

SOURCES OF STRUCTURAL INEQUALITY IN MANAGERIAL LABOR MARKETS

Rakesh Khurana and Mikołaj Jan Piskorski

ABSTRACT

This article proposes two mechanisms that allow actors to obtain unearned advantages in labor markets. The first mechanism is consistent with collusive closure arguments. However, it questions the assumption that those who seek to benefit from collusive closure will always initiate it. Instead, it suggests that under certain cultural conditions, closure may arise through a series of self-reproducing social constructions that restrict access to a position to those who conform to certain socially defined criteria. The second mechanism is consistent with Sørensen's discussion of the role of composite rents in generating unearned advantages. Whereas Sørensen focused on composite rents between actors and productive assets, the mechanism presented here suggests that actors can obtain unearned advantages even if workers are not specific to productive assets, as long as there are composite rents between these productive assets. Data in support of the models are provided from the executive labor market.

INTRODUCTION

If there is one characteristic that forcefully distinguishes sociology from other social sciences, it is the differentiation between an actor and an actor's position

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in the social structure (Simmel, 1950). Central to this distinction is the claim that rewards are attached to positions rather than to actors' performances. Thus, inequality between actors is generated by occupation of different positions and is largely independent of their efforts or resources (Sørensen, 1990, 1994). This line of reasoning forms the cornerstone of structural explanations of earnings inequality and stands in a marked contrast to individualistic theories, which postulate that actors are rewarded mainly on the basis of their individual resources (Coleman, 1990; Parsons, 1953).

The usefulness of structural explanations of inequality critically depends on the process of allocation of actors to positions (Sørensen, 1990). If actors are accorded a privileged position as soon as they possess appropriate resources, or lose it as soon as they lose their resources, positions reflect nothing more than the resources of the incumbent. In these circumstances, we can fully account for observed inequality by examining actors' resources. The fact that rewards are attached to positions gives us little theoretical insight into the sources of inequality (Granovetter, 1994). In contrast, when actors retain their privileged positions despite a loss of valued resources, or are unable to attain them despite possession of appropriate resources, structural advantages or disadvantages can occur. As incumbents obtain payments in excess of what is required to attract another occupant to that position, Sørensen (1996) suggested that these positional advantages represent rents. These rents are received at the expense of those actors who are unable to attain the position despite possession of appropriate resources.

Given the critical role of allocation processes to the emergence of structural advantages and disadvantages, social scientists have long sought to identify conditions under which such processes emerge in a number of social contexts (Parkin, 1979). Such analyses date back to Smith's (1776) discussion of collusive social relations in markets whereby actors seek to create artificial restrictions on the supply of available actors or supply of available positions. These collusive relations are often institutionalized through political institutions, professional societies or even caste systems (Weber, 1947). Once established, these institutions dictate that potential occupants of privileged positions must possess social or physical attributes of the dominant group or face exclusion. This exclusionary strategy allows the dominant group to secure for itself certain resources and advantages at the expense of other groups. Empirical research in settings as broad as inequality in income in the economy as a whole (Weeden, 2002) or as specific as venture capital (Piskorski & Anand, 2003) lends significant empirical support to the importance of collusive closure in generating structural inequality.

Whereas the collusive closure explanation presumes that structural advantages and disadvantages will appear only once power subverts the efficiency logic,

Sørensen argued that under certain conditions structural advantages and disadvantages could emerge even if actors seek to maximize efficiency gains. Specifically, he focused on the role of composite rents between actors and positions and the emergence of internal labor markets. Composite rents exist when two separate resources are so specific to each other that the benefit from their joint use exceeds the combined benefits from the separate use of each resource (Marshall, 1948). For example, composite rents between actors and assets arise when workers obtain specific on-the-job training and therefore are more productive in one firm than in another. Although both the employer and the employee would benefit from such investments, they first need to overcome significant incentive problems (Kahn & Huberman, 1988). A worker acquires skills only if there is a promise of a higher wage for doing so. However, the employer has an incentive to claim that the worker has not acquired these skills even when he in fact has, in order to save on wage costs. As the firm has an incentive to renege, the worker has no incentive to acquire the specific skills. To solve this problem, a firm can commit to a labor contract which attaches wages to different tasks, rather than to individual worker performances (Prendergast, 1993). In this case, a worker can be rewarded for skill acquisition by promotion to another job. The promise of reward through promotion, rather than through wage, gives rise to internal labor markets.

Although the creation of internal labor markets appears to be an efficient solution to contracting problems in the presence of composite rents, Sørensen (1994) argued that it had significant implications for earnings inequality between actors. Once internal labor markets are established, closed employment relationships emerge with vacancy chains replacing market allocation process (Sørensen, 1996). Since advancement in vacancy chains is driven by the availability of positions and actors' positions in the system (Sørensen, 1974; White, 1970), and not necessarily by an actor's performance in the position, actors may be allowed to occupy a position even though their performance or qualities do not justify it. Similarly, other actors may be prevented from occupying a privileged position, even though they possess appropriate skills or resources, because that position is not open to competition. Consequently, certain positions in a vacancy chain may give their incumbents a structural advantage or disadvantage.

In this article, we propose two additional mechanisms of allocation of actors to positions that generate positional inequality. The first one, proposed by Khurana (1998), is aligned with the view that traces the sources of positional inequality to collusive closure. However, in contrast to earlier arguments, Khurana questions the assumption that collusive closure will always be initiated by those who seek to benefit from it. Instead, he argues that under certain cultural conditions, closure may arise through a series of self-reproducing social constructions that restrict

access to a position to those who conform to certain socially defined criteria. The second model, proposed by Piskorski (2001), is consistent with Sørensen's model in that it seeks to explicate causes of structural advantages and disadvantages that are consistent with economic notions of efficiency. Whereas Sørensen traced structural inequality to composite rents generated by the relationship between workers and productive assets, Piskorski endeavors to show that structural inequality can emerge even if workers are not specific to assets. As long as occupation of a position requires an actor to work with two or more assets that are specific to each other, the process of allocation to such positions will generate structural advantages and disadvantages.

We find significant empirical support for both of our models in the context of labor markets for top executives. As we discuss in the conclusion, our evidence has broader implications for the understanding of inequality in external labor markets. Most accounts of external labor markets suggest that there should be no unearned advantages or disadvantages in these markets. This is because if anyone offered a wage below marginal productivity for occupation of a position, then it would always be profitable for another actor to offer a higher wage. Similarly, if anyone demanded a wage above his or her marginal productivity for occupation of a position, then it would always be profitable for another actor to demand a lower wage. Competition between the two classes of actors ensures that wage is equal to marginal productivity and there are no unearned advantages or disadvantages. However, our models show that under a set of specific conditions structural advantages and disadvantages can be present even in external labor markets. The presence of unearned advantages in such markets flies in the face of today's uncritical faith in markets as a mechanism for achieving such socially desirable goals as equal opportunity based on open competition, or advancement on the basis of merit.

LEGITIMACY CONSIDERATIONS AND CEO SUCCESSION

Collusive closure has long been held to be the primary mechanism through which certain actors secure advantages at the expense of others. Central to this explanation is the assumption that those who will benefit from the closure will seek to engage in collusive behavior. However, Khurana's research highlights that neither such pernicious motivations nor the implied solidarity among the selecting group is required for market closure. Instead, closure can emerge when those who control access to positions must respond to the interests and scrutiny of a number of constituencies, who seek to make sure that the selection of occupants of positions is legitimate. In these circumstances, a social matching process emerges and applies

a “legitimate, taken-for-granted and rational” set of principles in identifying and sorting candidates for the position.

As documented by Khurana’s research on the role of directors in the CEO search process, these legitimacy concerns are particularly acute in the external CEO market. There are two interconnected factors that elevate the board members’ concern with legitimacy, leading to the social matching mechanism and consequent structural inequality. The primary reason for board members’ concern with legitimacy is that the external CEO labor market is not a “market” in the ordinary sense. It is not even like the market for other executive positions. Instead of a perfect market with a large numbers of buyers and sellers engaged in relatively anonymous exchange, there is a small market in which buyers and sellers are few. Instead of principals directly transacting with agents, there is a disconnect between the interest of principals (shareholders) and their agents (directors). Instead of a low-risk transaction in which all the necessary information is freely available and widely circulated, there is a significant lack of information about potential candidates and about the position itself. Thus, the question of who is ultimately chosen depends, in part, on whether a firm’s board can gather detailed information about potential external candidates.

The second reason for the board’s concern with legitimacy in an external CEO search is the weakening of the boundaries between firms and markets. Choosing a new CEO is no longer considered a divine right of the incumbent or even of the board. In the past, the CEO or the board chose the successor through peer review on the assumption that people who have been in positions of leadership should decide who should run the corporation. Today, by contrast, it is increasingly treated as an event in which external constituencies have a strong interest and where they have a right to influence the outcome. These external constituencies – namely, shareholders, the Wall Street analysts and business journalists who claim to represent their interests – now constitute a recognized key constituency for most organizations. Investors, and especially institutional investors, increasingly rely on the judgments of these audiences when making investment decisions (Zuckerman, 1999). In these conditions, the best searches serve to legitimate both the search process itself and the final choice of the search committee and board, so that a new CEO can have a smooth transition into the position. Missteps during the search process can leave organizational observers and constituents alike seething about the search and hostile to its outcome. The search ends up an abysmal failure, not because the wrong candidate was selected, but because the mishandling of the process handicaps someone who may have been right for the organization. Both internal and external constituents, because of the manner in which the process was executed, may reject the outcome of a search that may have been appropriate from a strategic perspective.

ACHIEVING LEGITIMACY THROUGH THE SOCIAL MATCHING PROCESS

The context of difficulty in information gathering, as well as concern with the perceptions of external stakeholders, interacts with the structural nature of the external CEO labor market to close this market to all but a small number of candidates. Specifically, the process leads to a social matching approach toward identifying candidates. Social matching is a filtering process that takes place when individual and organizational actors are confronted with selections that are difficult to make because limited information hampers their ability to reliably distinguish one from another. Social matching leads to a closed CEO labor market because directors seize upon one or more externally identifiable characteristics of potential candidates to construct a narrowly defined candidate pool.

The term social *matching* has its roots in a study of the careers of school superintendents (March & March, 1978). Using data on one state's school superintendents, the researchers found that most of the superintendents were nearly indistinguishable across a range of criteria, including behaviors, career paths, credentials, and prior performance evaluations. Drawing on social psychological research on decision-making under uncertainty, the researchers' explanations for this lack of variation was that when matching individuals to jobs, organizational decision-makers relied on socially defined criteria or social matches – such as certification or adherence to an institutionally legitimate career – when matching individuals to jobs. In an external CEO search, agreement on which social criteria are most important is evidenced by an overwhelming consensus in favor of three observable standards: the candidate's current position; the performance of the candidate's current firm; and the status of the candidate's current firm.

Position Matching

Like most paths to power and status in established organizations, the path to the CEO position combines selection and socialization to ensure that a person occupying this position will act in an appropriate manner. Useem's (1984) study of corporate executives highlighted that most corporate chieftains move either horizontally or vertically through a similar career path. They arrive in the executive suite after a series of selection processes lasting years. Socialization, self-selection, and filtering significantly reduce the variability of plausible candidates. Difficulties in assessing performance due to limited information and impression management increase the difficulty of selecting among them. Because differences among plausible candidates are likely to be small, similar candidates may appear to

be different, and different candidates may appear to be similar. One empirical consequence is that firms choosing a CEO from outside the firm will more likely select external CEO candidates who have already been in top positions at other firms. In fact, 75% of new CEOs in the Standard and Poor 500 companies from 1990 to 2000 were either CEOs or presidents of the firms from which they originated.

Performance Attribution

Not only are plausible candidates likely to be similar in terms of experience, but they are likely to be similar in terms of their perceived effectiveness as well. The problem of discriminating among such candidates has been referred to as “selecting at the right tail” – that is, the extreme right-hand portion of the bell-shaped normal distribution curve. Most such candidates will be well qualified. It is possible that there will be speculation as to how the fortunes of the firm will vary based upon which candidate is selected. But the differences among candidates are usually so small, and the effects of external factors so large, that it is rarely possible to predict *ex ante* the performance consequences for the firm of selecting among the top candidates. In fact, dozens of academic studies have found that the relationship between leaders and organizational performance is at best tenuous and at worst non-existent. Despite the lack of conclusive evidence linking leadership to organizational performance, several scholars have noted the strong cultural, social, and psychological forces that lead to the attribution of organizational performance directly to individual leaders. As a result, [Khurana \(1998\)](#) finds, in choosing among external CEO candidates, firms attach great value to observable performance metrics in making their selection decision. Consequently, firms choosing a CEO from outside select external CEOs from firms that have positive performance.

Status Matching

The process that generates the selection in favor of individuals with prior experience as CEOs and associations with high-performing firms raises the question of whether boards are simply acting on the best information they have available. Yet if this were so, the issue of the status of a candidate’s current firm would not loom nearly so large as it does in an external CEO search. Prestige is, in fact, particularly important in CEO searches, and search committees see the status of the institution that a candidate comes from as potentially amplifying or reducing the status of their own firms. Similarly, candidates for CEO positions see the status of the potential employer as a source of their own status and hence

are unlikely to choose to head organizations of lower status. Consequently, both searching firms and candidates can plausibly consider only a match that maintains, or preferably increases, their reputations, and this mutual interest in reputation enhancement sets constraints that severely limit the positions to which candidates can aspire, and which vacancies appear attractive to potential candidates. Thus there is a process of self-selection that serves to limit the participants in a search. There should be little overlap, for example, between candidates considering jobs at low-reputation firms and those seeking positions at high-reputation firms. As is revealed by using a [Bonacich \(1987\)](#) centrality measure for firm status measured through director interlocks, 80% of outsider CEOs in the S&P 500 were coming from firms of similar or higher status.

IMPLICATIONS FOR STRUCTURAL INEQUALITY

Considered as either a process for filling vacancies or one for advancing careers, the external CEO search appears at first glance to offer almost unlimited opportunities for identifying candidates. However, the social matching process that lies at the heart of an external CEO search is likely to produce candidates who have passed through a series of promotional filters and who have been extensively socialized in institutions similar to the ones at which they are candidates to become outsider CEOs. Because of this, directors of searching firms are likely to find that those individuals who end up in the pool of candidates judged to merit serious consideration are quite similar to one another when it comes to the characteristics believed to be most important for the CEO position. It is true, of course, that each candidate is different from the others in certain respects, and that there will be a wide range of personalities, temperaments, and leadership styles evident among them. But compared to the important ways in which candidates who make it into the pool of finalists are similar, the consequences of these differences may be marginal.

The closure process in the CEO labor market has direct implications for rent-extraction. Because the corporate elite form a distinctive and identifiable network, they control valuable resources that support network activities such as continual recruitment from a restricted set of individuals. Moreover, such restrictions are subsequently supported through an extensive set of beliefs and practices that sustain network control of the resource. These restrictions, in turn, generate rent-extracting opportunities. In the case of the CEO labor market, these rent-extraction opportunities present themselves in the CEO compensation process. Because boards of directors are notoriously social organizations, where the goal is not to maximize profits but to avoid personal embarrassment while maintaining social cohesion within the board and the larger corporate community,

directors do not drive a hard bargain when negotiating CEO pay. For directors, it is simply bad form to nitpick over a couple of million dollars with another member of the group, particularly one who helps set director fees or serves on the compensation committee of other corporations. Moreover, boards often legitimate the compensation of their CEOs by hiring a compliant executive compensation consultant and then arguing that the pay is set in an arm's-length market transaction. One implication, then, is that executive compensation would have a weak relation to firm performance and result in a pay-setting process that is economically distortive. Recent corporate scandals around CEO pay levels and corporate disclosure practices suggest this may be true.

THREATS FROM THE MARKET FOR CORPORATE CONTROL

The foregoing discussion of the external search for executives clearly indicates that executive succession is heavily constrained by legitimacy concerns, which restricts access to only a few legitimate candidates. Although these access restrictions are enforced by boards of directors, and not executives themselves, they allow executives to reap benefits that would otherwise be dissipated by more equal competition for executive positions. However, the initiation of the executive succession process is not restricted only to the boards of directors. Executives and boards of directors also have to reckon with a powerful market for corporate control that can quickly eradicate any collusive efforts at closure.

In the market for corporate control, managers compete for the right to control organizations on behalf of shareholders. These managers look for profitable opportunities to assume the management of organizations. When the stock price of a company is high, it is unlikely that contesting managers can profit from replacing the incumbent managers. In contrast, such an opportunity is present in poorly managed firms, whose market value is low. Once the opportunity is identified, the contesting managers launch a takeover bid by offering to buy, at a premium, the stock held by the firm's shareholders. Although the firm's board members and incumbent managers can resist the takeover, shareholders are the sole decision makers (Walking & Long, 1984). The incumbents can only affect the outcome of a takeover bid by proposing a counter offer that would result in greater financial benefits for shareholders. Such an offer could in turn elicit a counter-offer from the hostile bidder. The whole process leads to a price contest between incumbents and contestants for the right to control the firm. As shareholders decide whether to change the control of the firm largely on the basis of the outcome of this contest, the whole process resembles an efficient market for corporate control in which control

over assets is allocated to those who value them most (Manne, 1965). Thus, the market for corporate control can be thought of as a mechanism for competitive allocation of managers to organizations.

The operation of the market for corporate control in the 1980s formed a particular threat to the entrenched process of executive selection. Prior to the 1980s, managerial social networks, reputations, and class interests played an important role in the incidence of takeovers (Zeitlin, 1974), leading to unequal exposure of firms to the market for corporate control (Marris, 1964). Firms managed by the members of the inner circle of the corporate elite were unlikely to receive a takeover bid, while other firms did not enjoy similar protection (Palmer et al., 1995). However, changes in corporate governance in the 1980s erased these differences. Developments in the financial industry allowed outsiders to secure short-term debt financing through junk bonds or other financial vehicles to complete the takeover (Baker & Smith, 1998). These changes removed financial constraints on these outsiders and allowed entrepreneurial firms and individuals to bid for the corporate control of firms (Jensen, 1993). The Supreme Court also lessened state laws limiting takeovers (Edgar vs. MITE, 1982), allowing outsiders to undertake even the largest deals. The increase in the number of potential participants in the market for corporate control – groups that had little reverence for the existing corporate pecking order (Hirsch, 1986) – eradicated the protective elements of the intercorporate social structure. In fact, empirical research on the topic suggests that in the 1980s neither size (Morck et al., 1988) nor connections to other large corporations or to banks (Davis & Stout, 1992) were likely to protect a firm from a hostile takeover bid.

The foregoing discussion suggests that the market for corporate control in the 1980s presents itself as a competitive arena where actors are matched to positions on the basis of performance, and with little regard to the social processes surrounding executive succession. However, against this general trend, Piskorski (2000) observed that numerous large American corporations avoided a hostile takeover bid, despite their poor performance. In fact, in apparent defiance of the prevailing climate that forced the great majority of organizations to increase shareholder value or face a hostile takeover, executives of certain organizations engaged in a set of value destroying strategies as if they considered themselves immune to a takeover. Such actions supported the managerial agendas and represented a rent transfer from shareholders to the managers.

COMPOSITE RENTS AND ALLOCATION OF ACTORS TO POSITIONS

In order to explain the apparent ability of certain actors to derive rents from their positions in this very competitive environment, Piskorski (2001) followed

Sørensen's footsteps and re-examined the effect of composite rents on the process of competitive allocation of actors to positions. Sørensen focused on composite rents derived from the relationship between actors and assets, such as those that emerge when workers have obtained specific on-the-job training. In contrast, Piskorski examined the role of composite rents between two non-human productive assets. These rents emerge when two firms tailor their investments to the exchange of goods and services they plan to undertake with each other. The main difference between the two types of composite rents lies in the solution to the problem of bargaining over the composite rent. In the case of composite rents between actors and assets, the internal labor market provides the solution. When composite rents between assets are present, a substantial amount of economic literature suggests that assets should be integrated and that one actor should be given control rights over both. Integration avoids costly bargaining between autonomous actors, as the single actor resolves the bargaining problems by fiat (Williamson, 1981). Piskorski (2001) has developed the implications of this basic economic observation for the process of allocation of actors to positions in labor markets. He argued that from a labor-market perspective, asset integration is akin to creating a position in a labor market in which the occupant of the position has to be capable of simultaneously managing two assets. As discussed in the model below, occupants of such positions are unlikely to be replaced following a decline in performance, leading to the development of positional advantages.

The model examines allocation of actors to positions in which contestants for a position replace the incumbent when they can offer higher performance at the same cost. Essential to the model are two assumptions. First, the model assumes that the probability of finding a generalist simultaneously capable of working with two assets is smaller than the probability of finding a pair of specialists, each of whom is capable of providing the same performance with one of the assets. Second, the incumbent of a position can be replaced either by a generalist, who occupies the entire position. Alternatively, the incumbent is replaced by a pair of specialists, in which case, the position is divided into separate components, each with control over a particular asset. This process of competitive replacement of incumbents of a position by generalists and specialists is consistent with widespread incidence of "bust-up" takeovers, events in which multi-business-unit firms were split into separate business units following a takeover (Davis et al., 1994; Davis & Stout, 1992). Empirical data for the 1980s suggest that following a takeover, approximately 80% of firms were quickly restructured, with numerous divisions sold off (Jensen, 1989). In practice, bust-up takeovers could take two forms. Consider, for example, a firm with two business units, one in forestry and another in paper production. In one form of the bust-up takeover, an arbitrageur, such as Carl Icahn, could launch a bid for a company after having secured buyers for its constituent parts, and without any intention of managing the firm after

takeover (Lipton & Steinberger, 1988). Once the bid was successful, the company was split apart and sold to specialists, with one acquiring the forestry business unit and the other the paper-production operation. In an alternative form of such a takeover, one of the two specialists could act as the arbitrageur. In this case, the specialist would launch a takeover bid for the firm as a whole. After the takeover was complete, the successful bidder would sell the unwanted business to the other specialist. Despite the differences in the actual mechanics of the takeover, in both cases a set of specialists would replace the incumbents.

The model is best explained by a stylized example of allocation to high-composite-rent positions and low-composite-rent positions, as illustrated in Fig. 1. In the figure, the dots represent different assets, while the dotted lines represent the boundary of a position. The width of the line between the dots represents the existence of composite rent between assets. Thus, there is no composite rent between assets associated with the position on the left-hand side. In contrast, there is substantial composite rent between assets associated with the position on the right-hand side. I assume that the composite rent amounts to 1 unit of performance. This rent would be lost if the position were separated. Each asset within the position has a queue of specialist contestants. Each contestant can provide different level of performance if they could control the asset. In the figure, I illustrate this condition with contestants A' and B', who can each deliver 1 unit of performance if given control over one of the two assets in the position, and contestants A'' and B'', who can each deliver 0.5 units of performance if given control over one of the two assets in the position. The incumbents of both positions are performing at 2.

For occupants of both positions, the process of replacement by a generalist is the same. A generalist contestant will replace the incumbent as long as the generalist contestant can perform better in that position than the incumbent for the same reward. In contrast, the replacement by specialists differs across the two positions. In order to replace the incumbent of the position with no composite rent, the contestants have to be able to perform at least at the incumbent's level. The only combination of contestants capable of reaching this level is A'B'. Each of them can perform up to the level of 1 with their asset, so the sum of their performance is 2. They can separate the position and each of them can manage one of the assets separately. The replacement of the incumbent of the position with substantial composite rent between assets, whose performance is also 2, is more difficult. Contestants have to be able to perform better than the incumbent in order to compensate for the costs imposed by the separation. Thus, the total performance of contesting specialists has to be at least 3. Since there is no combination of specialist contestants capable of delivering this performance, the incumbent is safe from replacement under these circumstances. In this example, the only threat of replacement for this incumbent comes from a generalist contestant. Thus, for

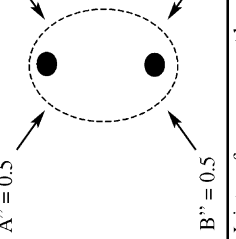
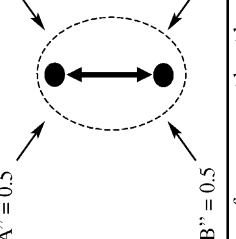
	<p>Low Composite Rent Position No Cost of Separation</p>  <p>$A'' = 0.5$ $A' = 1$ $B'' = 0.5$ $B' = 1$</p> <p>Joint performance must be at least 2 <i>Possible combinations of replacements:</i> $A'B'$</p>	<p>High Composite Rent Position Cost of Separation = 1</p>  <p>$A'' = 0.5$ $A' = 1$ $B'' = 0.5$ $B' = 1$</p> <p>Joint performance must be at least 2+1 <i>Possible combinations of replacements:</i> none</p>
Performance of Incumbent = 2	<p>Joint performance must be at least 1 <i>Possible combinations of replacements:</i> $A'B'$, $A''B'$, $A'B''$, $A''B''$</p>	<p>Joint performance must be at least 1+1 <i>Possible combinations of replacements:</i> $A'B'$</p>
Performance of Incumbent = 1		

Fig. 1. Composite Rent and Closure.

an equivalent level of performance, incumbents of high-composite-rent positions are less likely to be replaced.

Not only does composite rent associated with a position have an effect on the absolute likelihood of replacement for a given level of performance of the incumbent, but also it determines how sensitive that likelihood is to performance. Consider the effect of declining performance of the incumbent of both positions from 2 to 1. Now there are two more combinations of contestants capable of reaching this level for the position with no composite rent between assets. These additional combinations are: $A'B''$ and $A'B'$. In order to replace the incumbent of the position with high composite rent, the contestants have to be able to perform at the level of the incumbent and bear the costs of separation of the position. Thus, the total performance of specialists has to be at least 2. The only combination of contestants capable of reaching this level is $A'B'$. Thus, for the position with high composite rent, the decline in the incumbent's performance increased the number of potential specialist replacements by one. Thus, an equivalent decline in the incumbent's performance has a different effect on the likelihood of replacement of the incumbents of the two positions. The increase is larger for the incumbent of the position with no composite rent than for the incumbent of the position with high composite rent.

IMPLICATIONS FOR STRUCTURAL INEQUALITY

The foregoing discussion shows that an equivalent decline in the incumbent's performance has a different effect on the likelihood of replacement for the incumbent of low- and high-composite-rent positions, respectively. Occupants of low-composite-rent positions are very likely to be replaced following a decrease in their performance. In contrast, occupants of high-composite-rent positions are likely to keep their positions, despite the decline in their performance. The results of empirical analysis of the incidence of takeovers in the 1980s, reported in [Piskorski \(2001\)](#), are consistent with these predictions. When composite rents inside a firm are low, the incidence of takeover bids is driven by the performance of incumbents relative to other market participants. When the incumbent creates less value than an alternative actor could, the incumbent will be replaced. However, when composite rents inside a firm are high, the traditional characterization of the market for corporate control does not reflect the reality. Specifically, when performance of such firms declines, the increase in the likelihood of takeover is substantially lower. In fact, when composite rents are sufficiently high, the relationship between firm performance and the likelihood of takeover no longer exists, protecting the managers of these companies from replacement despite their poor performance.

This result points to a paradoxical situation whereby an efficient internalization of difficult transactions between business units, which is beneficial from the point of view of shareholders, also protects the managers from the market for corporate control, and thus provides scope for managerial agency.

The hypotheses put forward by the model together with the empirical results suggest that the existence of composite rents has substantial effects on structural inequality between actors in the labor market. Specifically, occupants of low-composite-rent positions cannot enjoy structural advantages or disadvantages. As soon as their performance declines, they lose their position and all of the economic privileges associated with it. This was the fate of many managers who were in charge of diversified companies that engaged in multiple businesses that were easily separated from each other. In contrast, occupants of high-composite-rent positions were structurally advantaged. Although their performance declined, they continued to occupy the position, and were able to enjoy the economic benefits over and above what they would be able to obtain if they occupied a low-composite-rent position. This apparent ability to extract rents from the position has been borne out in Piskorski's (2000) qualitative research of the behavior of managers in charge of firms that comprised numerous tightly integrated business units. For example, his analysis of the business strategy of a large chemical company reveals that managers of this company were able to embark on a number of strategies that satisfied their own empire-growing goals at a significant expense to shareholders.

CONCLUSION

The examination of the two models has important implications for our understanding of inequality in markets. Theoretically, markets are systems of exchange in which actors are matched to positions on the basis of actors' performances. In the ideal case, each buyer and seller acts independently of every other, so that positions and actors are matched impersonally through competitive dynamics. There are no relations of control in this market – any individual position is supposed to be able to be occupied by any competent laborer. Nor are there supposed to be any relations of authority in the market, except those necessary to provide rules of exchange and the enforcement of contracts. The distinctive feature of a market is the absence of such controlling mechanism and authoritative directions. Collectively, sellers might wish to keep the prices of their services higher than their marginal cost, but so long as they act individually, they are driven to bring them down into equilibrium to secure for each individual as large a share of the market as possible. As many sociologists and economists have emphasized, this is not a prospect that sellers usually enjoy and, whenever the means are available,

it is one that they quickly subvert. As [Marshall \(1948\)](#) notes, market participants abhor competition intensely and will often collude and resist market competition.

This line of reasoning suggests that as long as one is able to keep these collective efforts in check, the market will not generate any unearned advantages or disadvantages. Our models suggest otherwise. Khurana's description of the role of directors in the CEO search process highlights that neither such motivations nor any solidarity among the selecting group is required for the existence of unearned benefits. The closure process starts early in the CEO succession process, beginning with a reliance on directors' own suggestions of potential candidates, being furthered by the reliance on generally accepted criteria to sort candidates, and ending with directors gathering information about candidates largely through their own trusted contacts, primarily with other directors. The paradox and, perhaps, irony of the reliance on ties and other aspects of the social matching process, is that even when directors bypass the internal process of CEO succession to get away from its restrictiveness, they often end up duplicating a similar structure and order in their own processes. Directors, as they pursue the identification of candidates, establish and maintain a certain set of readily identifiable characteristics to narrow the number of potential candidates. While the directors may use their selection criteria to identify a manageable set of candidates, they are clearly at the same time maintaining and reproducing a structure.

Piskorski's model suggests that even if one eliminated all efforts at collusion, as well as all the social-matching processes in the market, structural advantages and disadvantages would still persist. Actors occupying positions with high composite rents would still enjoy advantages that would otherwise be foreclosed to them. This has important implications for the debate concerning the suitability of markets for corporate control as mechanisms to constrain managerial agency. "Marketists" argue that markets for corporate control are the most efficient means of controlling managerial agency ([Jensen & Ruback, 1983](#); [Manne, 1965](#)). [Kaufman and Zacharias \(1992\)](#) summarize this view:

In unfettered markets, corporate managers would be disciplined by a simple rule: a decline in a market value below the replacement cost of the firm would induce outsiders to bid for control with the intention of enhancing their wealth by the liquidation or reorganization of the acquired business [...] A perfectly fluid system would allow discipline to be imposed on inefficient managers and firms in a perfectly competitive environment with recontracting for all managerial talent with short-term contracts.

In contrast, sociologically informed accounts underscore the critical role of social instruments of control, such as boards of directors ([Khurana, 2002](#)) and organized shareholder action ([Kang, 1996](#)). Instead of proposing that the markets for corporate control provide a better method of managerial oversight than such social

instruments of control, Piskorski's model proposes an important contingency. The appropriateness of each control mechanism critically depends on the nature of the firm. When composite rents inside the firm are low and the incidence of takeover bids is tightly related to firm performance, managers need to maximize shareholder value in order to avoid a takeover bid. Under these conditions, therefore, markets for corporate control are appropriate mechanisms for controlling managerial agency. In contrast, when composite rents inside the firm are high, the incidence of takeover bids is not related to firm performance. Consequently, managers can pursue their own interests, at the expense of shareholders, without the threat of being replaced by market forces. Under these conditions, markets for corporate control no longer seem to be able to control managerial agency. Instead, active control by boards of directors and shareholders is important to ensuring that managers do not engage in behaviors that fulfill their goals at the expense of the population that owns stock in those companies.

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