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INTERNAL VS. OCCUPATIONAL LABOUR MARKET— A NEGLECTED DIMENSION OF HUNGARY'S POST-SOCIALIST TRANSFORMATION

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As a result of the economic transformation that followed the systemic change of the political order, the formerly prominent role of internal labour markets of large enterprises has been largely discontinued in Hungary and taken over by occupational type labour markets. At the same time the Hungarian labour market has become conspicuously closed and inflexible. Looking for the causes of this paradoxical situation the author calls attention to the fact that parallel to the dissolution of the earlier internal labour markets a new institutional infrastructure fitting the logic of operation of occupational type labour markets has as yet failed to evolve.

The severe transformationary recession of the 1990s in Hungary was eagerly accommodated in the labour market: employment declined in excess of the fall of production, and real wages declined substantially as well. With these socially painful adjustments over, Hungary's labour market is, however, now seemingly reluctant to accommodate the much-hoped-for economic upswing: even under the circumstances of positive economic growth and rising investment, employment continued to decline last year (in 1996); the relatively high rate of unemployment remains, and without effectively mitigating wage inflationary pressure; in spite of the fact that the majority of those squeezed out of employment have withdrawn from the labour force – particularly those with little hope to be rehired later –, long-term unemployment is not diminishing. This involves the danger

that the ongoing economic recovery will fuel wage inflation in a degree that calls for restrictive economic policies, with the consequence that the recovery may get stuck before growing demand for labour could bring forth any sizeable increase in employment. The overtly excluding character of the Hungarian labour market, moreover, as a result of which huge masses of people are compelled to make their living as self-employed, may act to perpetuate the current unfortunate state of affairs in which overpopulated and overfragmented small businesses are a medium of an acute danger of long-term economic dualisation.

In our searching into the causes and cures of this unfortunate situation in the rest of this paper, the legacy of the socialist era, most notably the prominent role and systemic characteristics of internal labour markets of large enterprises of the time, will be considered first. Next we will look at how those particular internal labour markets have largely disintegrated and dissolved into occupational labour markets in the 1990s without similarly far-reaching complementary changes in the institutional infrastructure of the labour market having been implemented, which produced a kind of institutional imbalance. We will argue that it is this uneven process of institutional development (combined, perhaps, with factors widely held responsible for unemployment persistence in some long-established market economies) that accounts for Hungary's disquieting labour market experience in the current initial stage of economic recovery. The main lesson we will draw from this assessment is that in the years to come a prerequisite of lasting economic growth and small-business modernisation in Hungary is the alignment of the institutional infrastructure of the labour market with the logic of operation of occupational labour markets.

The legacy of socialism — the prominent role and systemic characteristics of internal labour markets

Within the context of the indirect mechanism of central economic management of the 1970s and 80s, with labour power having remained the single typically privately-owned resource of production, labour markets were the most "authentic" markets of the Hungarian economy in that they were coordinated dominantly through market (i.e., non-bureaucratic) mechanisms¹.

¹ This straightforward proposition, to which I take the courage from the conception of affinity of ownership forms and modes of coordination put forward in KORNAI [1983]

As a matter of fact, under the conditions of the essentially transactive relationship that existed between buyers and sellers of labour, wage differentials and variations in working conditions played a prominent role in the allocation of workers among firms and occupations, economic branches and regions, etc., as well as in the motivation of workers' on-the-job behaviour². Direct government interventions into the allocation of labour were as a rule campaign-like and/or of limited range of effect; central wage regulation, a permanent component of economic regulation, served as a device to artificially constrain the overall rate of growth of workers' earnings in order to mitigate inflationary pressure rather than to directly influence earnings differentials; centrally imposed criteria of job classification and remuneration (the so-called wage tariffs) did not in fact substantially diminish employer discretion in the formation of earnings differentials; forced participation in the labour force was virtually absent.

At the same time, owing to the conditions of a bureaucratically coordinated, resource-constrained economy under which it operated, the Hungarian labour market differed markedly from labour markets in contemporary market economies. Most importantly, its normal state of equilibrium was characterised by an overall excess demand for labour – a disequilibrium that persisted at a high rate of employment³ and in the presence of a sizeable and expanding, characteristically small-scale private economy, the so-called second economy, acting as a supplementary source of living rather than an alternative to full-time employment in the large firm sector.

(and confirmed in his [1993*b*] – cf. his comments upon *Figure 15.1* in *Chapter 5*), will be qualified in the following paragraphs in accord with the relevant arguments of Chapters 11 and 16 of KORNAI [1980] and of Chapters 10 and 23 of his [1993*b*].

² This interpretation of the role of earnings differentials in Hungary goes as far back as MTA KTI [1971], a hotly debated study of the time written by a collective of reform-minded young economists, which remonstrated against glorification of workers' loyalty to their firms and denunciation of "migratory birds", and pointed out reasonable motives and favourable aspects of the high rate of workers' inter-enterprise mobility that had marked the first two years of the New Economic Mechanism. With full respect to the authors' bold protestation against the imposition of artificial constraints upon labour mobility and the stigmatisation of workers' voluntary quits, I will focus attention below on those systemic constraints which came to be recognised later as setting objective limits to the potential role of wage differentials in the coordination of labour allocation and in the motivation of workers.

³ Excess demand for labour prevailed even under the conditions of stagnation in the late 1980s, although employment (but not the rate of employment) declined somewhat. For an analysis of the development and fluctuations of labour demand see FAZEKAS - KÖLLÖ [1990].

With forced participation virtually absent, the attainment of this high rate of employment was conditional upon a correspondingly high rate of voluntary participation. Beside social transfers and allowances that reduced the time and money costs of market work and/or discriminated against the non-employed, this high rate of voluntary participation was brought about essentially by two spontaneous mechanisms, both bound to occur under the conditions of full employment, namely: 1. a kind of state-dependence of voluntary participation, augmented by 2. a positive feedback between the rate of employment and the rate of voluntary participation⁴.

1. As regards the former mechanism, the essence is that expanding employment (possibly through the mobilisation of previously non-employed labour) tends to augment the "normal rate of participation" by giving rise to the proportion of those who are "accustomed to employment" and thus willing to be in the labour force.

2. As for the latter mechanism, its essence is that the further the rate of employment and, with it, the earner/dependent ratio rise, the weaker the "relative purchasing capacity" of wages becomes (defined as the ratio of the average real wage to the per capita real consumption of the working population), meaning that households can only catch up with rising living standards by adjusting their participation decisions to earlier rises in the earner/dependent ratio, i.e., by further expanding their economic activity.

That is, while, in the absence of open unemployment, labour supply could not even temporarily be curtailed by withdrawals from the labour force of discouraged workers, a specific, long-run version of the so-called added worker effect was largely responsible for the fast attainment of a high rate of participation. In contrast to its short-run version, this long-run effect is produced not by job losses of some household members (typically primary earners), which, to the extent that their job losses are feared to be permanent, urge some previously non-employed (economically inactive) members in those same households to seek employment, but by the demonstration effect of the growth of consumption other households achieve by increasing their rates of participation.

While the rapidly growing rate of employment, via its (by definition negative) impact on the relative purchasing capacity of wages, prompted Hungarian households to increase their labour supply accordingly, it also weakened the motivating potential of the prevailing wage differentials, and so did the growing role of the second economy as a supplementary source

⁴ In the following discussion of these spontaneous mechanisms I draw on KORNAI [1980] and [1993*b*] (particularly on chapters referred to in *Footnote 1*).

of household incomes. To wit, both can be regarded, from the viewpoint of individual households, as processes leading to "more diversified portfolios" of their labour investments, weakening thereby their sensitivity (the subjection of their per capita consumption capacities) to fluctuations in the earnings (returns to the labour investments) of any one of their members.

Furthermore, while this weakened sensitivity would call for a widening of the wage scale as a way to counter the resulted loss in the motivating force of the prevailing wage differentials, the weakened relative purchasing capacity of wages, itself a consequence of the very same conditions (high employment rate coupled with high proportion of parallel participation in the second economy), in fact narrows the feasible range of those differentials for the following reason. Given the average wage, and assuming that minimum and/or reservation wages must be positively related to the costs of living at the prevailing living standards (not a particularly stringent assumption indeed), which in turn are higher, the higher the earner/dependent ratio and/or the larger the amount of additional labour incomes that households accrue, it follows that the higher that ratio and/or the larger that amount, the closer minimum and/or reservation wages must be to the average wage, meaning that the narrower will be the feasible range of wage differentials: Q. E. D.

This syndrome of widening of the necessary and narrowing of the feasible wage scales, with the weakened motivating force of wages it entailed, however, was not only a consequence but, as a factor giving rise to a particular kind of substitution effect in household behaviour, also a derived cause of the rising employment rate and growing proportion of second economy incomes, and thus a link in the positive feedback mechanism between the employment rate and the rate of economic activity previously described. To wit, the narrower the existing wage differentials in various dimensions (job effort, qualification, position in the job hierarchy, etc.), and the smaller the effect of a given percentage of variation of one's wage on the per capita consumption capacity of one's household, the less one is motivated to improve one's wage position (through improved performance, increased job search efforts, additional investments to one's human capital, etc.), and the more one is tempted to seek to find additional sources of income instead, i.e., to increase the economic activity of one's family and oneself (in the form of a higher earner/dependent ratio, multiple job holding, more extensive exploitation of one's opportunities to earn income in the second economy, etc.). All this led to the paradoxical result of an apparently self-sparing and at the same time self-exploiting population in Hungary, i.e., to a kind of aversion among them from jobs

that are demanding coupled with overtly work-centred time allocation patterns.

Under the conditions just described, firms responded to the harsh competition for labour in the first economy and the extensive presence of the second economy roughly in three ways⁵.

First, they could try to improve their competitive position in the labour market by raising their wages above the market rates. This course of action was indeed prevalent among those privileged few (mostly giants, relative to the size of the market) who, thanks to their strategically strong bargaining position *vis à vis* the proper authorities, managed to obtain relief from the rules of central wage regulation. As a result of what was just said about the limited motivating potential of wage differentials, however, even they could hardly expect to attain concessions of such a scale that would enable them to achieve permanent improvements of sufficient magnitudes. They could rather expect their competitive position to improve by using their informal bargaining position to make the proper authorities adjust the occupational composition of regular training to their particular needs, and by running apprentice workshops within that training⁶.

Second, in order to get hold of an enlarged pool of job applicants and reduce replacement needs arising from voluntary quits, firms could also experiment with concessions on performance and skill requirements. By doing so, they could rightly expect to appear more attractive as places of employment before those who were satisfied with their secondary earner positions in their households or had a major interest in the second economy as a source of income. Considerable concessions of this type, however, were not affordable but for firms with production technologies and work organisations largely immune to the inferior working morale and poor technical skills of a more or less significant part of their labour force.

Finally, firms could try to enhance their labour market attractiveness, motivating capacity and labour retaining power by establishing internal labour markets, i.e., offering part of their workers "privileges" by seniority and merits. Considering the predominance of large firms as employers most apt for the establishment of internal labour markets, and the high frequency of production disturbances and bottlenecks (due to short and uncertain supplies of inputs, worn and outdated, often idiosyncratic and ill-matched

⁵The ways and means of adjustment of Hungarian firms to the conditions of labour shortage are a main theme in FAZEKAS–KÖLLÖ *ibid.*, where their findings of more than a decade of labour market research are presented.

⁶For further details consult with FAZEKAS–KÖLLÖ *ibid.*

machinery, etc.) that called for a good amount of firm specific knowledge at all levels of the job hierarchy as a prerequisite of initiative and effective daily improvisations, no wonder that internal labour markets as a form of adjustment became preponderant in the Hungarian labour market.

In many respects they resemble their market economy counterparts (entry-port jobs, long-term employment relationships with a strong bearing of the length of tenure and on-the-job training on wages and promotion, etc.⁷), whose existence is usually traced back partly to the productivity enhancing effects of specific knowledge and skills acquired while working with the firm, partly to the role a positive association between earnings and tenure as a kind of deferred payment may play in discouraging shirking and quits and attracting job applicants of superior quality, and partly to the role long-term employment relation may play as a device for firms to learn more about the productivity of their workforce and thus improve job matching at reduced screening costs. Due to the above described systemic characteristics of the context in which they operated, internal labour markets of Hungarian firms were at the same time distinct in several respects⁸.

First, the rules that governed the allocation and pricing of labour in these internal markets were less transparent. Instead of collective negotiations taking place before the eyes of the workforce and according to more or less well-defined procedural rules and principles of representation, they were formed typically in behind-the-scene informal and selective, occasional bargains. Job assignments and rules of promotion were similarly less transparent and less unambiguous.

Second, the fortune of these internal labour markets was tightly dependent on how far a given firm could influence those bureaucratic decisions that formed the officially recognised catalogues of crafts and occupations, the occupational composition and curricula of regular training or the allocation of the right to run apprentice workshops.

⁷For the characteristics of internal labour markets in a market economy setting see OSTERMAN (ed.) [1984].

⁸ Their rules of operation, with particular attention to formal and informal mechanisms of wage determination, were brought to light in a large part in the late 1970s and early 1980s by shop-floor case studies carried out at large industrial and service firms by a research group headed by Gábor Révész. (For their findings see the respective chapters by Károly Fazekas and János Köllő in GALASI (ed.) [1982] and in the working papers collected in FAZEKAS et al. [1983a].) Their findings were confirmed and complemented by further empirical evidence and interpreted as indicating systemic distinctiveness by STARK [1986].

Finally, under the conditions of the predominance of task wage (as against time wage) as a form of workers' remuneration, the positive association between earnings and tenure, a distinctive feature of any internal labour market, was in its Hungarian version based not so much on one's regular job promotions and pay advancements as on informal practices that provided preferential treatment on the shop floor for the tenured in the daily allocation of tasks of differing wage/effort ratios, and – perhaps even more importantly – on generous overtime assignments for them. The primary role of informal overtime provisions in the operation of the Hungarian version of internal labour markets (and in the evasion of central wage regulation) as well as the less formalised and less bureaucratic – more informal and market-like - rules of allocation of labour and pay in these markets in general became particularly evident in the 1980s with the emergence and fast proliferation of intra-enterprise work partnerships⁹.

A paradox of transformation — inflexible occupational labour markets

As is well known, the Hungarian economy was hit by a severe transformationary recession in the 1990s¹⁰. Employment declined by over 25 per cent – in excess of the fall of production –, while real wages were eroding and registered unemployment rose to a rate of over 10 per cent¹¹. Clearly, a fall of employment in excess of the decline of production (with a corresponding improvement in productivity) would have been impossible had not a good part of the formerly established internal labour markets disintegrated and dissolved into occupational labour markets. To wit, internal labour markets in recessionary periods act as employment buffers in that they reduce the output elasticity of employment and, by so doing, tend to lower (or slow down the growth of) productivity.

That internal labour markets did in fact recede and give ground to occupational labour markets in Hungary in the 1990s should be placed

⁹ See, e.g., NEUMANN [1988] and STARK [1989].

¹⁰ The arguments that follow take the views and ideas advanced by KORNAI [1993a], [1995] and [1996] on the causes of the transformationary recession and conditions of recovery as a reference but are confined to aspects strictly related to the labour market.

¹¹ *János Timár* was among the first who took notice of the fact that compared to the dramatic decline of employment that was brought about by the transformationary recession (as a result of which Hungary's employment rate fell to a level even lower than is typical among market economies) the magnitude of the increase of unemployment was disproportionately small in absolute terms. (See TIMÁR [1994].)

primarily on the account of privatisation which brought in its train the predominance of firms too small and shaky to maintain internal labour markets¹². This is shown particularly blatantly in the almost explosion-like spread of self-employment. Obviously, given the natural desire of the overwhelming majority of workers for income and job security, such an abrupt proliferation of self-employment could hardly have occurred had employment opportunities in internal labour markets not diminished drastically. Moreover, self-employment in Hungary today is in a large part only a mask that hides extremely precarious employment relations (representing the polar opposite of the kind of employment relationship characteristic of internal labour markets) whereby separation costs as well as taxes and social security contributions can be saved. The excessive multiplication of this kind of compelled (pseudo-)self-employment should be seen as not a manifestation of a working population highly entrepreneurial in spirit but an indication of a temporary detour, or perhaps even worse: a low-equilibrium trap, of small-business development¹³.

Another piece of indirect evidence of the disintegration of formerly established internal labour markets and their dissolution into occupational labour markets is the withdrawal of firms from regular training: the role they would play in regular training by establishing and operating apprentice workshops in their factories (as a device to get access to a larger and selected pool of skilled young workers) is now increasingly assumed partly by workshops run by the training schools themselves, partly by micro-businesses who can thus benefit from tax relieves (and also from informal fees that families of apprentice candidates without a place of practical training might be forced to pay)¹⁴. Similar conclusion can be drawn,

¹² SMITH [1988] finds that only firms large enough (with a staff of about 500 at least – according to OI [1983] 1000) establish internal labour markets.

¹³ This is suggested by the apparent inconsistency of the relatively low rate of failure and retreat of our overpopulated and overfragmented small-business sector: as many as two-thirds of those small and mostly young undertakings which were surveyed in 1993 were still in business in 1966. (See LENGYEL (ed.) [1996].) Moreover, the death rate of those from among them which had been started under the pressure of necessity was below that of the total sample. And although the size of the units (measured on their staff) that had survived increased somewhat during that three-year period, this did not hold for the small-business sector as a whole (see figures in Footnote 16). For my view of the current state of health of the Hungarian small-business sector and its developmental prospects see GÁBOR [1997].

¹⁴ While the number of apprentices participating in regular vocational training dropped by 17 percent between 1990–1991 and 1993–1994, those from among them who attended training shops run by schools even increased by 58 percent while the number of apprentices trained in groups at firms decreased by 49 percent. At the

tentatively at least, from the statistical observation that, other things being equal, those from among the unemployed who prior to unemployment were relatively low paid in their jobs – and can thus be assumed to constitute a sub-sample in which workers with shorter or no tenure in an internal labour market are overrepresented –, if get reemployed, typically register a wage gain while the formerly better-paid reemployed will typically suffer a loss¹⁵. As for waged employment in micro-businesses, registered employment is rare among them¹⁶ but where it exists, it does so mostly in the form of casual/seasonal and part-time employment with practically no guarantee of job and/or income security of any kind. Furthermore, small-business owners prefer to rely on references obtainable from fellow-entrepreneurs when searching for new employees¹⁷ – again a practice that would clearly be foreign to an internal labour market context, where employers had better rely on their workers' recommendations.

Of course I do not want to say that internal labour markets in Hungary have been deprived entirely of their conditions of existence. (Just as it would be a mistake to ignore, when talking about the predominance of internal labour markets, the role occupational labour markets played in the 1970s through the 1980s as places of employment for those large segments of workers who were only loosely attached to the labour force and/or eager to accept less-remunerative-less-demanding jobs – or simply unskilled and untrainable.) Managers of newly established Hungarian subsidiaries of multinational companies, for instance, make their best to adopt Western-type internal labour markets, as is demonstrated by their efforts to build up their own systems of training as a private source of supply of skilled labour for themselves. In other cases privatisation of existing firms, where it was not followed by the introduction of new technologies, left their old-type, informal internal labour markets almost unaltered in spite of management

same time participation in other (non-group) forms of regular training grew by 12 percent. (*Source* of figures: BENEDEK (ed.) [1994].)

¹⁵ This observation is reported (and given a hypothetical interpretation that – unlike the one I am proposing – relies on the theory of statistical discrimination) in KÖLLÖ - NAGY [1995].

¹⁶ According to figures reported in LAKY [1996], the average number of employees in unincorporated small-undertakings of single owners – typically own-account workers – did not change from 1993 to 1995: it remained as low as 0.3. As for corporations, the ratio of those with a staff of less than 20 even increased, from 72.5 to 87 percent, between 1991 and 1995. A particularly striking increase could be observed in the ratio of the smallest corporations: the proportion of those with a staff of 10 or less grew from 47.6 to 74.8 percent in the two-year period of 1993 to 1995.

¹⁷ See LAKI [1997].

efforts¹⁸. What I do want to say though is that in Hungary today a much smaller proportion of workers have a chance to be employed in internal labour markets than what they were used to in the 1980s, and a much larger proportion should rest satisfied with employment opportunities occupational labour markets offer (for the most part including self-employment).

Meanwhile, however, labour market in Hungary has become conspicuously closed and inflexible. Notwithstanding the remarkable gaining ground of occupational labour markets, it responds to economic recovery in ways (not even) predominance of internal labour markets would imply. As a matter of fact, even under the conditions of positive economic growth and rising investment employment continued to decline last year; the relatively high rate of unemployment remains; in spite of the fact that the majority of those squeezed out of employment in recent years have withdrawn from the labour force – particularly those with little hope to be rehired later – and are now economically inactive (therefore not counted as unemployed), long-term unemployment is not diminishing; wage inflationary pressure has not lessened¹⁹.

This paradoxical behaviour of the Hungarian labour market – excessive job-rationing²⁰ and wage-inflationary pressure in the context of occupational labour markets – is intellectually embarrassing indeed. More importantly, it involves the danger that the ongoing economic recovery will fuel wage inflation in a degree that calls for restrictive economic policies,

¹⁸ This was demonstrated by case studies – e.g., BÓDIS [1996], [1997] and JANKY [1996] – of an ongoing research project (entitled "Economic sociological investigation of hierarchical economic organisations") informed by the ideas of CSONTOS [1994] and coordinated by him until his early death in 1997.

¹⁹ For a solid and carefully-documented general account of the labour market impacts of the Hungarian economic transformation see GALASI - KERTESI (eds.) [1996].

²⁰ The phenomenon of job rationing as a regime in which otherwise apt outside applicants are widely denied jobs even despite their lower wage claims is traced back by efficiency wage theories in part to workers' unobserved heterogeneity. This being the case, and considering the fact that the existence of internal labour markets are also traced back in part to this heterogeneity, it follows that efficiency wages and internal labour markets are in this respect conditional upon each other. (Cf. WEISS [1990].) Note also that the role internal labour markets may play in maintaining a regime of excessive job rationing is tacitly acknowledged in the so-called insider-outsider approach by LINDBECK-SNOWER [1988] as well, in which insider workers, understood as "full-fledged employees", are claimed to be able and willing to make underbidding by the outsiders expensive for the employers to accept and/or disagreeable for the outsiders themselves to engage in.

with the consequence that the recovery may get stuck before growing demand for labour could bring forth any sizeable increase in employment²¹. The overtly excluding character of the Hungarian labour market, moreover, as a result of which huge masses of people devoid of entrepreneurial spirit are notoriously deprived of the possibility of waged employment and are compelled to make their living as self-employed, may contribute to the perpetuance of the current unfortunate state of affairs in which overpopulated and overfragmented small-businesses are a medium of an acute danger of long-term economic dualisation and thus represent a threat to rather than a catalyser of economic transformation. In order to escape these dangers it is essential to explore what causes lie behind labour market inflexibility.

Obviously, differences in historical precedents and peculiarities of the transformationary recession preclude the possibility of extracting immediately adaptable lessons and direct guidance from treatments of labour market rigidities market economies experienced following the oil-price explosions. At the same time, a special account of their findings, one that considers them in the light of the peculiarities of the Hungarian case, may serve as a useful starting point of exploration.

Note, first of all, that similar to the situation the majority of the developed market economies faced following the oil price explosions, Hungary in the 1990s got acquainted with high unemployment rates coupled with high rates of inflation. This syndrome, commonly known as stagflation, was originally assumed to arise in part from anomalies of adjustment ("friction") accompanying accelerated structural changes. The larger the structural (regional, occupational, etc.) disequilibria of the labour market at a given point of time – the argument goes –, the higher the rate of unemployment necessary to discipline inflationary pressure²².

²¹ In his discussion of the role the development of wages and consumption played in the transformationary recession, and of the kind of income policy to be pursued in the recovery, Kornai repeatedly calls attention to this danger – see KORNAI [1993a], [1995] and [1996]. (For a markedly different position on the same issues see MATOLCSY [1997].)

²² I.e., the higher the natural rate of unemployment in a competitive economy; and the higher the equilibrium rate of unemployment (NIRU or NAIRU) in imperfect competition – understood as the rate at which workers' real wage claims and firms' real profit claims are consistent with each other and, as a result, price-inflation expectations are fulfilled. (Note that the theory of imperfect competition is itself a product of the 1980s – see BLANCHARD [1986] and BLANCHARD - SUMMERS [1988].) Since the arguments below refer to the conditions of imperfect competition, the concept of equilibrium unemployment is adopted hereafter.

An important implication of this approach is though that with accelerated structural changes having been accomplished stagflation is bound to disappear – an implication that was not entirely supported by later experience. True, equilibrium unemployment declined in the 1980s but not as far as its pre-stagflation level and with considerable variation among individual countries. This directed analysts' attention to the effects institutional factors like 1. labour market corporativity, 2. path-dependency of equilibrium unemployment (usually labelled as hysteresis) or 3. internal versus occupational labour markets may exert upon a country's unemployment performance. It is these factors whose responsibility for the inflexibility of the Hungarian labour market we now consider²³.

1. Initial attempts to find out why the unfavourable effects of the oil-price explosions lasted longer than had been anticipated, and why they varied in degree from country to country, yielded the assertion that there exists a theoretically well-arguable U-shape relationship between labour market corporativity (centralisation of wage negotiations) and unemployment performance²⁴.

Centralised (macro-level) collective bargaining is claimed to have the most desirable properties on the ground that unions negotiating in such setting are in a position that both allows and enables them to take full account of the unfortunate effect excessive wage claims (ones that are inconsistent with the anticipated growth of productivity) may exert on the rate of price inflation. They will thus not easily fall victim of wage illusion on one hand. On the other hand, they are aware of the danger an unanticipated acceleration of price inflation entails, namely, that it normally invokes restrictive economic policies as counter-actions, which in turn result in declining employment, imposing involuntary unemployment upon a part of their membership and increasing burdens of unemployment benefit contributions upon the rest.

Micro-level collective negotiations are claimed to have favourable properties as well, which would explain the relatively good unemployment record of those countries where unions are engaged typically in firm-level bargaining. Here trade unions will feel obliged to show self-restraint for they know that at a firm facing highly price-elastic demand for its products workers face highly wage-elastic employment opportunities. Consequently, unions will fear that higher wages (whether or not increasing production

²³ References to the literature on which the relevance of these factors for Hungary is considered are placed in footnotes at the respective sections.

²⁴ See CALMFORS - DRIFFIL [1988].

costs will be passed on to buyers in the form of higher prices) may lower the firm's profits (either because of falling revenues or as a consequence of lower profit margins) and induce staff decrease.

Industry-level bargaining, by contrast, is clearly the worst alternative setting as far as equilibrium unemployment implications are concerned, for industry unions negotiating separately will act like non-cooperating players in a prisoners' dilemma game. That is, they will know that none of them bears full responsibility for the impact excessive union wage claims in the aggregate make on the rate of unemployment and inflation, and since each of them will know that everybody else will think this way and act accordingly, they all are likely to end up with showing minimum restraint. Also, with demand for an industry's output being less price elastic than that of a firm (in consequence of the lower substitutability of an industry's output), industry unions have less reason to bother about the industry-level employment impact of their wage claims.

Now, in Hungary today, taking the as yet rudimentary state of industrial relations into consideration²⁵, one should be sceptical about the merits of an explanation of labour market inflexibility that would draw too heavily on the above arguments. Be the differential equilibrium unemployment impacts of different degrees of corporativity as claimed, the most one can extract as lessons relevant to the Hungarian case are "ifs". One can only say that had macro-level tripartite negotiations turned out to be more productive, and/or had the implementation of some kind of Western-type income policy (that would have filled the gap the hasty elimination of central wage regulation in 1990 had left behind) been tried and found effective as a device to moderate wage inflation, etc., then Hungary might have tided over the economic transformation at lower costs, i.e., with less restrictive economic policies and thus less job losses²⁶. Similarly, equilibrium unemployment in the years ahead could in principle be favourably affected by a macro-level collective agreement in which the parties would commit themselves to moderate wage inflation. Realistically, however, it is exactly the present rudimentary state of industrial relations that makes it hard to believe in the feasibility of such an agreement. Hungary's strongly divided trade unions keenly competing for a shrinking constituency base can hardly be expected to enter into such an agreement.

²⁵ For facts substantiating this unfavourable general assessment see LADÓ - TÓTH (ed.) [1996].

²⁶ In his assessment of the results of the much talked-of corrective measures of Bokros-package KORNAI [1996] himself sees it as a fortunate accident, presumably the consequence of a surprise inflation, that real wages declined considerably in 1995.

Do they still become resigned to doing it, it would be naïve to assume that they will indeed be up to consistently meet the negotiated terms.

2. Similar doubts can be cast on the merits of the oldest (but still quite recent) versions of path dependency arguments²⁷ as far as their relevance to Hungary is concerned. True, they start out from the assumption that trade unions act as partial representatives of insider workers' interests – a kind of partiality which is clearly manifest in union behaviour in Hungary as well. This partiality, however, could produce hysteresis only in so far as our unions were massively involved in wage setting.

As against these early explanations, later interpretations of this same phenomenon are based on assumptions that do seem directly applicable to the Hungarian case. Namely, they assume that either employers are (for good reason or not) reluctant to hire from among the long-term unemployed or (if only for this reason) the long-term unemployed lack the confidence necessary to effectively compete for jobs, or both. They argue that since increasing unemployment tends to increase the incidence of long-term unemployment – the proportion of long-term unemployed in total unemployment –, it causes an upward shift in equilibrium unemployment, i.e., an increase in wage inflation at any given level of total unemployment²⁸.

True, these latter interpretations, too, examine wage setting in a collective bargaining context. Nevertheless they may serve as a suitable reference in finding out the causes of labour market rigidity in Hungary for, in the first place, they allow, implicitly at least, for the possibility that, thanks to the high proportion of long-term unemployed in total unemployment, large segments of insider workers remain defended against the unfavourable impacts of massive unemployment – even in the lack of strong union support. Moreover, their reasoning would even account for the kind of low-employment-equilibrium trap situation where the disciplinary (wage-inflation moderating) effect of an initial increase in total

²⁷ See BLANCHARD - SUMMERS [1986], [1991].

²⁸ See LAYARD - NICKELL [1986]. Although this line of reasoning appears to differ fundamentally from the previous one in its departure, as LEVER [1995] pinpoints: depending on how broadly or restrictively the notion of 'outsiders' are defined – whether it is meant to refer to the long-term (how long?) unemployed only or, more broadly, to the unemployed, or it should embrace non-union member employees and/or workers in non-internal labour market jobs as well – can one regard the two lines of reasoning as theoretically more or less distinct from each other and attempt to decide (possibly with the help of econometric analysis) which of the two fits reality better.

unemployment has been more than offset by the sufficiently large increase of long-term unemployment it called forth. Yet, what would be essential in the adoption of these interpretations to the Hungarian case is to address the issue of what (presumably institutional) factors determine whether a given (increase in the) rate of unemployment will be associated with larger or smaller (growth of the) incidence of long-term unemployment.

Finally, according to a third characteristic explanation the observed dependency of current rates of equilibrium unemployment on past rates of unemployment has to do primarily with capacity utilisation fluctuating in the course of a business cycle²⁹. Namely, with capacity utilisation having declined in the initial phase of a recession, a fall of investments and an increase in capital scrapping are bound to follow – with the result that capital stock will shrink. Granting this, when recovery comes it soon leads to an overutilisation of the undersized capital stock, with the consequence that price and wage inflation will start to accelerate at a relatively low rate of employment (and a correspondingly high unemployment rate).

Now, in view of the enormous magnitude of the reduction of capital stock that accompanied the transformationary recession in Hungary, this argument deserves serious consideration. At the same time, it should be kept in mind that hysteresis of such origin, unless the rise of inflation thus induced is misdiagnosed and suppressed by hastily adopted restrictive economic policy measures, is transitory by nature, and that timely anticipation of an imminent and fast recovery may give impetus to business investments early enough to simultaneously accelerate the upswing and prevent an undue transitory rise of inflation.

3. While traces of the ideas reviewed and reflected upon in the foregoing appear incidentally in the study of the ongoing transformation of the Hungarian labour market, the marked and sudden contraction of the domain of internal labour markets and its bearing on the prospects of economic transformation have somehow remained beyond our range, leaving obvious parallels with market economy experience unrecognised and unexploited. The section that follows is meant to amend this negligence.

²⁹ See SOSKICE–CARLIN [1989].

Labour market in institutional imbalance — a clue to the riddle of inflexible occupational labour markets

Cross-country comparative labour market studies usually reveal marked correspondence between the historically established patterns of coexistence of internal versus occupational labour markets and certain aspects of the institutional infrastructure that surrounds the labour market (vocational training, statues of labour, industrial relations, employer and employee attitudes and norms of behaviour, etc.)³⁰.

The instrumentality of this correspondence becomes obvious in the light of the costs parties to an employment contract – workers and firms – incur if they terminate their contract: the lower these transaction (separation/replacement) costs, the more viable occupational labour markets are³¹. These separation/replacement costs are in turn lower, the closer substitute job offers of different employers are for a worker with a given qualification, and the closer substitute workers with a given qualification are for a firm, i. e., the more standardised the skill-requirements of a given occupation and the actually acquired skills of workers with a given qualification are. Now, the more standardised occupational skills and skill-requirements are, the more reasonable it is that occupational skills be acquired in specialised training institutions obliged to respect the established occupational standards in their subject-matters of instruction, rather than in the form of on-the-job training. Furthermore, under the conditions of low separation/replacement costs that highly standardised occupational skills acquired in specialised training institutions

³⁰ See especially EYRAUD et al. [1990]. Also see HASHIMOTO–RAISIAN [1988].

³¹ These costs include the so-called quasi-fix costs of employment born by employers (costs of recruitment and selection, direct and indirect costs of training of newly hired workers, severance payments, etc.) as well as those direct and indirect costs that workers incur in case of a change in their place of employment (search costs, reduction in one's expected life-time earnings, etc.), which might be substantial in internal labour markets and negligible in occupational markets. (Cf. OI [1983].)

Note that equilibrium unemployment is also seen as a function of institutional factors – namely, of the existence of severance payment, a characteristic of internal labour markets – in the multiple-equilibrium model set up by SAINT-PAUL [1995] in the spirit of BLANCHARD–SUMMERS [1988]. In that model severance payment has an unfavourable impact on equilibrium unemployment partly by discouraging separations, partly by strengthening the bargaining position of (insider) workers. This gives rise to the conjecture that there is an overlapping between the first two of those explanations of high equilibrium unemployment that were discussed in the above under the heading of hysteresis unemployment and ones that concentrate on the effects of institutional factors related to the type of the labour market.

entail, workers can best promote their interests collectively by forming or joining unions that are organised along the lines of crafts and occupations, and by pressing for collective agreements that include well-defined job demarcation lines and formal qualification criteria of admittance that are uniform throughout the economy.

With an internal labour market, by contrast, a two-pillar system of vocational training is compatible whereby basic occupational skills acquired at school are complemented by a large amount of special skills, varying in contents from firm to firm, that can only be acquired while working. In view of the long duration of employment contracts and the strong bearing of the length of tenure and on-the-job training on earnings and promotion, workers can best advance their interests collectively by forming or joining unions that are organised at the level of the firm (or group of firms within the same branch of the economy), and by pressing for collective agreements that include well-defined and enforceable rules of hiring, firing, and promotion (possibly together with other kinds of job property rights provisions).

Whether the configuration of the labour market and its institutional infrastructure in a given country at a given time is more of internal or occupational type is the result of a historic process of institutional evolution. In the course of that process tensions arising from the perception of unexploited opportunities and/or unfulfilled expectations by workers and firms (their dissatisfaction with each other's attitudes and behaviour, with the performance of training institutions, with the prevailing system of collective bargaining, and so on) would call forth institutional adjustments that gradually eliminate inappropriate institutional elements. Presumably it is mainly these gradual adjustments that eventually produce a constellation which is largely self-perpetuating (with compatible and mutually reinforcing opportunities and expectations) even amidst extreme swings in economic environment.

The particular equilibrium that such a stable, self-perpetuating institutional configuration represents should be respected by labour market policies as well (themselves coming within the institutional infrastructure of the labour market): it constrains the choice of the effectively adaptable set of policy instruments. Faced with a predominantly internal labour market configuration, for instance, active labour market policies should take into account that participation in retraining programs cannot procure tenured jobs for the prime-age unemployed, and to the extent this is known to them, they may be reluctant to undergo retraining. In a configuration where the typically occupational labour markets of small firms dominate,

on the other hand, granting wage subsidies to employers hiring from the unemployment pool will not be cost efficient either: non-renewed, short-term employment relations and high turnover rates will result.

As for the present situation of the Hungarian labour market, it is far from any kind of a self-reproducing institutional equilibrium. As a matter of fact, the remarkable gaining ground of occupational labour markets has not been accommodated by the institutional environment. Namely, parallel with the liquidation of an increasing part of firms' apprentice workshops, the kinds of skills and qualifications acquirable in vocational training have become ever less transparent and standardised – lack of coordination and supervision has led to an enormous inflation of certificates of dubious credence and market value³². Moreover, falling investments consequential upon the recession, by hindering the process of large-scale replacement of obsolete capacities, retarded the devaluation of job-specific skills and thus the diminution of separation costs. Trade union organisation along the lines of crafts and occupations has not gathered momentum either. Or, while the expectations of the main army of the unemployed bear the imprints of their earlier internal labour market experience, too many of the newly trained face as job applicants the disheartening experience of distrust towards their qualification certificates on the part of employers³³, etc.

Taking established market economies as a reference, the gaining ground of occupational labour markets in Hungary in the course of transformation should thus be assessed as an irregular, uneven process. In the period of transformationary recession the role of internal labour markets as employment buffers has been reduced (perhaps, even beyond what one would regard as normal in a market economy) without the conditions of operation of occupational labour markets (i.e., low separation/replacement costs, that could have effectively moderated wage-inflationary pressure by intensifying competition between insider and outsider workers, etc.) and

³² To refer back to regular vocational training, what lies behind the category of "training not in groups" as a form of training currently in expansion is in a large part training in technologically obsolete and/or narrowly specialised shops in the small-business sector, which are for this reason alone inopportune to train apprentices the niceties of an occupation.

³³ That those who enter the labour market after completing their studies in regular vocational training have nevertheless relatively good chances to get a job can partly be explained by their willingness to accept jobs that were and/or could be filled with unskilled workers. (This explanation is suggested in Chapter 5.3 of ILO [1997].) It is indeed reasonable to assume that to the extent school and/or qualification certificates are unsound signals of one's acquired general knowledge and/or occupational skills employers are induced to hire formally overeducated and/or overskilled workers.

thus a later expansion of employment having been created. Such being the case, active labour market policies (like massive retraining programs or generous wage subsidies) could as a matter of course not be particularly effective either³⁴.

To conclude this section, the main lesson to be drawn from the above assessment of the Hungarian situation is that to the extent occupational labour markets retain their prominence in the years to come, a prerequisite of the degree of labour market flexibility and policy efficiency necessary for sustainable economic growth is the formation of an appropriate institutional infrastructure, i.e., one that fits and confirms the logic of operation of occupational labour markets. This could, perhaps, best be promoted here and now by redesigning the system of vocational training in a way that could yield transparency. The work should possibly start with the specification of the skill-requirements of occupations and then continue with the elaboration of their standard cores of instruction – in themselves a huge task, which could hardly be carried out successfully without government assistance or involvement of organisations representing workers' and employer's collective interests. The point is that only to the extent the credibility of officially recognised qualification certificates issuable by training institutions is reestablished can the expectations of workers and employers gradually adjust to the principles of operation of occupational labour markets and get reinforced by fulfilment.

Rights and wrongs of alternative institutional arrangements — summary, qualifications and conclusions

In our searching into the causes of the apparent closedness and inflexibility of Hungary's post-socialist labour market, the dimension of internal vs. occupational labour market was highlighted. The essence of the diagnosis thus established is that the rapid disintegration of the particular internal labour markets of the 1980s and their dissolution into occupational labour markets in the 1990s have not been matched by a corresponding transformation of their institutional infrastructure, which produced a kind

³⁴ Based on a wide range of unemployment literature, FALUS [1991] called attention to the important role active labour market policies would have to play already in the initial stage of economic transformation, and attempted to specify the main "strike directions" that she believed could be appropriate under the constraints of transformation. Yet, her expectations, although moderate compared to the views prevailing that time, turned out to be too ambitious in the light of later experience.

of institutional imbalance. It is fundamentally this institutional imbalance that I blamed for why, after occupational labour markets having become predominant (without which the dramatic decline in waged employment that was experienced in the 1990s could not indeed have taken place), today's Hungarian labour market responds to the initial stage of economic recovery in ways – i.e., with wage and employment tendencies – characteristic of internal labour markets, endangering thereby lasting economic growth and small-business modernisation.

I noted that predominance of internal or occupational labour markets does not mean their exclusiveness. I conceive it in a way similar to how Kornai thinks of the predominance of state vs. private ownership as the basis of bureaucratic vs. market coordination³⁵. The same way as it is not possible to specify exactly what proportion of state ownership is just large enough to exclude the predominance of market coordination – obviously, this critical proportion will depend on, *inter alia*, how far state ownership is penetrated into different kinds of economic activities –, it cannot be determined specifically in what proportion jobs should be of this or that type so as to entitle one to speak of the predominance of a given labour market type³⁶. The most one can say is that in a proportion large enough to bind the infrastructural institutions to conform to the logic of operation of that particular labour market type, and that in this respect it is primarily

³⁵ See e.g. KORNAI [1983].

³⁶ The parallel may apply also to the market-like vs. bureaucratic nature of employment contracts in that employment relations in an internal labour market – although any employment relationship is inherently a dominantly market-type, transactive relationship, in which employees as owners of their labour undertake certain tasks for certain remuneration – are more bureaucratic in nature: employers retain more discretion in managing the labour power of their employees (in exchange for providing them guarantees for job security and promotion) than is the case in an occupational labour market. (For a transaction-costs interpretation of the bureaucratic aspects of internal labour market-type employment relations see the seminal paper by WILLIAMSON et al. [1975]; other interpretations view employment relationship as a particular kind of principal-agent relationship and stress the problem of moral hazard; again others, following the footsteps of HIRSCHMAN [1995], point out the importance of 'voice' as a political-institutional mechanism of adjustment characteristic of internal labour markets, as against 'exit' as a competitive mechanism characteristic of occupational labour markets – see e.g. FREEMAN [1980].) Occupational (internal) labour markets may thus be seen as representing a configuration of ownership form and mode of coordination closer to (farther away from) the pole of pure private ownership and pure market coordination.

skilled manual (non-managerial) jobs in the market sector of the economy whose distribution by labour market types matters³⁷.

Before granting that infrastructural institutions (vocational training, collective bargaining, statues of labour, expectations of employers and workers, active labour market policies, etc.) should therefore conform to the logic of operation of the predominant labour market type, one must pose the question of whether this would not incapacitate the other type and thus result in a degree of institutional homogeneity that, while promoting short-term efficiency, endangers long term adaptability³⁸.

The answer to this question should differentiate according to how unambiguously workers of different crafts and occupations are separated from each other with respect to the types of labour markets their jobs represent, i.e., how segmented labour markets are in this respect³⁹.

1. Among crafts and occupations where this kind of segmentation is sharp – jobs belonging to them are associated unambiguously with this or that labour market type – the principles of operation of their respective labour market types can be expressed directly in the heterogeneity of the institutional infrastructure.

2. Yet, such a high degree of segmentation by occupation is an exception rather than a rule – at least among crafts and occupations we are primarily interested in. Part of those completing regular training and entering the labour force with a given qualification get employed, temporarily or lastingly, in the occupational labour market, others in internal labour markets. Would not an institutional infrastructure adjusted to the logic of the dominant type of labour market of a given occupation lead in that occupation to the incapacitation of the other labour market type and thus eliminate institutional heterogeneity?

True, mutually reinforcing interactions taking place between the dominant type of a labour market and an institutional infrastructure that conforms to it are such that they have an unfavourable impact on the costs

³⁷ It is by and large this range of jobs to which the comparison of the role internal vs. occupational labour markets play in Britain and France is confined in EYRAUD et al. *ibid.*

³⁸ Based on a wide selection of the relevant literature, GRABHER - STARK [1997] convincingly demonstrate the importance of organisational diversity in the evolutionary potential of economic institutions in general and under the conditions of post-socialist transformation in particular.

³⁹ For a review of the recent literature on labour market segmentation see MCNABB - RYAN [1989].

of operation of the non-dominant type (e.g., they impose excess costs of training, search, collective bargaining, etc. on those who would rely on it), inhibiting it from ever taking over predominance. Nevertheless it can subsist in its non-dominant position and thus contribute to the perpetuance of institutional heterogeneity in so far as its comparative advantages are large enough to compensate for these excess costs. (For instance, a firm can benefit from an internal labour market even in an occupational type institutional environment inasmuch certain individual characteristics of workers are of vital importance but can only be learned after long years of service, or as long as a low turnover rate is worth these excess costs for some other reasons.)

Although it might be redundant, I shall conclude my paper by noting that the concept of labour market type was used all along in the foregoing as a descriptive category devoid of any normative connotation. The reason I feel that such an ending is appropriate is twofold, namely: 1. I am afraid that the literature of labour market segmentation (or its loose reading) may make someone associate the concept of internal labour market with the positive notion of a submissive version of capitalism, or of the upper segment of the labour market, and the concept of occupational labour market with the negative notion of rough (wild) capitalism, or of the lower segment of the labour market, and see on this ground the preponderance of internal labour markets as a desirable goal in its own right⁴⁰. 2. My insistence on the formation of an institutional infrastructure adjusted to the logic of occupational labour market as a way to the flexibilisation of the Hungarian labour market may seem to be motivated by an opposite commitment: a predilection for unbridled competition of laissez-faire capitalism.

1. From the observation that poorly paid arduous jobs devoid of promotion prospects are located, as is emphatically stressed in the literature of labour market segmentation, primarily outside internal labour markets, it does not follow that it is the logic of operation of occupational labour markets *per se* that accounts for the accumulation of these unfavourable job characteristics. Suffice it to say that holders of some prestigious degrees of high market value view exactly occupational labour markets as the most suitable institutional setting for them to make a career. Realistically, both

⁴⁰ Ironically though, it is exactly internal labour markets where BARTLETT [1989] thinks employers have excessive negative (i.e., punitive) event power over their employees. (See his vehement refutation in Chapter 7 of the idea of regarding employment relation as a series of bilateral spot contracts with neither of the parties having any real authority over the other – an idea that was put forward in ALCHIAN–DEMSETZ [1972].)

types of labour markets have, as was pointed out incidentally in the preceding, right and wrong sides of distinctively their own.

A comparative advantage of occupational labour markets as against internal labour markets is that owing to the more flexible adjustment of employment to production fluctuations, economic recessions are less likely to involve falling productivity and deteriorating international competitiveness. Furthermore, job losses are less likely to result in long-lasting unemployment, and if only for this reason an early acceleration of wage inflation is less of a danger in a later recovery. At the same time occupational labour markets have the comparative disadvantage of an inferior working morale, and a stronger resistance to technological innovations that entail large-scale modifications in the skill requirements of an occupation. These are less of a problem in an internal labour market, given the possibilities of workers' internal promotions, reallocations and retraining. Or, owing to low separation costs, workers employed in an occupational labour market can quit with ease if they are made a better job offer but can be laid off with ease as well. In an internal labour market, by contrast, workers enjoy higher job security and more calculable career prospects but at the price of facing substantial losses if it comes to dismissal.

More important than going further with the enumeration of the right and wrong sides of the respective types of labour market is from the viewpoint of our topic to emphasise that, on one hand, their comparative advantages can only unfold in an institutional environment that fits their particular logic of operation; otherwise their advantages remain latent and only their disadvantages become apparent. On the other hand, no such thing can exist like a labour market that would be characterised by the comparative advantages of either of the two types untinged with their disadvantages, i.e., one that would combine the respective advantages of both. To be sure I do not mean to say that their unfortunate effects cannot be restricted. Active labour market policies should serve for exactly this purpose – but again as themselves coming within the institutional infrastructure of the labour market they should comply with the requirements of institutional coherence in order to be effective.

2. Granting that neither of the two types of labour market is superior to the other in terms of their social and/or economic impacts, why do I favour the emergence of an institutional infrastructure that would conform to the logic of occupational labour markets? After all I could start out from the assumption that, facing an institutional infrastructure seemingly inconsistent with the logic of operation of occupational labour markets,

employers will increasingly resort to building up their own internal labour markets, with the result that the present anomalies of the disrupted institutional balance of the Hungarian labour market will gradually be eliminated spontaneously.

Sure my position is dictated by neither a concealed taste for occupational labour markets, nor even my rejection of the above assumption as for the time being unrealistic. Instead, it is based on a confrontation of the above described comparative advantages and disadvantages of the respective types of labour market, and the lessons that were drawn in the equilibrium unemployment literature after the oil price shocks, with my diagnosis of the overtly excluding character and inflexibility of the Hungarian labour market. This confrontation suggests to me – and this is what I tried to demonstrate throughout my paper – that considering the urgency of a marked reduction of wage inflation as a condition of any sizeable expansion of waged employment (this latter being in turn, as was pointed out, a necessary condition of small-businesses embarking on the road to modernisation), it is the predominance of occupational labour markets that promises a smoother way to economic development *here and now*.

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