

**HOW FIRMS SHAPE INCOME INEQUALITY: STAKEHOLDER POWER,
EXECUTIVE DECISION-MAKING, AND THE STRUCTURING OF EMPLOYMENT
RELATIONSHIPS**

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Abstract

Focusing on developed countries, I present a model explaining how firms help determine rates of income inequality at the societal level. I propose that the manner in which firms reward individuals for their labor, match individuals to jobs, and where they place their boundaries contribute to levels of income stratification in a society. I argue the determinant of these three processes is due, in part, to systems of corporate governance affecting the power and influence of different organizational stakeholders, resulting in variance in the types of employment relationships that predominate in a society. I conclude with a discussion of the research implications of emphasizing employers and employment practices as key determinants of societal-level income inequality.

Keywords: income inequality; employment relationship; internal labor markets; wage setting; job matching; firm boundaries; corporate governance; executive compensation

Despite Plutarch's millennia-old warning that "an imbalance between rich and poor is the most fatal ailment of all republics," income inequality in the United States (US), which increased 22.5 percent between 1980 and 2011, is now greater than at any point since the onset of the Great Depression (Atkinson, Piketty, & Saez, 2011). Other industrialized nations also experienced rising income inequality during this period, including Finland (17.8%), Germany (15.4%), Japan (20.6%), and the United Kingdom (UK) (32.9%), providing evidence of a broader, global trend. The implications of understanding this phenomenon are profound as a host of issues with great relevance, such as economic mobility, educational attainment, and life expectancies are found to be related to income inequality (Stiglitz, 2012; Wilkinson & Pickett, 2009).

Not surprisingly, scholars from across the social sciences have aimed to better understand this phenomenon, typically advancing either market (e.g., skill-biased technological change, globalization) or institutional (e.g., unionization, minimum wages, and tax policy) explanations for its rise (Morris & Western, 1999). While providing many insights on the dynamics behind rising income inequality, these accounts leave significant variance unexplained. In particular, one of the challenges of existing theories is that they are often not substantiated by cross-national analyses (see DiPrete, 2007; Gottschalk & Smeeding, 1997; Heyes, Lewis, & Clark, 2012). Income inequality is a complex phenomenon with many factors likely playing a role in its rise, and as such, opportunities exist for developing new ideas that can explain cross-national rates of income inequality, complementing and extending our current perspectives of the phenomenon.

Taking an initial step toward this end, I introduce a model that suggests a key factor determining rates of income inequality at the societal level are employers' actions regarding how they structure employment relationships. Though not often considered in existing theories of the phenomenon, employers shape inequality by deciding how much to pay different workers in different jobs (Baron, 1984). Research has indicated that across developed countries, over the past several decades, both within- (Lazear & Shaw, 2009) and between-firm (Faggio, Salvanes,

& Van Reenen, 2010) income inequality has risen, and that much of that rise results from firms paying otherwise equivalent workers differently (DiNardo, Fortin, & Lemieux, 1996; Groshen, 1991). In fact, studies have suggested that nearly 40 percent of the total variation in wages across countries emerges from similarly skilled workers being employed in firms that reward them differently (see Abowd & Kramarz, 1999). Because over 90 percent of the labor force in developed countries are employees of organizations (Marsden, 1999), research on income inequality can be importantly enhanced by taking into account decisions employers make about how to pay their workers, how they match workers to positions, and where employers place their boundaries (i.e., how many workers do they employ). These considerations will help determine the extent to which wages vary across different types of workers. How executives come to make decisions about how to structure their firms' employment relationships, I argue, is a consequence of the power and interests of different organizational actors (March, 1962). I describe how corporate governance mechanisms allocate power to various organizational stakeholders and how these resulting power differentials affect the distribution of labor income in a society through the decisions executives make about how to structure their employment relationships

Notwithstanding evidence suggesting employers play a significant role in determining societal rates of income inequality, contemporary organizational scholarship has been mostly silent about the phenomenon. A number of scholars have explored the consequences of wage dispersion at the intra-organizational level (for a review see Shaw, 2014) without much attention given to where inequality emerges. While organizational research has long examined employment practices – such as wage setting (Balkin & Gomez-Mejia, 1990; Larkin, Pierce, & Gino, 2012), executive compensation (Wade, O'Reilly, & Pollock, 2006), outsourcing (Davis-Blake & Broschak, 2009), and layoffs (Budros, 1997) – the distributional consequences of these changing practices to society has also been largely overlooked.

Earlier conceptual work from the structuralist perspective did take seriously the role of employers in wage-setting outcomes. According to this view, organizations are a key source of income inequality because they provide unequal access to remuneration, rewards, and opportunities for advancement, independent of worker characteristics (Baron, 1984). This perspective failed to explain how firm practices aggregate to societal-level outcomes, however, as empirical research focused on explaining patterns of inequality *within* firms (e.g., Kalleberg & Van Buren, 1994). While an important area of inquiry, a singular focus on within-firm income inequality may mask the broader impact of these employer choices. For instance, strategies that lower within-firm income inequality, such as outsourcing and layoffs, may increase inequality within a society. As a result, explaining what gives rise to wage dispersion inside firms is not sufficient to explain income inequality within a country; rather, one must also consider how decisions made inside the firm influence the dispersion of wages throughout the labor market.

In this paper, I introduce a model to explain how executives' decisions regarding their firms' employment practices influence societal rates of income inequality. That is, I theorize about factors that are determined by employers and associated with inequality, but are observed across countries where those factors will noticeably vary. For employers to help determine rates of income inequality necessitates that a country's labor force be employed predominately by firms versus self-employment or employment in the informal economy. Thus, my model is most relevant for the study of labor income inequality in developed countries.

I first argue that employers vary in the extent to which they hold an internal, organizational orientation or an external, market orientation (see Jacoby, 2005). This choice informs the types of employment practices employers use, and I examine the distributional impact of a set of those practices on society. Specifically, I explore how decisions made by employers about how they set wages, how they match workers (including executives) to positions, and where they place their boundaries affect income inequality at the societal level.

Second, to explain cross-national variation in the use of these practices and to introduce a set of factors that influence how employers come to these decisions, I leverage insights from power-dependence (e.g., Emerson, 1962) and socio-political theories of corporate decision making (e.g., Cyert & March, 1963). I take the perspective that organizations are a site of conflict among different stakeholders who have vested interests in these decisions (Freeman, 1984; March, 1962). This perspective is relevant because the choices employers make about the types of practices to use help determine how resources are allocated to different stakeholders and as such, are subject to contestation (Bidwell, Briscoe, Fernandez-Mateo, & Sterling, 2013).

The paper is organized as follows: I begin with an overview of the literature on income inequality, focusing on some of the main explanations given for its rise. I then introduce my model of how employers influence societal rates of income. I conclude with a discussion of implications for theory and empirical research of the phenomenon.

DEFINING AND EXPLAINING INCOME INEQUALITY

Income inequality captures the distribution of income across participants in a collective, be it an organization, a region, or a country. Income is derived from a number of sources, including earnings derived from labor, business, and investments (e.g., capital gains, dividends, and interest) (CBO, 2011). Wealth, a distinct but related construct, captures the total value of assets a family or individual owns – including homes, investments, and other savings. While any discussion of economic inequality can be informed by considering both non-labor earnings and wealth, the model presented here is about the role of firms in the wage-setting process. Therefore, I focus solely on *labor income* inequality.¹

Income inequality is also distinct from poverty. Whereas inequality indicates disparity in how resources are allocated, poverty captures the number of individuals living in a state of resource deprivation. Although one aspect of income inequality could be high rates of poverty, a society can have high-income inequality and no poverty, or low-income inequality and high

poverty. Although in many countries the two measures are correlated, since the late 1960s, much of the developed world has seen rates of poverty decline while income inequality has risen (World Bank, 2012), suggesting that the factors that influence income inequality do not always have similar effects on poverty. Relatedly, income inequality differs from social inequality, which characterizes the existence of unequal opportunities and rewards for different social positions in a society—such as class, race, or sex—and encompasses an array of areas, including access to education, healthcare, and voting rights (Sen, 1992). While there is often a reciprocal relationship between them, factors influencing income are distinct from those influencing social inequality, necessitating independent study of the phenomena (Kenworthy, 2007).

Income inequality can be measured in a number of ways and each method captures somewhat different aspects of the phenomenon. For example, measures such as the Gini, Theil, and Atkinson indices consider the allocation of income throughout the income distribution. Others, such as simple ratios (e.g., top 1 percent, bottom 10 percent), and range ratios (e.g., 90/10, 50/10 percentiles), focus on a single or ratio of points to draw inferences about the income distribution. The choice of measure is important as it contains "implicit judgments about the weight to be attached to inequality at different points on the income scale" (Atkinson, 1975: 47). For example, the Gini index – a measure of the extent to which of income among individuals or households deviates from a perfectly equal distribution – is most sensitive to inequalities in the middle and less sensitive to inequalities at the top and bottom of the distribution. Simple and range ratios capture dynamics at a pre-defined point(s), making them less useful for understanding dynamics throughout the distribution. Examining the top 1 percent of earners, for instance, provides few insights on how income is distributed within the top 1 percent as well as on distribution throughout the lower 99 percent (Ray, 1998). Because the model I present has implications for incomes throughout the distribution, for each employment practice discussed, I identify which parts of the income distribution are likely to be most affected.

Trends in Income Distribution

Prior analyses have revealed remarkable variety in rates and changes in income inequality across countries and over time (e.g., Alvaredo, Atkinson, Piketty, & Saez, 2013; Roser & Cuaresma, 2014). Notably, as measured by the Gini index, between 1980 and 2011 income inequality rose considerably in diverse countries such as Australia (23.9 %), Poland (12.7%), Portugal (48.4%), and Sweden (29.1%); remained relatively unchanged in countries like Denmark (2.6%), France (4.7%), and Switzerland (- 1.5%); and declined in Ireland (- 8.9%) and South Korea (- 11.9%).² Scholars from across the social sciences have attempted to explain this variance, focusing primarily on market- or institutional-based accounts. Before introducing my model, I summarize some of the most common explanations for income inequality, discuss their limitations, and suggest that incorporating the study of employers and employment practices may complement these existing perspectives. There are a number of reviews on the topic (e.g., Katz & Autor, 1999; Levy & Murnane, 1992; McCall & Percheski, 2010; Neckerman & Torche, 2007), so I cover the literature briefly.³

Technological Development

Efforts to explain income inequality have been developed primarily within the field of neo-classical labor economics (DiPrete, 2007). Orthodox economic theory explains wage differentials as being the product of variations in worker productivity and supply and demand. Following this tradition, skill-biased technological change (SBTC) has emerged as one of the most widely-cited drivers of income inequality. The SBTC argument states that income inequality reflects changes in the relative supply of skilled labor and exogenous technological change. Technologies enhance the marginal productivity of skilled workers while either lowering or leaving unchanged the marginal productivity of unskilled workers (Autor, Katz, & Kearney, 2008; Johnson, 1997). One of the most popular technologies examined is the microcomputer, which increases the demand for those with the requisite education and skills while making

possible the routinization of certain types of work, rendering many middle-wage jobs expendable (Acemoglu, 2002; Milgrom & Roberts, 1990; Violante, 2002).

Globalization

A related account for rising income inequality is that it is a consequence of globalization (Bentele & Kenworthy, 2013; Dreher & Gaston, 2008). Much of the early study on globalization and income inequality focused on trade flows. Two theoretical arguments, the Heckscher-Ohlin model and the Stolper-Samuelson theorem, speculate that as less-developed countries integrate into the world economy, the demand for and returns to unskilled labor increase in those countries, reducing income disparities. Conversely, the demand for skilled labor in developed countries increases while the demand for low-skilled labor declines, exacerbating disparities (Leamer, 1995). Empirical research, however, has not supported these accounts. Studies found income inequality rose in developing countries as they integrated into the world economy (Harrison, McLaren, & McMillan, 2011). More recent research on the impact of globalization on wages and employment has examined the geographic shifts in the production of goods. For example, studies of the impact of China's manufacturing sector's ascension have found it to have a detrimental impact on manufacturing employment and wages (Autor, Dorn, & Hanson, 2013).

Unionization and Wage Bargaining

Another widely-cited explanation for rising income inequality is declining rates of unionization (e.g., Jacobs & Myers, 2014). Research on unions and income inequality focus primarily on two effects. First, a between-group effect whereby unions raise wages among less-educated workers, thereby reducing inequalities between occupations. Second, a within-group effect as collective bargaining standardizes wages within firms and industries, thereby reducing differences between workers with similar characteristics (Freeman, 1980; Western & Rosenfeld, 2011). Research also suggests spillover effects in which the threat of unionization encourages non-union firms to adopt similar employment practices (Farber, 2005). Supporting these claims,

Card (2001) found that 15 to 20 percent of increases in income inequality in the US between 1970 and the early 1990s was due to declines in unionization; Fortin and colleagues (2012) found similar results in Canada. Countries with greater unionization densities have, on average, lower rates of income inequality (Alderson, Beckfield, & Nielsen, 2005), as do those with more centralized wage-bargaining systems as centralization mutes the influence of different groups on the wage-setting process (Oskarsson, 2005).

Public Policy

Economic, political science, and sociological research also points to the direct role of public policy in impacting societal-level income inequality (e.g., Heathcote, Perri, & Violante, 2010; Kenworthy & Pontusson, 2005). This literature has focused heavily on two policy-related outcomes: minimum wage and tax rates. When a minimum wage rate is increased, the overall wage distribution is impacted by both a direct effect as workers earning less than the future minimum rate receive a wage increase, and an indirect effect whereby the wages of many workers above the minimum are increased so as to retain the relative wage ranking of occupations within firms (Morris & Western, 1999). Combined, these two effects reduce income inequality by increasing wages at the lower end of the wage distribution (see Blackburn, Bloom, & Freeman, 1990; DiNardo et al., 1996; Volscho, 2005). Others have suggested that income concentration is an artifact of tax law, as across countries and over time, higher marginal tax rates are associated with lower after-tax inequality (Alvaredo et al., 2013), as are specific tax policies aimed to redistribute earnings (Neumark & Wascher, 2001). In fact, some scholars have argued that over the long run, public policy intervention is the primary predictable mechanism through which income inequality can be reduced, emphasizing that political decisions help determine how income in a society is distributed (e.g., Bartels, 2008; Piketty, 2014).

Limitations of Existing Research

Each of the aforementioned research streams have made important contributions to our understanding of factors affecting rates of income inequality. However, while providing many valuable insights, these accounts do leave some key questions unanswered. In particular, these accounts do not always hold up to cross-national comparison. For example, comparable levels of income inequality have not been observed in countries such as those in Continental Europe, Japan, and Scandinavia, despite these countries' heavy adoption of computer technologies (Lin & Tomaskovic-Devey, 2013). Also, rates of income inequality in many countries began climbing before the widespread introduction of information and communication technologies (ICTs) and stabilized in the 1990s when ICTs were more widely diffused (Card & DiNardo, 2002; DiPrete, 2007; Katz & Autor, 1999). Data from countries such as Austria, Finland, Italy, and Sweden suggest that high and increasing levels of union density have not prevented increases in income inequality (Heyes et al., 2012). Many countries with low rates of income inequality have no or limited minimum wage laws (Card, Heining, & Kline, 2013), and minimum wages tell us little about changes throughout the wage distribution. Given the vast differences in tax law across developed countries, cross-national comparisons in this area have also proven challenging (Gottschalk & Smeeding, 1997).

Due to the complexity of the phenomenon, it stands to reason that a singular, universal explanation of income inequality is unlikely to emerge, and there is seemingly ample opportunity to develop new theories of how income inequality in a society is determined. Given the vital role played by firms for wage-setting outcomes, an organizational theory-based perspective on income inequality may be a particularly valuable addition. In particular, a firm-centered theory may help address some empirical puzzles plaguing existing theories of income inequality. For instance, that technology has not led to rising income inequality in many countries may be due to how those technologies are adopted by firms (Fernandez, 2001). Evidence also shows that otherwise equivalent establishments located in different countries and establishments of the same

firm across countries vary in the employment practices utilized (e.g., Finegold & Mason, 1999; Siegel & Larson, 2009). As such, a firm-centered account can help link market and institutional factors to individual outcomes by highlighting how a firm’s broader macro environment gets translated into firm practices that impact workers (Baron & Bielby, 1980).

In the sections below, I introduce my model of how employers impact income inequality at the societal level (see Figure 1). I first describe how employers generate inequality through the processes of wage setting, job matching, and boundary placement. I then describe factors that may influence how executives enact these three processes.

Insert Figure 1 about here

FIRMS AND INCOME INEQUALITY

Human Resource Systems and Firm Strategy

A number of typologies of employment exist, including that from Boxall and Purcell (2011), Lepak and Snell (1999), and Sonnenfeld and colleagues (1988). I borrow from Jacoby’s (2005) typology as it is the most parsimonious yet still captures differences in employment dynamics relevant to the study of income inequality. According to Jacoby (2005), systems of corporate employment can be categorized broadly into two ideal types: *organizational* or *market oriented*. Table 1 outlines some basic features of each type of system. The main distinction between the two systems is the extent to which they rely on internal (i.e., organizational) versus external (i.e., market) criteria in the structuring of employment relationships. An organizational focus is associated with stable employment with low turnover, extensive use of training, and the dominance of internal considerations – such as a desire for equity – on executive decision making. In such a system, employers protect workers from many of the vagaries of market forces; they take a longer-term perspective on performance and favor corporate strategies that

necessitate a stable, well-trained, and loyal workforce. A market focus, on the other hand, is characterized by flexible employment relationships with higher turnover, fewer opportunities for training, and pay and allocation decisions based on external criteria. The shorter-term orientation discourages employers from bearing market risks on behalf of their workers and encourages them to utilize employment practices that lower costs and increase flexibility (Kalleberg, 2011).

Insert Table 1 about here

Whether a firm adopts an organizational or market orientation is related to the firm's choice of employment practices (Jacoby, 2005; Kalleberg, 2011). I focus here on a set of practices likely to impact the distribution of income in a society, arguing that firms generate income inequality through how they reward workers (including executives) for their labor, how they match them to jobs, and where firms place their boundaries (i.e., how many workers the firm employs). In countries where a higher proportion of employment is in firms using an organizational (market) orientation, I argue income inequality will be lower (higher). Importantly, employers fall along a continuum between having an organizational versus market orientation, and firms do not necessarily utilize one strategy but often use combinations of both (Siegel & Larson, 2009). That is, within a given firm, some workers can be governed by employment relationships based on external market considerations while other workers are governed by organizational considerations (Lepak & Snell, 1999). Nonetheless, the emphasis here is on the consequences to society of the relative propensity of firms to pursue a market versus an organizational orientation and the types of practices they are likely to utilize as a result.

Wage Setting and Job Matching

Neo-classical economics emphasizes that income differentials are the result of unequal endowments in productive capacities among individuals; therefore, individuals with identical

skills should obtain relatively equivalent earnings regardless of the job they are in (e.g., Becker, 1964). Wages, however, are typically tied to jobs rather than individuals (Granovetter, 1981; Thurow, 1975), and once we allow features of a job to influence wage outcomes, how firms match workers to positions and how they reward workers for their labor become important determinants of how labor income is distributed in a society (Sørensen & Sorenson, 2007).

An internal, organizational orientation toward wage setting is consistent with the use of internal labor markets (ILMs), whereby "pricing, allocation, and training decisions are governed by a set of administrative rules and procedures" rather than by external market forces (Doeringer & Piore, 1971: 1-2), and workers' jobs and wages are insulated from external market forces (Cappelli, 2001). One of the more evident manifestations of this approach is in the wage-setting process. Historically, the most common method used by larger firms to set compensation was through job evaluation – a formalized system for ascertaining the relative value of different jobs in a firm (Gomez-Mejia, Berrone, & Franco-Santos, 2010) – which was utilized, in large part, to reduce wage inequality inside of firms (Sanchez & Levine, 2012). For example, in a prototypical point-based job evaluation system, such as the Hay System that emerged in the 1940s and gained worldwide popularity over the ensuing decades, each job is evaluated along dimensions such as required skill, effort, scope of responsibility, and working conditions (Boxall & Purcell, 2011). Jobs are then assigned wages based on their value to the firm and in relation to other jobs within the organization. Though jobs that require greater levels of competencies and are more highly valued by the firm receive greater pay, historically these systems were developed to create a sense of internal pay equity (Dulebohn & Werling, 2007). By assigning wages to the job and establishing criteria by which jobs are compared, employers hope to mitigate perceptions of inequity in how wages throughout the hierarchy are set (Pfeffer & Davis-Blake, 1992).

There are at least two factors, then, that suggest the presence of ILMs across a population of firms will reduce income inequality in a society (see Figure 2). First, to ensure internal equity

across jobs, firms utilize administrative procedures – guided by concerns for internal equity – that set appropriate pay differentials across jobs, implying greater equality of compensation than would otherwise exist, and that lower within- and between-group income differentials. Second and relatedly, ILMs are typically associated with a wage premium that is greater for lower- than higher-skilled workers (Groschen & Levine, 1998), suggesting a between-group effect whereby wages are more compressed between lower- and higher-skilled workers than would be otherwise. In fact, in countries like Japan, the UK, and the US, income inequality was at its lowest levels when ILMs predominated, and the breakdown of ILMs coincided with rising income inequality in a number of countries (Cappelli, 2001; Davis & Cobb, 2010).

Insert Figure 2 about here

Unlike in ILMs, the use of market-based employment practices reduces the influence of bureaucratic processes that determine hiring, promotion, and remuneration. Opening them to competition affords firms greater flexibility in how they manage their employment relationships; this competition appeals to firms who favor a market orientation (Jacoby, 2005). The consequences of a market-based employment relationship on income inequality are also significant. Rather than wages being set through evaluation systems that promote internal equity, in external labor markets, wages are more likely to be based on the relative quality of workers, evidenced by performance, skills, and credentials, as well as on the broader market forces of supply and demand. Individual variations in performance can be significant (Schmidt & Hunter, 1981), and market-oriented wage setting reveals and reflects these variations through pay differences. As such, wage-setting systems that reward workers based on their productivity, such as is the case in pay-for-performance schemes, can lead to higher levels of income inequality since they increase the wage gap between more and less productive workers (Bandiera,

Barankay, & Rasul, 2007; Lemieux, 2011). In the US, the use of these schemes, which are more common among higher-income workers, is responsible for over 20 percent of the rise in income inequality between the late 1970s and the early 1990s (Lemieux, MacLeod, & Parent, 2009). A number of studies have also substantiated that worker wages are positively correlated with firm profitability (e.g., Blanchflower, Oswald, & Sanfey, 1996; Gürtzgen, 2010) and found an increased use of firm-based compensation practices such as bonuses and stock options (e.g., Kruse, Freeman, & Blasi, 2010). Wages, then, for workers with similar skills but in different firms will vary based on disparities in firm performance.

Similarly, when hiring occurs largely from outside of the firm, information asymmetries between workers and employers are likely to impact wages. Bidwell (2011) argued that differences in pay between external and internal hires should reflect differences in the observable characteristics between the two types of candidates. Firms have less knowledge of external candidates' unobservable skills and talents. To compensate for this, these candidates typically have greater levels of observable traits, such as education and credentials. Because those observable traits are easily transferrable across firms, whereas unobservable characteristics – such as tacit knowledge (Althausen & Kalleberg, 1981) or culture fit (Chatman, 1991) – are not, observable characteristics are more highly rewarded in the labor market. Moreover, because external hires lack information about their fit for the job and within the firm, they must be compensated for the increased risk they bear by switching employers. External hiring, then, can lead to higher income inequality at the societal level because in comparison to individuals lacking them, employees with greater levels of visible credentials and stronger social networks receive greater rewards (Bidwell, 2011; Bridges & Villemez, 1986). Likewise, when hiring occurs predominately from outside the firm, younger and lower-skilled workers are often sorted into and remain in lower-paying jobs (Autor & Houseman, 2010), as are women and minorities (Prokos, Padavic, & Schmidt, 2009). Rather than individual attainment being a function of

bureaucratic procedures, careers span across firms with little predictability (Bidwell & Briscoe, 2010), implying greater variance in wage outcomes for similarly skilled individuals. In short, where firms rely more heavily on market-oriented wage setting and external hiring, we should see movement away from the middle of the income distribution towards the tails, leading to greater wage dispersion at the societal level.

Proposition 1: *In countries where workers are employed by firms favoring the use of external labor market rather than internal labor market mechanisms to set wages and match workers to jobs, income inequality at the societal level will be higher.*

Executive Compensation

One factor regularly cited for why income inequality has risen over the past 35 years is the gap in wages between the highest earners – those in the upper 1 or .01 percent – and all other earners (e.g., Atkinson et al., 2011). The average annual earnings of the top 1 percent of wage earners in the US grew 275 percent from 1979 to 2007 (CBO, 2011). Those in the remaining top 20 percent, the middle 60 percent, and bottom 20 percent grew by 65, 40, and 18 percent, respectively (Kim, Kogut, & Yang, 2013). Understanding overall changes in income inequality, therefore, can be markedly enhanced by considering the influence of top incomes.

Though salaries in many professions, such as those for professional athletes, celebrities, and finance professionals increased dramatically during this period (Kaplan & Rauh, 2009), data show that in countries such as Germany (Bach, Corneo, & Steiner, 2009), the US (Bakija, Cole, & Heim, 2012), Australia and the UK (see OECD, 2011: 351), non-financial executives, managers, and supervisors constitute the largest occupational category of the highest earners. Across countries, there is considerable variance in the relative pay of executives to the median worker. For example, in 2012, the ratio of CEO pay to the median worker was 58 to 1 in Norway, 67 to 1 in Japan, 104 to 1 in France, 147 to 1 in Germany, and 354 to 1 in the US (The Globalist, 2013). Given the representation of executives among top earners and the stark cross-

national differences in how well compensated they are relative to the average worker, how firms set compensation for executives plays a key role in determining a society's level of income inequality. I examine three ways in which firms set the compensation of their executives that may influence societal levels of income inequality: performance-based pay, external benchmarking, and external hiring.

Performance-based pay and external benchmarking. Over the past several decades in many developed countries, there has been an effort to tie executive compensation more closely to metrics of firm performance. In particular, across many countries, executive compensation schemes increasingly include equity compensation, whereby options to purchase shares of stock at a set price are granted to management on the basis of firm performance (Murphy, 2013). Where firm performance outpaces wage growth – such as in the US where between 1990 and 2005 when average worker wages increased 4 percent while corporate profits increased 107 percent – inequalities in income will increase. Specifically, the upper tail of the income distribution will shift outward.

Interestingly, however, a tighter coupling of executive compensation and firm performance does not seem sufficient for explaining the growth in CEO wages. Notably, evidence confirms that in many places, CEO pay has outpaced firm performance, growing 298 percent in the US during this same period (Anderson, Cavanagh, Collins, & Benjamin, 2006). One reason for the outpaced growth of executive wages results from how executive compensation gets set. Notably, a number of studies have examined the practice whereby corporate boards, often aided by compensation consultants, benchmark the pay of their executives to those of other firms (see Kim et al., 2013). When benchmarking, executive compensation is targeted at a specific range (e.g., 50th, 75th, 90th) of the benchmarked firms; rarely ever is it below the median (Bizjak, Lemmon, & Naveen, 2008). If most firms use external benchmarking and aim to pay at or above the median, pay will increase due to the upward bias in

target and the repeated "leapfrogging" of firms (Elson & Ferrere, 2013). Moreover, this benchmarking system creates feedback loops such that the decision by a small number of corporate boards to dramatically increase executive pay has a sizeable influence on executive pay at other firms (DiPrete, Eirich, & Pittinsky, 2010). When creating the benchmark, boards often include a set of aspirational firms that are larger and employ considerably higher paid executives. For example, in 2012, the median firm on Viacom's benchmark list was 56 percent larger by market capitalization and had double its revenues (Mider & Green, 2012). Thus, even where a firm sets its benchmark at the median of its benchmark group, that group is often upwardly biased, making an executive's pay much greater than the median of a comparable set of firms. As a result, the use of external benchmarking to set pay has the potential to drive executive income higher than would be expected by rising corporate profits alone.

Potentially, a firm could set wages for all its workers via external benchmarking; however, for a number of reasons, it is unlikely this would curb rising income inequality. First, in many settings, because executive compensation is tied more closely to firm performance than it is for most workers, to the extent that corporate profits exceed workers' returns to their marginal product, income inequality will increase. Second, because executive wages are considerably higher than those of the average worker, worker wages would have to increase at a higher rate than that of executives to prevent inequality from growing. Third, the incentive for firms to set worker wages above the median and to use a biased benchmark group is likely to be lower than when benchmarking for executives. Therefore, to the extent that firms use external benchmarking to set pay, we should see higher rates of income inequality at the societal level as the right tail of the income distribution will grow and shift outward.

In contrast, employers can rely on internal benchmarking of CEO pay, whereby the CEO wage is set in comparison to the salaries of those employed in the company. In some of the earliest analyses of executive compensation, researchers considered the possibility that

executives were paid on the basis of comparison to other employees of the firm (e.g., Simon, 1957) or a combination of comparing executive pay to that of similar firms and utilizing internal comparison (Patton, 1951). Firms such as Whole Foods cap CEO pay at its average annual wage, while others such as Northwestern Corporation ensure that executive compensation is "internally equitable and consistent" (Brancaccio, 2012). Where executive compensation is determined in larger part by internal benchmarking, the ratio of executive pay to that of the average workers is likely to be somewhat constrained. To the extent that this practice is common in a society, top incomes are likely to be reduced, thereby lowering aggregate income inequality.

Proposition 2a: *In countries where firms favor the use of performance-based pay systems to remunerate executives, income inequality at the societal level will be higher.*

Proposition 2b: *In countries where firms favor the use of external rather than internal benchmarking to set executive pay, income inequality at the societal level will be higher.*

External hiring. Another factor linked to rising executive compensation is the increased incidence of firms recruiting CEOs from outside of the organization. During the 1970s in the US, fewer than 15 percent of newly appointed CEOs were hired externally. By the late 1990s, nearly a third of all CEO appointments came from outside of firms (Murphy & Zabochnik, 2008). Much in the same way that external hiring of workers alters the demand for observable skills, the utilization of external hiring represents a shift in the reliance on general managerial versus firm-specific skills. Such a shift increases competition for skilled labor in the executive labor market, driving up wages (Murphy & Zabochnik, 2008). To compensate executives for the loss in future value of their firm-specific investments, the hiring organization may also need to pay a premium to entice an executive to switch firms (Harris & Helfat, 1997). In fact, many of the more generous executive compensation packages have been the result of contracts negotiated with external candidates at the time of hire, not deals reached with incumbents (Murphy, 2013). Combined, these factors suggest that the reliance on external hiring of executives is likely to be

associated with higher levels of compensation, thereby exacerbating income inequality by increasing the size of the right tail of the country's income distribution and shifting it outward.

Proposition 2c: *In countries where firms favor the use of external rather than internal hiring to match executives to their positions, income inequality at the societal level will be higher.*

Firm Boundaries: Who and How Many to Employ

Non-standard work arrangements. The prototypical standard employment relationship consists of stable, full-time employment in which the worker is employed directly by the firm. Executives can, however, organize work utilizing a number of arrangements that fall under the umbrella term *non-standard work*, which includes contracting, outsourcing, temporary work, and part-time employment (Cappelli & Keller, 2013a). Non-standard work arrangements differ from standard ones in a number of ways, including administrative control often being handled by a third-party organization (such as in the case of temporary and contract labor), and no expectation of continued employment (Kalleberg, 2011). When making the decision to use non-standard work arrangements, executives may be motivated by a variety of factors, such as increasing the firm's flexibility or lowering economic and social comparison costs (Autor, 2003; Nickerson & Zenger, 2008). In general, employers favoring a market orientation are more likely to utilize these non-standard work arrangements (Kalleberg, 2011). Not surprisingly, researchers have begun to explore the causes and consequences of these work arrangements for employers and workers (Cappelli & Keller, 2013b; Dube & Kaplan, 2010; Peck & Theodore, 2007). Few efforts, however, have been made to connect their spread to rising levels of income inequality.

In part-time and temporary arrangements, workers are employed directly by the focal firm but at rates typically below what is earned by full-time employees. Because many workers are employed in these positions involuntarily and often face constraints in the number of hours they can work, total labor income inequality is likely to increase as a result of these

arrangements. As part-time and temporary workers are utilized in place of full-time workers, we should expect societal rates of income inequality to rise.

When employers externalize employment through use of outsourcing or offshoring, the distribution of jobs within the organization changes. Entire functions and departments are routinely extricated from the firms' boundaries and handled by outside vendors. For example, Cappelli (1999: 74) recounts how IBM outsourced all clerical jobs below the rank of executive secretary to employment agencies like Manpower Inc. Research has shown that outsourced employees have fewer opportunities for promotion and training than those retained in-house (Walsh & Deery, 2006). Moreover, in a study of outsourcing of janitors and security guards, Dube and Kaplan (2010) found that outsourced workers earn routinely less than in-house employees, and that this is in large part due to mid- to high-paying jobs turning into lower-paying jobs or being removed altogether (see also van Jaarsveld & Yanadori, 2011).

By outsourcing, firms can keep the wages and conditions of employment closer to market rates without disrupting norms of equity (Cappelli, 1999; Nickerson & Zenger, 2008). In so doing, these jobs become separated from ILMs that reduced the wage disjuncture across hierarchical levels and between occupations. While some high-skilled contract workers benefit from such arrangements (Kunda, Barley, & Evans, 2002), the vast majority of contract workers are employed in low- or middle-wage jobs. In the case of firms moving or outsourcing jobs to vendors in a foreign country, domestic income inequality is likely to rise due to higher unemployment. Outsourcing and offshoring, therefore, should be associated with greater levels of income inequality at the societal level. In particular, we should see a hollowing of the middle, growth in the left tail, and potentially modest growth in the right tail of the income distribution.

Proposition 3: *In countries where workers are employed by firms favoring the use of non-standard work arrangements, income inequality at the societal level will be higher.*

Layoffs. Another market-oriented practice firms use to alter their boundaries is performing layoffs – a termination of employment for reasons generally out of an employee's control. Typically, employers utilize layoffs in an effort to improve the firm's efficiency (Hallock, 2009). While layoffs can be temporary, here I focus on permanent terminations. In the short-run, displacement increases unemployment, exacerbating societal income differentials. Widespread layoffs affect market dynamics, increasing the supply of workers and lowering their bargaining power, thus driving down wages. In the medium- to long-term, evidence from across a number of developed countries shows that having been laid-off contributes to a long-lasting, negative impact on workers' wages once they reenter the workforce (e.g., Hijzen, Upward, & Wright, 2010; Schmieder, von Wachter, & Bender, 2010). Job displacement in the US has disproportionately affected those in lower- to middle-income occupations, such as craftsmen, operatives, laborers, and supervisors, as well as those working in manufacturing industries that traditionally paid good wages (Conyon, Girma, Thompson, & Wright, 2001; Kletzer, 1998). To the extent that laid-off workers are predominately employed in low- and mid-wage jobs, downsizing will increase income differentials at the societal level as the middle of the income distribution shrinks and the left tail grows and shifts outward.

Proposition 4: *In countries where layoffs affect a larger proportion of workers, income inequality at the societal level will be higher.*

FIRM COALITIONS, CORPORATE GOVERNANCE, AND EMPLOYMENT PRACTICES

In the section above, I argued that societal levels of income inequality are determined, in part, by decisions made by firms. Specifically, I contended that rates of inequality are affected by the extent of employment in firms that predominately utilize practices reflecting a market versus an organizational orientation. To what extent, however, do individual employers and their executives differ in their preferences for a market or organizational focus? Viewing firms as a set

of political coalitions (Cyert & March, 1963; March, 1962), I argue the answer is that because these two orientations have distinct implications for how firm resources are divided among various stakeholder groups, the power and interests of different organizational actors help determine which strategy an employer will pursue. Coalitions consist of groups of individuals with similar interests seeking to have their preferences met by the organization. Coalitions themselves often have divergent interests, and in most cases, no single group is able to determine the goals they want the organization to pursue. In Emerson's (1962) account of power-dependence relations, he argues that outcomes from an exchange relationship derive from the dependence one party has upon another in obtaining a needed resource (see also Pfeffer & Salancik, 1978). What determines the outcomes of negotiations between coalitions is determined, in part, by the relative power of each. Coalitional power and changes therein should be reflected in the goals, strategies, and practices used by the organization (Wry, Cobb, & Aldrich, 2013).

I focus here on two key stakeholder groups that make firm-specific investments (Aguilera & Jackson, 2003): shareholders and executives. I argue that their interests and influence play an important role in whether a firm utilizes an organization or market orientation when structuring their employment practices. A third stakeholder group, labor (i.e., non-management workers), also has a vested interest in the outcome of firm decisions. While I do discuss labor's influence on employment practices in the discussion section, because labor power is typically codified into laws that determine the scope and strength of labor protection – including collective bargaining rights, which have been studied extensively by scholars of the phenomenon – I offer no formal proposition for the influence of labor on income inequality.

Shareholder Influence: Monitoring and Incentives

Share ownership structure. Since the writings of Berle and Means (1932), social scientists have been interested in understanding how stock ownership structure influences organizational action since a firm's controlling interest directly affects its goals and structure

(Chaganti & Damanpour, 1991; Fiss & Zajac, 2004). This influence, however, is moderated by the extent to which equity ownership is concentrated. When share ownership is dispersed among a large number of shareholders, executives have greater discretion to pursue strategies that enhance their own personal interests (Demsetz & Lehn, 1985). For example, dispersed ownership is associated with a greater proclivity of management to pursue firm growth strategies through diversified acquisitions (Amihud & Lev, 1981), to utilize compensation schemes rewarding growth rather than performance (Wright, Kroll, & Elenkov, 2002), and to provide workers with better paying jobs (Liu, van Jaarsveld, Batt, & Frost, 2014). Concentrated ownership, on the other hand, encourages corporate boards to weigh shareholders' interests more heavily when evaluating firm strategy (Desender, Aguilera, Crespi, & Garcia-Cestona, 2013).

There are, however, many different types of shareholders, such as families, mutual funds, and private equity firms, which have different interests, investment strategies, and time horizons. Shareholders fall largely into two types: those taking a longer-term, strategic view and those taking a shorter-term, financial view of their investments (Aguilera & Jackson, 2003). For example, throughout much of Continental Europe, Japan, and Latin America, large shareholders tend to be banks and corporations (e.g., customers or suppliers) who use equity stakes as a means to pursue strategic interests. The potential loss of commercial business outstrips dividend income, motivating these shareholders to prefer strategies that enhance the long-term survival prospects of their investments (Schneper & Guillen, 2004). A longer-term perspective translates into a preference for firm strategies based on long-term growth and product market domination, reinforcing forms of corporate organization that allow firms to benefit from workers' accumulation of firm-specific and other human capital investments (Amable, 2003).

In contrast, shareholders with a shorter-term, financial view, such as private equity firms and many types of institutional investors, are more likely to encourage firms to engage in actions that maximize profitability (Cobb, 2015; Useem, 1996), thus performance in equity markets

plays a more significant role in corporate strategy (Jensen & Murphy, 2009). One consequence of this system is that the market plays a central role in determining firm structure. As John Brian, CEO of Sara Lee, stated, “Wall Street can wipe you out. They are the rule-setters. They do have their fads, but to a large extent there is an evolution in how they judge companies, and they have decided to give premiums to companies that harbor the most profits for the least assets” (Lowenstein, 1997). Evidence shows that investors pursuing financial interests motivate firms to engage in tactics that increase shareholder value in the short-term and to engage less in long-term strategic decision making (Bushee, 1998; Connelly, Tihanyi, Certo, & Hitt, 2010). The prevalence and influence of shareholders with short-term interests, therefore, is likely to be associated with firms minimizing their investment in fixed assets and making their boundaries more permeable. The benefits accrued to employers from utilizing ILMs are gained over the long run (Cappelli, 2001), so a short-term focus reduces their value to the firm and its investors. Additionally, several scholars have suggested that the growth of private equity and institutional investors pursuing market interests has led to wage cuts and corporate reorganization via layoffs (Batt & Appelbaum, 2013; Fligstein & Shin, 2007; Shleifer & Summers, 1988). Shareholders concerned with maximizing market returns are also likely to prefer more open, flexible employment relationships as it provides for a tighter coupling between wages and productivity (Sørensen & Kalleberg, 1981).

Proposition 5a: *In countries where equity is owned predominately by investors pursuing short-term financial interests, employers will be more likely to take a market orientation when structuring their employment relationships.*

The structure of equity ownership can also influence executive compensation. Throughout many developed countries, the increase in executive pay has been largely due the growth of equity-based compensation (Murphy, 2013) achieved, in part, by investors who advocated its use (Jung & Dobbin, 2014; Westphal & Zajac, 1998). In recent years, foreign

investors – particularly UK- and US-based institutional investors – have increased their shareholdings in foreign firms, placing pressure on them to adopt and abide by US corporate governance (and employment) practices (Ahmadjian & Robinson, 2001; Fiss & Zajac, 2004; Jacoby, 2005). This leads to higher executive pay and the increased use of equity-based pay in firms in which they invest (Murphy, 2013). However, not all shareholders are as willing to endorse expansions in executive compensation. Many pension funds, for example, have attempted to curb executive pay through proxy contests, and the AFL-CIO tracks the vigilance of institutional investors on executive pay issues, showing considerable variance in these investors' willingness to support management over pay issues.

Taken together, this suggests that firms will be more apt to use performance-based pay, external hiring, outsourcing, part-time labor, layoffs, as well as have higher levels of executive compensation when a firm's equity is predominately owned by shareholders pursuing shorter-term interests and favoring the use of equity-based executive compensation.

Proposition 5b: *In countries where equity is owned predominately by investors favoring high levels of equity-based compensation, employers will be more likely to take a market orientation when structuring their employment relationships.*

Takeovers and corporate control. A second external monitoring mechanism that influences executive decision making is the threat of takeover (Walsh & Seward, 1990). Takeovers are coupled frequently with a change in management, thus the market for corporate control raises the cost of self-dealing for executives (Manne, 1965) and ensures executives attend to the interests of shareholders (Fama, 1980). While countries vary considerably in the extent to which hostile takeovers are used to discipline managers (Schneper & Guillen, 2004), studies have revealed that when freed from takeover pressures, executives extract higher pay for their workers (Bertrand & Mullainathan, 1999, 2003) and pursue stakeholder-friendly practices such

as community development (Kacperczyk, 2009). Non-shareholding stakeholder welfare is thus thought to be enhanced when management has more autonomy.

One direct consequence of takeovers is that they often lead to employee layoffs (Conyon et al., 2001), which, as discussed above, can exacerbate inequalities in income. Moreover, an active market for corporate control discourages management from taking actions that lower firm market value, thus making the firm an attractive takeover target. Taking on debt, stock repurchases, increasing dividend payments, spinning off under-performing business units, and reducing labor costs through various forms of restructuring are all strategies management has employed in response to takeover threats (Davis, 2009). While beneficial to shareholders, each of these actions undermines firm stability by reallocating resources in order to enhance short-term performance. Because the benefits of ILMs are long-term in nature, the risk of takeover makes ILMs a less appealing option for employers and workers. For example, changes in share ownership are thought to weaken firms' reputations for long-term relationships (Shleifer & Summers, 1988), thus threats of and successful hostile takeovers are likely to discourage workers from making firm-specific investments. Without such investments, ILMs become less necessary and external labor market mechanisms are utilized more frequently.

Proposition 6: *In countries with a more active takeover market, employers will be more likely to take a market orientation when structuring their employment relationships.*

Aligning interests through incentives. While the direct impact of executive pay levels on income inequality was discussed above, here I suggest that an indirect effect, whereby monetary incentives influence executive decision making about what types of employment practices to use. Financial theorists have proposed that equity compensation is used to align executives' goals with those of the firm (e.g., Jensen & Meckling, 1976), and managers with equity in the firm are more likely to embrace shareholder concerns and direct the firm in their joint interests, thereby reducing the gap between ownership and control (Dalton, Hitt, Certo, &

Dalton, 2007). Specifically, stock options provide an incentive for managers to make decisions that boost equity values, often with the consequence of lower worker wages and increased employment insecurity (Minsky, 1996). Furthermore, such schemes typically have short vesting periods that allow executives to reap the rewards of their actions before their full effect may be realized, disincentivizing the use of firm strategies based on firm stability and long-term growth (Murphy, 1999). Taken together, where monetary incentives are tied more closely to market investor interests, executives are likely to utilize firm strategies that favor flexible employment relationships and short-term performance. Such a short-term focus discourages the use of ILMs and encourages altering firm boundaries through non-standard work arrangements and layoffs.

Proposition 7: *In countries where executive compensation is based primarily on firm financial performance, employers will be more likely to take a market orientation when structuring their employment relationships.*

Executive Power and Decision Making

While there exist constraints on their discretion, by the nature of their position, top executives have considerable power and authority to set firms' goals and strategies (Fligstein, 1991). Whether they choose a market or organizational orientation is determined, in part, by their own beliefs about the most effective way to structure their employment relationships. These schemas, which emerge from prior experience (Skinner, 1953), help determine the goals of and guide decisions in the firm (Finkelstein, Hambrick, & Cannella, 2009; Prahalad & Bettis, 1986). The functional and educational background of an employer's top executive(s), therefore, are likely to play a role in determining the purpose of the corporation as well as its objectives and strategies (Fligstein, 1990; Ocasio & Kim, 1999).

The fields of finance and economics have a strong commitment to the primacy of markets. This suggests that executives with a background in these fields will hold more positive views toward using market mechanisms to structure employment relationships. CEOs with a

background in finance or economics are also thought to consider shareholder interests over those of other stakeholders when making strategic decisions (Fiss & Zajac, 2004) as these disciplines strongly support the shareholder value orientation. The prevalence of CEOs with a strong financial background suggests these firms prefer CEOs "who understand the financial ramifications of business decisions" (Sanders, 2011). Evidence shows that CEOs of German firms with a law or economics background are more likely to espouse a shareholder value orientation (Fiss & Zajac, 2004). CEOs with a background in finance have also been found to be more likely to engage in downsizing (Budros, 2000).

In contrast, executives with backgrounds in other disciplines may be less inclined to implement market-oriented practices if they conflict with other objectives. For example, executives in Germany tend to have PhDs in engineering or science (Aguilera & Jackson, 2003) and are guided by a desire to achieve technical excellence, rather than pursuing narrow financial interests (Lawrence, 1980). Evidence also suggests that firms develop more novel strategies and are more likely to alter them over time when its executives have a more diverse background (i.e., one spanning a number of functional areas) (Crossland, Zyung, Hiller, & Hambrick, 2014). Given a predisposition toward a market orientation and attention to financial measures of performance, I expect that in comparison to firms with CEOs with other backgrounds, CEOs with a functional or educational background primarily in finance or economics are more likely to structure their employment relationships utilizing a market orientation.

Proposition 8: *In countries where executives have a background predominately in finance or economics, employers will be more likely to take a market orientation when structuring their employment relationships.*

DISCUSSION

Income inequality is one of the defining social problems of contemporary times (World Economic Forum, 2014), and scholars from across the social sciences have sought to better

explain where it arises from and to what effect. With but a few exceptions, however, explanations ignore the role played by firms. Employers are of great importance to the study of the phenomenon because they make decisions about who to hire, how much to pay, and how many to employ (Baron, 1984), and, as such, influence rates of income inequality at the societal level. Furthermore, how executives are impacted by monitoring structures, incentives, and the schemas used when making these choices is squarely in the purview of organizational scholarship, making our field uniquely suited to study income inequality. That few have done so while having the capacity to add much to the scholarly debate provides an interesting opportunity. By introducing a model of how employers influence income inequality at the societal level, I hope to provide future researchers a platform for the study of this phenomenon.

The model I present articulates the distributional consequences of different employment practices and how firms come to make them. Specifically, I discuss how three key elements of firms' strategy and structure – how employees (including executives) are rewarded for their labor, are matched to jobs, and where a firm places its boundaries – affect societal rates of income inequality. I theorize that when wage setting and job matching are based primarily on internal (external) considerations, income inequality in a society will be lower (higher). In ILMs, the wage premium for lower-skilled workers is typically higher than for higher-skilled ones (Groshen & Levine, 1998), providing lower levels of between-group income inequality than would be experienced outside a firm's boundaries. The desire to maintain norms of fairness also implies a smaller disjuncture in wages between workers throughout the hierarchy (Doeringer & Piore, 1971). Wages tied to worker productivity and firm performance as well as a reliance on external hiring, lead to greater returns to workers' observable characteristics, such as education, credentials, and productivity, creating greater variance in returns to labor. These same considerations also influence rates of executive pay such that when firms utilize performance-based pay, external benchmarking, and external hiring, executive pay will be greater. Moreover,

efforts to externalize employment through non-standard work arrangements and layoffs also put downward pressure on wages of low- to mid-income workers, further exacerbating wage differentials at the societal level. Taken together, whether employers take an organizational versus a market focus when structuring their employment relationships has important distributional consequences for society.

I also discuss a number of firm-level factors that help determine whether a firm takes a market or organizational orientation. Leveraging insights from power-dependence and socio-political theories of executive decision making, I argue that firms are composed of a set of coalitions with different interests and sources of influence. Because a market versus an organizational orientation has implications for how firm resources are allocated between stakeholders, the power and interests of different organizational actors helps determine which strategy an employer will pursue. Specifically, I contend that the structure of equity ownership, the prevalence of a corporate takeover market, the structure of executive compensation, and decision making schemas of top executives encourage the adoption of practices associated with a market versus an organizational orientation.

Implications for Organizational Theory

Earlier contributions to organizational theory, such as the behavioral theory of the firm (e.g., Cyert & March, 1963), paid considerable attention to the role coalitional conflict played in affecting firm outcomes. The model presented here suggests these same mechanisms may be relevant to our understanding of societal-level outcomes. Furthermore, while organizational scholars have made many important advances in our understanding of changing employment practices and the forces motivating them, scant attention has been paid to the distributional consequences of these decisions on society. This omission has had the consequence of leaving the study of income inequality to fields of study less likely to consider the role of employers and firm-level decision making. The lack of attention to social outcomes is part of a broader trend

whereby organizational theory has largely bypassed the study of societal issues and instead focused on firm outcomes and inter-organizational dynamics (Perrow, 1986). When social issues are considered, such as in the study of corporate social responsibility, researchers too often examine firm outcomes to the neglect of studying firms' impact upon society (see Banerjee, 2008; Walsh, Weber, & Margolis, 2003). There is a precedent, however, for the study of social issues by organizational scholars, as the impact of hierarchies on individuals and society was a central concern of earlier scholarship (e.g., Boulding, 1953). Notably, a number of early accounts speculated that the processes and modalities prevalent in organizations directly impacted the well-being of their employees (Katz & Kahn, 1966; Whyte, 1956), and more contemporary research has found that the type of job one holds (e.g., its position in the organizational hierarchy) plays a vital role in outcomes related to individual health and well-being (e.g., Marmot et al., 1991). By viewing firm strategy and structure as an important driver of societal-level income inequality, this model points to employers as key drivers of social welfare and suggests that within the purview of organizational theory, researchers should once again explore firms as promulgators of societal change (Hinings & Greenwood, 2002; Stern & Barley, 1996).

Conceptual work from the structuralist perspective of stratification was acutely interested in the impact firms had on their environment, and argued that employers, through their decisions about processes of job allocation and wage setting, help determine levels of income stratification (Baron & Bielby, 1980). Empirical studies in this milieu, however, documented features of organizations giving rise to intra-firm income inequality, without attention given to how firms impact inequality in a society (Sørensen, 2007). As a starting point, I take insights from the structuralist perspective and combine them with economic and sociological literature on labor markets as well as organizational scholarship on employment practices. From this, I develop a model that articulates a set of mechanisms through which firm strategy and structure leads to

societal-level income inequality. In so doing, I answer recent calls to integrate income inequality research and organizational theory (Sørensen & Sorenson, 2007).

Lastly, while organizational scholars have been largely silent about the factors that lead to societal levels of income inequality, the impact of income dispersion on individual outcomes, such as motivation and turnover (Shaw, Gupta, & Delery, 2002; Trevor, Reilly, & Gerhart, 2012; Wade et al., 2006), as well as firm-level outcomes like performance (Bloom, 1999; Fredrickson, Davis-Blake, & Sanders, 2010), have been important areas of inquiry.⁴ Generating a more complete understanding of how firms create income inequality, therefore, may inform interest in the impact of income inequality on individual, group, firm, and societal dynamics.

Implications for the Study of Income Inequality

Existing perspectives on the rise of income inequality focus primarily on market-based explanations (e.g., SBTC, globalization), unions, minimum wages, and tax policy (Morris & Western, 1999: 642). While each of these streams have provided valuable insights into the drivers of income inequality, the explanations are often not supported by cross-national analyses (DiPrete, 2007), suggesting other factors may be important. By failing to consider the role of firms in processes of wage setting, job matching, and boundary placement, existing research overlooks potentially important firm-level factors driving differences in income inequality over time. Employers help determine labor market outcomes (Baron & Bielby, 1980), and research indicates that much of the increase in income inequality is due to employers paying similar workers differently (Groshe, 1991). "The market is always embodied in specific institutions such as corporate hierarchies" (Piketty, 2014: 332); as such, the model I present here extends existing research by examining why corporate hierarchies vary in their strategy and structure based on factors that influence executive decision making.

A firm-centered theory of income inequality may also complement existing theories of the phenomenon. For example, research has shown differences in the extent to which computer

programmable design tasks are handled by front-line operators versus engineers and whether these capital investments lead to labor force reductions. This research suggests employer choice determines whether technology is skill-biased and leads to layoffs (e.g., Kelley, 1994; Noble, 1984). Technology also provides the means for companies to alter their boundaries through outsourcing and offshoring (Sahaym, Steensma, & Schilling, 2007). Studies of the effects of minimum wage rates may be enriched by considering how many and which workers get sorted into low-wage jobs. Incorporating in existing theories how executives come to make these decisions suggests the presence of boundary conditions that can add greater precision.

Future Research Directions

The model I have developed here is not without limitations. First, while some of the constructs I include have well-established, valid measures, others, such as the presence of ILMs, do not. Previous research used proxies such as organizational size as an indicator of ILMs (e.g., Davis & Cobb, 2010). Over the past 30 years in the US, the firm size-ILM link, however, has weakened as many of the largest employers (e.g., Wal-Mart) now pay low wages and do not utilize ILMs to the extent that many of the large firms did in decades prior (e.g., General Motors, AT&T). Future empirical research, however, can exploit large-scale, matched firm-employee data found in many Scandinavian countries, and others such as the Longitudinal Employer-Household Dynamics and the Workplace Employment Relations Study that provide information on remuneration, occupational breakdowns, and employment practices of a number of large firms in a society. Cross-national comparisons, as proposed here, will likely necessitate collaborations between scholars with expertise and data access across countries.

Second, I do not theorize about the role of labor as a key organizational stakeholder. Individually, employees have little power to impact firm strategy, but employee power can be enhanced greatly when they can mobilize and act collectively through unions. Important goals of unions are to set pay equally across similar workers and to limit the wage disjuncture across

different workers, which tends to reduce wage dispersion (Western & Rosenfeld, 2011).

However, because a number of studies have sought to establish a relationship between unions and income inequality, I did not offer propositions about the connection here.

Notably, however, unions play a crucial role in how much discretion firms have in structuring their employment relationships. For example, unions have been shown to deter the use of contingent employment relationships (Gramm & Schnell, 2001) and reduce levels of executive compensation (Banning & Chiles, 2007). Their ability to influence firm outcomes depends greatly on the scope and strength of union representation rights (Beramendi & Cusack, 2009). In countries like the US, the UK (since 1980), Canada, and New Zealand, for example, unions bargain with individual firms and plants, leading to greater intra-industry variance on the impact organized labor has on wages, benefits, and conditions of work. This is not the case, however, in the Scandinavian countries and in Germany, where systems of codetermination, work councils, and other forms of industrial democracy provide workers greater power in determining the trajectory of the labor market (Scheve & Stasavage, 2009). While beyond the scope of this paper, any discussion of income inequality can be importantly informed by examining union density rates and the extent to which collective bargaining is centralized versus fragmented as these factors have influence on the types of practices firms use to structure their employment relationships (Oskarsson, 2005; Western & Rosenfeld, 2011).

Finally, my efforts to achieve parsimony led me to focus on a relatively small number of employment practices. Other practices, such as those related to high-performance work, may affect wage dispersion, and future research can explore additional ways in which employers influence rates of income inequality. Moreover, I utilized a single theoretical perspective in developing my arguments for how executives choose between a market and organizational orientation. Insights from other organizational theories, however, may also shed light on how these decisions are made. Below, I briefly elaborate on two such theoretical perspectives.

Institutional environment. The formal and informal institutions in a society may also play a key role in how employment relationships get set and the extent to which executives have the discretion to influence them (Crossland & Hambrick, 2011). For example, whether a country's system of corporate governance favors minority versus majority shareholders influences the types of investors that take equity stakes in firms (Coffee, 2001) as well as how active the takeover market is in a country (Schneper & Guillen, 2004). Moreover, labor laws, the presence of skill formation institutions, levels of unionization, and centralized wage bargaining may play integral roles in employers' use of ILMs, their ability to use non-standard employment relationships, and the prevalence of layoffs (Crouch, Findegold, & Sako, 1999; Dasgupta, 2001). Furthermore, in collectivist cultures, inequalities in income are more likely to be seen as disruptive and illegitimate. Such concerns, for example, are thought to be a main reason why executive compensation is much smaller in Japan than in countries like the US and the UK (The Economist, 2010). Future research can explore more closely the regulatory, normative, and cultural-cognitive institutions in a society that may impact processes of wage setting, job matching, and firm boundary placement.

Organizational population dynamics. Insights from population ecology emphasize that a firm's strategy is influenced by the social technologies available to it at the time of its founding (Stinchcombe, 1965). Firms that emerged during eras when institutional and economic factors favored either the use of a market or organizational orientation, therefore, may be affected by these factors when determining how employment relationships get structured. For example, firms that emerged following the managerial revolution at the turn of the 20th century employed a higher proportion of administrative workers than firms founded in older industries (Marquis & Tilcsik, 2013). When employment is concentrated in firms that emerged in a period where an organization orientation dominated (e.g., in the US from the 1950s to the 1970s), we should expect to see firms continue to use practices associated with an organization orientation and

greater resistance to efforts to utilize a more market-oriented approach. Future work can explore the types of employment relationships that dominated in the eras of firms' founding to determine whether these factors influences rates of income inequality at the societal level.

CONCLUSION

Witnessing rising levels of income inequality throughout much of the developed world and holding concerns for its impact on society, scholars from across the social sciences have made great strides in understanding the phenomenon. However, there is more work that can be done to refine, enhance, and expand our knowledge of the factors driving rates of income inequality around the world. Considering societal levels of income inequality to be, in part, an outcome of processes that set wages, match workers to positions, and determine where firm boundaries are placed opens up important and new avenues of research for scholars of both income inequality and organizations. While employer practices are not the sole determinant of income inequality, they play an important yet understudied role. Accounting for the ways in which employer practices influence societal outcomes has the potential to enrich our understanding of the dynamics undergirding income differentials and provides organizational researchers a starting point to examine this critical social issue.

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FOOTNOTES

¹ Most aggregate measures of income inequality include all forms of income, but because investment income is disproportionately earned by top earners, a key factor differentiating measures of top incomes from those considering lower parts of the distribution is the role of investment income versus salary income (Piketty, 2014). In some instances, the distinction between investment and labor income gets blurred, particularly in the context of stock-based compensation. Across countries, stock option compensation sometimes appears as wage income or capital income in tax statistics, depending on the tax law (Atkinson et al., 2011). This makes cross-national analyses of stock options on income inequality complex. For the purposes of this model, labor income includes the value of options as they are earned as a condition of employment.

² Based on my own calculations on data taken from the *Standardized World Income Inequality Database* (Solt, 2014).

³ I concentrate my review on explanations that involve the setting process and those that are the most common explanations for the phenomenon. Other explanations that I do not cover include family formation practices (see McCall & Percheski, 2010) and political representation dynamics (see Brady & Sosnaud, 2010).

⁴ Political scientists are also interested in the impact of income inequality on outcomes such as voter behavior (e.g., Meltzer & Richard, 1981).

TABLE 1

Features of Organization and Market Oriented Employment Systems

	Organizational Orientation	Market Orientation
<i>Wage setting</i>		
How do wages get set?	Tied to job using formal job evaluation; based more on administrative rules; lower pay variance within and across jobs	Tied to individual using external market mechanism; based on skills and performance; larger pay variance within and across jobs
Goal	Internal equity; reduce costs of social comparison	Externally competitive wages; incentivize worker productivity
<i>Job matching</i>		
How do workers get matched to positions?	Internal hiring (above entry-level); based on seniority	External hiring; based on skills and credentials
Goal	Reduce avoidable turnover; encourage development of firm-specific skills	Just-in-time skill acquisition
<i>Skill development</i>		

How do workers gain skills?	Employer develops talent; on-the-job formal and informal training	Employer acquires talent; reliance on skill development outside the firm
Goal	Greater stability and predictability of skill supply	Avoid costs of developing and maintaining excess internal talent

Firm boundaries

Where does firm place its boundaries?	Stable boundaries; heavy reliance on stable, full-time employment relationships	Permeable boundaries; heavy reliance on non-standard work arrangements and work reorganization
Goal	Operational stability	Operational flexibility

FIGURE 1

Model of Firms' Affect on Societal-level Income Inequality

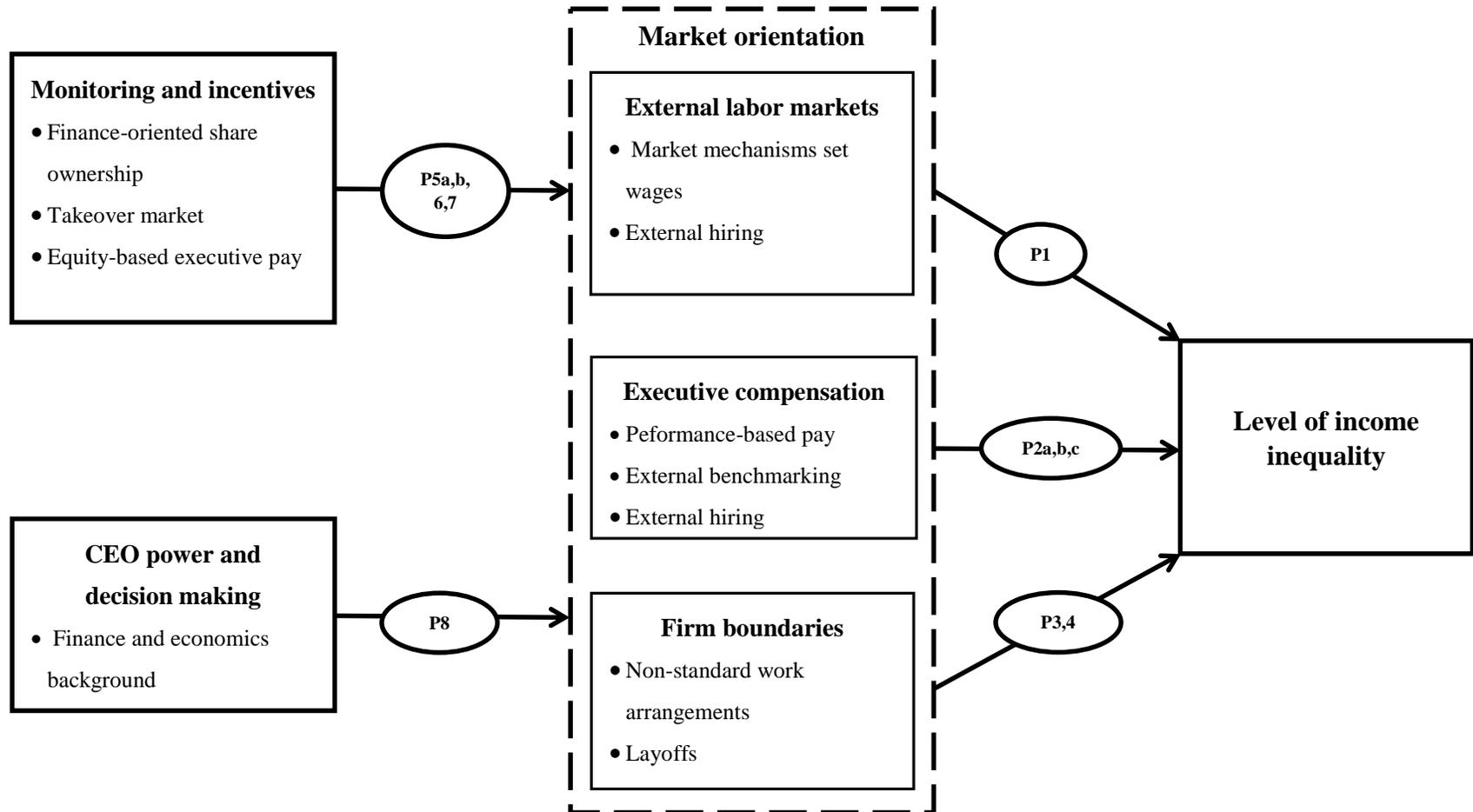
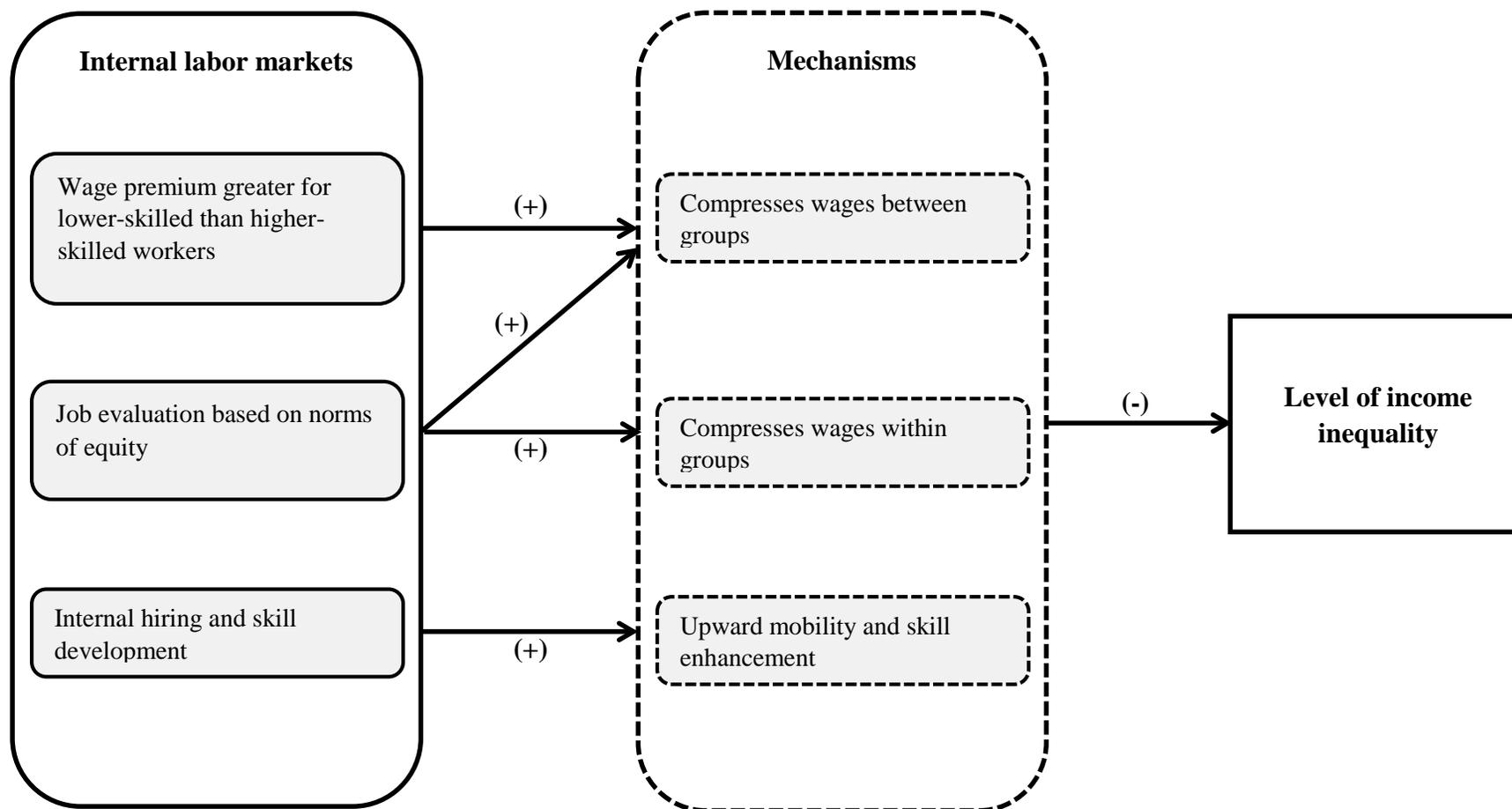


FIGURE 2

Internal Labor Market Mechanisms and Societal-level Income Inequality



BIOGRAPHY

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