



“Summary of article by Paul S. Osterman: Internal Labor Markets: Theory and Change” in Frontier Issues in Economic Thought, Volume 4: The Changing Nature of Work. Island Press: Washington DC, 1998. pp. 192-195

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Traditional economic theory held that the labor market acted as a high-turnover spot market where at least one side of the market --either employers or employees-- saw few advantages in maintaining stable employment. In the 1950s, 1960s, and early 1970s however, the rival Internal Labor Market (ILM) theory gained acceptance. ILM theory argues that labor markets tend to be made up of distinct noncompeting groups, while a "port of entry" separates work within the firm and from the external labor market. Labor markets inside the firm are governed by a unique set of rules and actions unlike those found in conventional markets. This essay presents the development of ILM theory since its inception, and offers an integrative theory of how ILMs evolve.

CHANGES IS THE ILM MODEL

The internal labor market model generally described in the literature from the mid-1940s to the mid-1970s was based on unionized workplaces, characterized by strict job classifications, seniority, grievance procedures, etc. Beginning in the 1970s, as firms modified past practices in order to improve performance, to keep unions at bay, and to cope with changes in the economy (including high economic volatility, technical change, and increasing education levels of workers), a competing model of the ILM emerged. The new model, stemming from the American nonunion sector and from the spread of Japanese factories transplanted to the US, stressed direct communication with workers, team production, and quality circles.

Such changes in the nature of firms and the economy have posed the following challenges to ILM theory: 1) are ILMs still relevant, or are they breaking down? 2) are the traits of ILMs changing? and 3) what is the degree of variation in the structure of ILMs in similar industries in different countries?

Reasons why ILMs might be losing importance include such trends as white collar and managerial layoffs, the rise of the contingent and temporary workforce, and the rise of regional networks (rather than single firms) for the stages of careers. Recent Current Population Survey data on length of job tenure reveal that ILMs are still quite significant, but are deteriorating at the edges. While ILMs are of greater relevance for women, for men there has been a "nontrivial" drop in the fraction of middle aged workers who hold longstanding employment relationships. It is also clear that there has been an increase in contingent employment; some firms seem to offer security to a core labor force, then surround the core with peripheral employees. However, it

remains to be seen if the loosening of relationships with a portion of the labor force can explain the recent trends in job tenure.

There is evidence that the rules that govern ILMs are indeed changing. Many firms are organizing work around more flexible job boundaries, greater attention to training, more communication with the labor force, performance based pay, and in some cases enhanced job security. Firms that have been found to adopt these measures are those that have close links to international markets, that were part of larger organizations, that used high skilled technology, that emphasized quality rather than price competition, and that valued employee wellbeing. While transformations of this kind in the United States mimic those of Japan, it is interesting to note that outside the auto industry, many Japanese owned plants in the United States show little resemblance to Japanese management models.

In short, ILMs are much more open to question than they have been in the past. Firms are now using a number of ILM systems that range from the standard union model to models that mimic those of Japan. Variation exists across nations, even among firms that operate similar product markets.

UNDERSTANDING HOW INTERNAL LABOR MARKETS EVOLVE

There are a variety of conceptual frameworks that have been used to explain the existence of ILMs, including performance based models, social process models, and external environment models.

Performance based models propose that ILM rules are determined by calculating the configuration which will produce the most output. This category includes three subgroups. The first two are found in the economics literature. The oldest theory, supported by evidence of wage returns on job tenure, holds that ILMs lower the cost to the firm of training and retaining skilled workers. More recently, economists have claimed that ILMs are more efficient because they reduce transaction costs, resolve principal-agent problems, and maintain job stability through the use of efficiency wages. A third performance based model comes from industrial relations, human resource management and organizational sociology. Unlike economists who tend to focus on control through fear of unemployment or loss of wage premiums, these groups tend to emphasize that ILMs induce greater worker commitment by increasing employee identification with the goals of the firm. Increased commitment leads to more effort, more attention to quality, lower turnover, etc.

Social process models can be passive or active. ILM rules may result from the inertial impact of customs and norms that are part of a firm's history and accumulated sense of what is appropriate, or they may be an outcome of political contests for power within the firm.

External environment models propose that ILM structure is influenced by external factors as obvious as government employment and wage policies, or as subtle as differences in educational or cultural systems. The external environment may also act through channels of imitation. According to some sociologists, institutions may seek legitimacy by imitating powerful actors in their environment.

AN INTEGRATIVE THEORY

Performance systems, social processes within the firm, and the influence of the external environment can be integrated into a dynamic theory of the evolution of ILMs. The performance impulse is the impetus for change in ILM structure. To fully understand this change however, performance must be viewed in a much broader sense than can be found in the economics literature. Performance based changes in ILMs are simultaneously influenced by norms, customs, politics, mimicry, and the external environment.

Performance concerns have certainly driven the adoption of workplace innovations such as team production, quality circles, etc.. The economic explanations that focus on control however, are not adequate. Efforts to improve quality may lure employers to improve control over the labor force but many observers of Japanese and European ILM models emphasize employee cooperation and commitment more than control. It has been argued that commitment is a subtle form of control grounded in psychology rather than in economic principles. Nonetheless, it appears that commitment is a truly distinctive dimension of performance, separate from control. At the same time there is a fine line between the two concepts, and ILMs may achieve the best gains by operating in each realm. While performance can explain the changing nature of ILMs it can also explain how ILMs are fraying at the edges. It is possible that there are many circumstances where the traditional forms of work organization is superior and cheaper.

While performance considerations are very strong, changes in ILMs have also occurred because of customs, norms, and political considerations. The time and compromise involved in union acceptance of work rule changes is but one example of such cases. Finally, the evolution of ILMs is also a function of aspects of the external environment.