if demand and supply reach a market price that would satisfy the willingness to buy of the purchaser and the willingness to sell of the seller. To be able to define a market exchange however, we first need to be able to define the object of the market exchange, and in the commodity market, defining a commodity may not be straightforward. In the Utilitarian tradition, a commodity is defined according to the utility derived from its consumption, whether utility is defined in terms of ophelimity (i.e. satisfaction) or use-value (i.e. desirability). Supporting the former definition, which they associate with the material welfare school, Cooter and Rappoport (1984) maintain that there is a categorisation in the consumption of goods and derived satisfaction. This classification goes from the material and observable, which they link to health and survival matters for instance, to the purely nonmaterial and unobservable, which they link to comfort and luxuries. The point of interest for this discussion of assessing market value here is twofold, in terms of relativity and perception of value.

By definition, an ordinal view is based on relative values, but as soon as one end of the scale becomes a theory or policy focus, this end will represent an ideal to be promoted by this theory or policy. Thus, if the material welfare school wishes to argue in favour of the cardinal character of utility by starting with an ordinal assumption (Cooter and Rappoport 1984), this order represents a scale of relative values between commodities on which market interactions should be based. In effect, by seeking to promote the cardinal nature of utility, the material welfare school starts from the assumption of an ordinal view of commodities and related needs, and then focuses on one end of the scale, one ideal that material commodities should be the focus of economic theory and market interactions.

Another approach which starts from an ordinal assumption and leads to one ideal is the psychological approach to human needs of Maslow (1943). Maslow promotes an ordinal view by categorizing human needs on a scale from self-esteem and creativity at the top of the

classification to the most basic or physiological needs at the bottom. His universal hierarchy of needs is based on his observations of a small sample of high-achieving people, such as Albert Einstein, who would in a sense reflect an ideal human character. In both approaches however, starting with the assumption of ordinality to set a universal standard could eventually promote some commodities and related needs (e.g., high-tech products) at the expense of others (e.g., anti-malaria drugs). In effect, if pursuing a specific ideal becomes the norm in market interactions, other ideal characteristics may be perceived less valuable and hence not be subject to market exchange.

Perception is therefore essential for valuing commodities in market exchange. For instance, an ideal focused on the observable characteristics of commodities which then becomes the dominant norm in market interactions will make material commodities perceived to be more valuable than less observable commodities. In line with this norm, the classification promoted by the material welfare school gives a predominant role to the high degree of visibility of commodities. On the contrary, the feminist school has drawn attention to the invisibility and consequently low value of care in market interactions (Folbre 2001). Similarly, the ecological school has drawn attention to the embeddedness of the economy within the environment, often undervalued in market exchange because they are less observable, such as air purity for example. In this sense, an ideal defined as a scale of relative values may serve as a reference point in market interactions of the commodities that could be perceived to be more valuable than others if this ideal became the norm in market exchange.

Each individual has however different preferences over one commodity which may be in conflict with the reference point or dominant ideal in market interactions. In a recent contribution, Kregel (2012) reflected on the view put forward by Adam Smith in his *Theory of Moral Sentiments* that each individual only knows his own preferences, and that, as a result, imagination is the only tool through which individual expectations of others' behaviour can be formed. Kregel then goes on to argue that the choices made by individuals in free market exchanges rely on different perceptions of the desirability of commodities and that this diversity is somehow homogenised by the price of the commodity. Taking the example of diamonds from Petty's "The Dialogue of Diamonds", "the existence of a market [...] allows transformation of a large part of the elements that distinguish each individual exchange from any other into sufficiently systematic differences in price relative to an ideal type of diamond taken as a

reference point” (Kregel, 2012: 6). Thus, price homogenises diversity through the marketplace relative to an ideal type of the commodity exchanged.

But how is this ideal formed? The argument put forward here is that this homogenisation process must be based on a hierarchy of values representing an ideal perceived to be acceptable as a reference point in the market exchange. Under the assumption that individual imagination is anchored in collective ideals, the price of the object of market exchange reflects to a certain extent an ideal shared by a group of individuals. In other words, price is the result of the homogenisation process but norms allow the transformation from the specific elements of the individual exchange to setting a price in a particular context.

## **2.2. Ideals as Reference Points in Market Exchange**

Market interactions are first and foremost between market players before being about commodity exchange in the sense that individuals have to agree on a standard against which to value the commodity concerned in the exchange. Each individual will attach more or less value to different characteristics of a commodity. To do so, each player has a unique set of social identities, such as race, gender, age, educational background, which will come into play in each individual’s imagination to create an ideal standard. Two players sharing a common identity will share the standard of this common identity. Standards of fairness shared by individuals within a group identity provide stability to norms by setting the rules of resource allocation. Once stability is reached, future games are constrained by these standards until conflict with other groups arises and new common standards emerge to reach stability. In that respect, Koford and Miller (1991) argue that the equilibrium reached is likely to involve individuals committed to an ethical standard, and other individuals not committed to this standard. Then, those committed to an ethical standard have a moral obligation to punish those who violate the norm, which sustains the existing norm over time. The “dominant” standard here will determine whether the outcome is fair or not according to that standard.

Norms and institutions of our cultural and biological heritage influence the standard of fairness used to assess the optimality of a decision. Since norms and institutions are socially and historically constructed, it makes us wonder the extent to which fairness in market interactions should be considered from the perspective of the individual, as an atomistic being, or from the perspective of a group identity whose members share a similar norm of fairness. The complexity of the individual as a social being means that, to a large extent, perception of identities and

associated norms of behaviour serve as a basis for an individual's expectations of others' behaviour. In the literature, the concept of identity is usually related to gender, racial, historical or cultural matters. The research on identity in effect points in the direction that the individual is a social individual who is rational according to a set of optimal behaviours or identity-related ideals (Akerlof and Kranton 2000). The concept of identity is related to the fact that individuals are attached to social categories to which they feel a sense of belonging such as ethnicity, gender, or age. Insider-outsider models of identity, for example, suggest that individuals are more likely to conform to the insider's norms of behaviour and ideals if they feel themselves to be insiders, while outsiders will act differently and create their own sense of identity partly by acting as outsiders. In other words, outsiders will conform to the norms of behaviour and ideals of the outsiders' group which will identify them as outsiders.

The idealistic vision of an identity is based on a social perception of perfection attached to this identity, constructed historically, and which can be consciously or unconsciously reproduced over time. As norms emerge, an ideal sets the criteria of optimal behaviour which is identity-specific and serves as a basis for social interactions. Belonging to a group sharing a common ideal engenders a sense of identity for its group members. Goette et al. (2006) in effect show how group membership creates social ties which lead group members to enforce a norm of cooperation between them. Being part of a business, country, or international organization creates a sense of identity related to an ideal vision of the business, country or international organization. For example, professional ethics create a sense of belonging to members of a professional group, which may be through a code of conduct. Members share a common vision of what the ideal professional in that group should be. Thus, institutions create an image of an ideal human being towards which human behaviour should tend, in a particular context.

As discussed in the next section in the context of the labour market, a reference point based on perception could have the consequence of increasing inequalities between groups of individuals where a group of individuals sharing an identity may be perceived ideal for some occupations or more valued economically.



### **3. HIERARCHY OF IDEALS IN LABOUR MARKET INTERACTIONS<sup>2</sup>**

#### **3.1. Identities and Inequality**

In the context of market exchange, unequal outcomes are more likely to be created and sustained in markets where the exchange is based on the norm of fairness of the dominant group of players. Groups of interest may be composed of employers, employees, or stakeholders, whose norm of fairness may differ from one another depending on the perspective adopted: whether fairness is understood from the employer's point of view or from the employee's side. In the shirking approach to efficiency wages, for example (Shapiro and Stiglitz 1984), employees may deem it fair to shirk on the basis that their wages are lower relative to others. Employers can thus create incentives to increase labour commitment and therefore productivity by raising the pay rate. In line with the gift-exchange relationship, the marginal effort provided by employees responds to signals sent by employers with marginal increases in pay and vice-versa<sup>3</sup>. Another theoretical perspective, still part of efficiency wage theories, is the fair wage-effort hypothesis (Akerlof and Yellen 1990). This hypothesis argues that wages are set above market clearing levels essentially because employers have a perception of how much they should pay for a given task or effort, as much as employees have a perception of how much they should be paid for a given task or effort. In other words, the market identity of agents influences their perception of fairness and labour market outcomes as a result, including job opportunities and relative wages.

For employers and employees, both the supply of labour and the demand for labour depend on the price of labour. However, given that the monitoring of individual performance and effort is difficult, determining the price of labour for a type of worker must rely on a perceived social value of the effort-related capabilities of this type of worker. Assuming that effort is not measurable and varies across individuals, the assessment of the value of a particular type of worker must rely to some extent on the social perception of this type of worker outside the workplace. The norm of fairness influences both the employees' and the employers' perception of a fair-wage for groups of workers sharing an identity such as race, gender or age. Social norms then place a relative value on the effort of different groups.

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<sup>2</sup> This section draws on Charles (2012: pp. 37-52).

<sup>3</sup> Based on an experimental labour market, Fehr et al. (1998) found that the social norm of reciprocity in a gift-exchange relationship implies that workers will put more effort into their job when they are paid above the market-clearing wage.

Stratification economics in effect shows how group disparities in market outcomes can be sustained and exacerbated over time. Stratification economics integrates the significance of group positions and status from sociology with self-interested behaviour from economics (Darity 2005, Mason 1995). From this perspective, the existence of gender and ethnic inequalities is the produced outcome of “investments” in social norms that have promoted structured and cumulative advantages for some demographic groups. Norms therefore serve as rules for reproducing the advantages of certain social groups at the expense of others. According to stratification economics in particular, the relative value assigned to social groups is mostly historically determined. In the process of market allocation, this relative value serves as a benchmark or rather as a criterion of optimality to define what job, level of wages, or resources should be allocated to what group. Whether one group is deemed to be worse off or better off in the process of market allocation depends on a benchmark according to which one group is perceived to be worse off or better off.

In the context of labour market interactions, ideals of market identities set the criteria of optimality in the allocation of jobs and wages in the labour market. The identity of the profit-maximizing producer or utility-maximizing consumer is essential to understand market behaviours, but accepting that market agents have multiple identities leads to a more complex view of market agents. If market agents have multiple identities, it follows that the optimality point in the programs of profit-maximization and utility-maximization can be influenced by these multiple identities. In the context of labour market interactions for example, the dominant social identity of the profit-maximizing producer may influence labour demand decisions. Hiring and firing decisions are likely to be influenced by the identity to which the decision-maker belongs, essentially to minimize the uncertainty of dealing with unknown behavioural norms associated with other groups' identity.

### **3.2. Illustrations**

Looking at the integration of minorities in the German and U.S. labour markets, let us illustrate how employers can be influenced by their own identity as white, black, Hispanic or Asian, immigrant or non-immigrant, male or female. First, looking at European labour markets, an extensive study on the economic situation of immigrants by Casey and Dustmann (2010) looked specifically at the sense of identity held by first and second-generation immigrants in the German labour force to understand its implication on their labour market outcomes (i.e.

employment, unemployment and earnings across generations). In a household survey, immigrants were asked about their own sense of identity, whether they felt a sense of belonging to the German identity or to their country of origin. One surprising result concerned second-generation immigrants. The authors found a positive correlation between the home country identity and employment, and a negative correlation with unemployment. For a one standard deviation increase in males' home identity, there was circa 6.6 percentage point increase in the employment probability and 2.8 percentage point decrease in the unemployment probability. The main reason put forward by the authors is that the strong sense of belonging to their countries of origin may enhance their incentive to draw upon ethnicity-based networks to find a job. However, this positive association could primarily be attributed to the fact that second-generation immigrants with a strong sense of belonging to a group of immigrants will have greater employment opportunities in immigrants' types of occupations, thus making use of ethnicity-based networks, than their peers trying to integrate into the "non-immigrant" group. To enter non-immigrant types of occupation, immigrants may face identity preferences of employers which are similar to the employer's own identities. As a result, ethnicity-based networks represent a means by which immigrants can access to the German labour market instead of competing directly with non-immigrants in jobs where non-immigrants represent the ideal employee.

Second, looking at the U.S. labour market, unequal access to employment opportunities between identity groups is especially evident in economic downturns. For instance, compared with previous recessions in the post-war era, the recession started in December 2007 saw a record contraction in U.S. employment which led many to talk about the "Great Recession". Elsby et al. (2010) conducted a thorough analysis of the U.S. labour market in times of recession and specifically over the period 2007-2010. Focusing on the flows in and out of unemployment, they found that the parts of the labour force with the highest unemployment rates and high rates of entry into unemployment are namely, the young, less educated labour force, and ethnic minorities. An increasing number of individuals are out of the labour force, or become part of the unemployed labour force. The employed labour force remaining in labour markets is therefore likely to be highly vulnerable to the contextual swings in market confidence. In effect, Elsby et al. (2010) also found that, across the last post-war recessions, variations in employment accounted for between 50 and 80 percent of declines in total hours. This means that the number of workers rather than the number of hours worked per worker explains the fall in overall

employment. The important question raised here is who is expected to remain in the U.S. labour force during the Great Recession. In other words, how and why existing inequalities are likely to be affected by this fall in overall employment. To investigate this question, one needs to understand the identity preferences of employers in a period of recession – or increasing uncertainty – since identity concerns can influence personal preferences through norms, and consequently labour market outcomes.

Given that the future is uncertain, especially in economic downturns, the hiring or firing decision is very likely to go in favour of the agent of the same social category as the decision-maker in order to sustain this social category over time. The well-known “Glass Ceiling effect” recalls this phenomenon. The Glass Ceiling effect represents the fact that non-dominant groups, such as non-white and female agents in Western economies, are unable to access higher level job positions across the labour market. The dominance of an identity group at the top of high-earning occupations sustains the norm that this elitist group is the optimal group in high-earning occupations, thus preventing other groups from breaking through the Glass Ceiling. Arestis et al. (2013) have also shown that the considerable changes in income distribution caused by the process of financialisation over the past 30 years have influenced social norms of fairness regarding the level of wages and job opportunities for men and women across different ethnic groups of the US labour force. Income distribution changes have created and reinforced social norms that have interacted with “fair-wage constraints” to produce and perpetuate “socially acceptable” gender and ethnic identities with different income and wealth characteristics, thus leading to differences in bargaining power linked to these identities in the labour market. The formation and persistence of “socially acceptable” gender and ethnic identities has therefore established a source of inter-group conflict and increasing earning inequalities in managerial and financial occupations. Two market agents with similar abilities, skills, and education but with two different sets of social identities are likely to face unequal labour market opportunities. In times of rising uncertainty, identities that do not match the “ideal” identity from the perspective of the labour demand are likely to suffer most from the lack of job and income opportunities. In the U.S. labour force, whites represent the dominant identity of both agents (employees) and principals (employers). In 2008, whites represent 80.66 percent of the full-time labour force and 83.61 of the part-time labour force (Current Population Survey 2010). These figures also correspond to the proportion of whites in managerial occupations since 81.9 percent of U.S. managers are whites, and 62.6 percent are men. A typical manager in the U.S. labour

force would therefore be a mature white man, or woman depending whether the occupation can be classified as a “male job” or “female job”. As a result of the financial crisis and related recession, full-time employment has fallen significantly across the U.S. labour force together with a rise of the flexible labour force (i.e. men and women working part-time (Sahin et al. 2010)). This trend is confirmed by the positive growth rate in part-time employment across all ethnic groups. From 2008 to 2009, all ethnic groups have suffered from the loss in full-time employment opportunities. However, the fall in full-time employment opportunities has been uneven across ethnic groups. For example, whites have experienced a fall of 5.98 percent in full-time employment while blacks have experienced a fall of 8.64 percent in full-time employment from 2008 to 2009. In contrast, part-time workers across most ethnic groups have experienced positive growth rates over the same period. The rise in part-time employment opportunities has also been uneven across ethnic groups. Looking at the highest growth rates across ethnic groups, employers in search of a more flexible workforce seem to have favoured whites and Hispanics with a growth rate in part-time employment of 7.38 percent and 18.66 percent, respectively, from 2008 to 2009, against 4.29 percent for blacks.

#### **4. CONCLUSION**

As argued by Kregel (2012), market prices tend to homogenize the diverse characteristics of a commodity. The aim of this paper was to argue that price is the result of the homogenisation process but norms allow the transformation from the specific elements of the individual exchange to setting a price in a particular context. Looking at the labour market, the evidence presented tends to suggest that norms and ideals homogenize the diversity of the labour force through the perceived relative value of identity groups.

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