Chapter 3
Mechanisms and Hypotheses

3.1 Introduction

The previous chapter reviewed three theories that dominate the research field about network effects in labor markets. The purpose of the review was to find theories that help to answer the second and third research questions posed in this book, namely whether good jobs can be found using personal contacts, and whether this effect of personal contacts is due to particularism or intensive search. Our conclusion was that the reviewed theories are not sufficient to answer the third research question because observable contact effects can be attributed to both particularism and intensive search.

This chapter explores the implications of particularism and intensive search for the relationship between contact effects and labor market outcomes. I will consider two characteristics of contact persons – status and employee referrals – that are often found to affect labor market outcomes. Our objective is to find a procedure which enables us to draw inferences about the existence of mechanisms from observed contact effects. Similar to the logic of crucial experiments, additional hypotheses are singled out which can differentiate between competing explanations. First, hypotheses are formulated that can differentiate between intensive search and particularism when contact status effects are observed. Then, I formulate hypotheses that can differentiate between the two mechanisms when employee referral effects are observed.

3.2 Explaining the Effects of Contact Status

PARTICULARISM

The implications of particularism for contact effects can be derived on the assumption that institutions constrain particularistic selection. According to organizational theories and empirical research, bureaucratization, i.e. the use of standardized procedures and achievement criteria, undermines the influence of ascriptive factors by reducing subjectivity in personal decisions (for an overview, see Reskin and McBrier 2000). The reason is that personnel managers or personnel departments are interested in using formalized selection and the employers' potential deviation from meritocratic procedures would create conflicts within the firm (Pfeffer and Cohen 1984). There is some empirical evidence that personnel departments
have an influence on the use of hiring practices (Cohen and Pfeffer 1986, Marsden and Campbell 1990, Marsden and Gorman 1999). If personnel departments are able to constrain the behavior of employers, it is reasonable to assume that personnel departments can also constrain the allocation of jobs to newcomers and the setting of wages.

The application of these ideas to the Hungarian context assumes that employees of personnel departments in Hungary are interested in and have sufficient power to enforce meritocratic selection. To my best knowledge, there is no available literature about the actual working of personnel departments in Hungary. Indirect evidence about the working of personnel departments can be obtained by studying the relationship between meritocratic selection and personnel departments. If personnel departments enforce meritocratic selection, then they are likely to increase the chances that job seekers were carefully screened before they got the job.

These arguments imply the following hypothesis:

**Organizational Conflict Hypothesis** *Conditional on the positive effect of personnel departments on screening, the returns to contact status in terms of earnings or receiving a job offer are lower in firms where personnel departments exist.*

**INTENSIVE SEARCH**

In many studies, the theory of employee referrals was used to elaborate the intensive search problem. Our review of social resources theory indicated that the effect of contact status might also be interpreted in terms of intensive search. This subsection is devoted to hypotheses which can differentiate between these competing accounts.

To develop the implications of intensive search for contact status effects, I make use of the matching model of Jovanovic (1979, 1981). Note that a new interpretation will be attached to some parameters of the model. The model is presented in a compact form in Appendix 1. Here I restrict myself to a non-technical exposition. After explicating the relation of the model to the intensive search problem, I show how the theory of employee referrals can be derived from the matching model and an ancillary assumption. Then I modify the ancillary assumption so that it is consistent with the idea that contact status effects are based on the intensive search mechanism.

Consider the following scenario. Employers face the problem of detecting the quality of the match between the job and an applicant. In an open labor market where all job seekers and employers could meet, employers learn about job seekers via observing their education. In actual labor markets, access to individuals depends on the search channel used. Recruitment channels create a prior expectation about match quality because a particular channel is used by a relatively homogeneous group of people. Informal contacts, in general, and employee referrals, in particular, are especially successful in creating such a homogeneous pool. A homogeneous pool is, however, valuable when the average quality of this pool is satisfactory.
In a world where personal contacts would exist between individuals with the same productive skills, employers who are satisfied with their employees could hire the friends of their workers without any screening effort. Observing educational qualifications would not provide new information. If, however, personal contacts were established independently of productive abilities, employee referrals would create an extremely heterogeneous pool of applicants. Thus, the prior expectations about the quality of applicants are practically useless and employers have to learn about match quality by observing the educational qualifications of the applicant. In reality, there is some correlation between the similarity of productive abilities and the existence of personal contacts, thus employers should take both prior expectations and educational qualifications into account.

The lesson is that similarity of productive abilities between the contact person and the applicant has a positive impact on employers’ evaluation of the productive skills of the applicant, provided the average quality of the currently employed workers is good. It is assumed that the quality of the workforce is good (otherwise employers would not rely on referrals). Therefore, the similarity of productive abilities increases employers’ estimate of match quality (see also Appendix 1.1). The theory of employee referrals assumes that referrals produce a homogeneous pool of applicants. Assume further that wages are related to estimated match quality. Taking these results together, employee referrals increase the value of wage offers. This result is theory of employee referrals.

A new result can be obtained if the conditions that affect the average quality of applicants are examined. Employers believe that the quality of applicants will be high if they believe that their employees are not interested in referring bad applicants. The theory of employee referrals and social resources theory suggest different factors which make employers believe in the sincerity of contact persons. In the theory of employee referrals, paying efficiency wages generates trust in employees. Contrary to this, social resources theory implies that the employer’s trust in the contact person is based on status. Therefore, we can expect that

**Status Hypothesis** The returns to employee referrals in terms of earnings or the probability of receiving a job offer increase with the status of the contact person.

Note that the hypothesis can be applied to the study of earnings and the likelihood of receiving a job offer, conditional on having applied for the job. The matching model assumes that employers are free to set wages on an individual basis. In reality, employers do not always set wages on an individual basis due to collective wage agreements or to internal labor markets. If employers are not able to set wages on an individual basis, then employers offer the job to the applicant with highest match quality.
3.3 Explaining the Effects of Employee Referrals

As mentioned in Section 2.3, the theory of employee referrals is consistent with both the insider–outsider version of particularism and with intensive search. A hypothesis that can distinguish between the two mechanisms can be derived from an analysis of how employers can trade off the various components of labor costs. Referral systems can be related to particularism only if the interpersonal relations between current employees and newcomers have implications for the training and turnover of newcomers (otherwise employees have no power) and it is easy to monitor performance (monitoring is necessary since employees cannot be fully trusted). Under these conditions, referrals help to keep training costs and costs associated with turnover low, while referrals cannot substitute for monitoring costs. Note that under particularism employers save screening costs since, due to the insider power of employees, they do not screen prospective employees carefully. Therefore, under particularism, employers will not screen the applicants, but they will carefully monitor their employees.

The intensive search mechanism implies the opposite: careful screening and low efforts to monitor employees. To see this, consider the employers’ problem of picking up the best applicant under the intensive search problem. Since the problem of employers is detecting the qualities of applicants, the aim of picking up the best applicant often implies that the vacancy is open for a long time. Employers can balance labor costs by cutting monitoring costs. In short, if prospective employees are not supervised closely, employers can spend considerable resources to screen the applicants.

This argument is not new. It was argued that the situation where employees are not supervised but they are carefully screened describes applies to relatively high status positions. Monitoring costs are absent when employers trust their employees, and the employment relationship is explicitly based on the idea of mutual trust. Emphasis on trust is inconsistent with supervising since supervision would be perceived by employees as not being trusted, and this perception would undermine their commitment to the firm (Frey 1994, Baron and Kreps 1999). Recent developments in class theory (Erickson and Goldthorpe 1992, Evans 1992) suggest that trust-based employment relations are typical for high status jobs. Demand for trust is higher in these jobs because competence is difficult to evaluate, and doing the job well involves substantial autonomy. Uncertain competence evaluation and autonomy facilitate the building of the employment relationship on the basis of trust, on the one hand, and the use of referrals, on the other (Dornstein 1977). This argument was generalized: employers rely on informal methods when the damage potential of employees is substantial (Boxman 1992).28

To summarize, the intensive search account implies that monitoring costs are very high, which justifies large investments in finding a good applicant. In short, under the intensive

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28 See also Barron et al. (1987) for an earlier argument that hiring bad workers have serious consequences in jobs where the capital/labor ratio is high.
search mechanism, the use of referrals is an *ex ante* safeguard to avoid bad applicants. If this is so then employee referrals are used as additional screening devices. This does not contradict the argument that referrals reduce the costs of screening since referrals might be cheaper than formalized screening devices like ability tests. The insider–outsider version of particularism assumes that employees have control over hiring decisions. Therefore, referrals cannot be used as *ex ante* safeguards, hence employers invest in monitoring rather than in screening. Under particularism, referrals lead to the use of *ex post* safeguards.

The implications of intensive search mechanism for screening and supervision are expressed in the following hypothesis:

**Trade-off Hypothesis** *People who got their job through an employee referral were more carefully screened and are less often supervised than people who found the job through other sources.*

Note that the particularism account implies that employee referrals should increase the amount of monitoring and decrease employers’ screening activities.

Next to the analysis of the trade-off between ex-ante and ex-post safeguards, there is another approach to our problem. If intensive search is the underlying mechanism, employers face the problem of detecting the quality of the match between the job and the employee. As we have seen in the previous section, educational qualifications and the method of match provide information about the quality of the worker-job match. Since production also provides information about productivity, learning about the match quality continues after hiring. The matching model of Jovanovic (1979, 1981) is useful to explore the implications of employers’ observation of production for employee referral effects. The argument is presented in a compact form in Appendix 1.2.

When production takes place, employers can learn more about the quality of match. However, the amount they will learn depends on the precision of their prior expectations. If employers knew the productive abilities before they hired the applicant, they would learn nothing after hiring, hence their estimate of match quality remains relatively stable over time. Contrary to this, low precision of prior expectations create opportunities for learning about the worker, which, in turn, leads to relatively large increase in estimated match quality. In short, matching methods that produce precise expectations about applicants hinder the growth of earnings. Since precise prior expectations lead to better jobs, a counter-intuitive result is obtained: earnings advantages that are due to prior precise expectations become smaller or eventually disappear with job tenure. Since the precision of prior expectations depends on the use of employee referrals, the following hypothesis is implied.

**Earnings Dynamics Hypothesis** *Getting a job through employee referrals has a negative impact on the rate at which earnings are growing.*
This hypothesis expresses the implications of the intensive search mechanism. Note that particularism implies no decreasing returns over time. Particularism might imply the opposite: with the help of the contact person, the newcomer will be promoted earlier than their counterparts, or the increase in their salary will be relatively large.

### 3.4 Summary of the Hypotheses

This chapter developed hypotheses that can explain observed contact status and employee referral effects. Our aim was to be able to distinguish between particularism and intensive search. To achieve this goal, four additional hypotheses were derived. Given the hypotheses, the explanation of contact effects can proceed as follows. First, observe whether contact status or employee referrals help people to find a good job. If contact status has such an effect then test the organizational conflict and the status hypotheses. If the organizational conflict hypothesis turns out to be true, we have particularism; if the status hypothesis turns out to be true, we have intensive search. If employee referral effects are observed, test the trade-off and the earnings dynamics hypotheses. If these hypotheses are confirmed then we have intensive search; otherwise, particularism is operating. Table 3.1 summarizes this strategy in a compact form.

**Table 3.1**  
_Hypotheses in order to explain contact effects (\(? = \text{no particular expectation})_

<table>
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<th>Observed contact effect</th>
<th>Name of the Hypothesis</th>
<th>Expectation under</th>
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<td></td>
<td></td>
<td>Particularism</td>
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<tr>
<td>contact status</td>
<td>Organizational Conflict</td>
<td>?</td>
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<tr>
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