

# **HOW NATIONAL SYSTEMS INFLUENCE EXECUTIVE DISCRETION: A STUDY OF CEO EFFECTS IN THREE COUNTRIES**

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## **ABSTRACT**

Using a variance-partitioning analysis on a 15-year matched sample of 103 U.S. firms, 103 German firms, and 103 Japanese firms, I find strong evidence that the magnitude of CEO influence on firm performance is greater in U.S. firms than in German and Japanese firms.

## **INTRODUCTION**

Abundant anecdotal evidence points to the conclusion that America's corporate leaders, compared to executives in other countries, are seen as mattering a great deal. They are the objects of celebrity (Hayward, Rindova, & Pollock, 2004) and vilification (Wiesenfeld, Wurthmann, & Hambrick, in press), seemingly beyond what occurs in other countries. They are paid far more, and especially receive much more incentive compensation, than their peers in other advanced economies (Conyon & Murphy, 2000). Numerous reasons might be put forward to explain this extreme "romanticization" of American CEOs (Meindl, Ehrlich, & Dukerich, 1985), including the possible existence of what has been called "America's infatuation with celebrity" (Hayward et al, 2004: 647). However, a more concrete, structural reason might exist as well: CEOs of American corporations may actually matter more, or have more influence over corporate outcomes, than do CEOs in other countries. It can reasonably be argued that CEOs in the United States have fewer constraints on their actions, or greater discretion (Hambrick & Finkelstein, 1987), than do their peers elsewhere. An array of factors, including national values, corporate ownership structures, and governance arrangements, all align to provide the CEOs of American firms substantially greater latitude of action – freedom to add and drop product lines, reallocate strategic resources, open and close facilities, hire and fire employees, and reorganize – thus allowing them to more readily put their distinctive marks on their firms, including the performance of their firms. This is not to say that American CEOs are more talented, or perform better, than CEOs elsewhere, but rather that they simply have a bigger influence – for good and for ill – than do their CEO counterparts in other advanced economies. This is the essential idea I explore in this paper.

## **PRIOR RESEARCH ON EXECUTIVE EFFECTS**

Do CEOs matter? Initial answers to this question tended to adopt one of two polar views. One view, the "strategic choice perspective," argued that an organization's characteristics – its strategy, structure, processes, and in turn performance – are greatly subject to the influence of powerful human agents, particularly its top executives (e.g. Child, 1972). The opposing, more deterministic, view argued that executives are greatly constrained by environmental forces, by their organizations' own histories and entrenched cultures, and by the requirement to adopt socially-legitimized strategies and structures (e.g. Hannan & Freeman, 1977).

The first of a series of empirical studies that sought to resolve this debate was Lieberman and O'Connor's (1972) widely-noted investigation based upon a sample of 167 U.S. firms over a 20-year period. The authors employed a variance-decomposition methodology, in which they partitioned the total variance in several performance variables (sales, profit, and profit margin) into year, industry, company, leadership, and unexplained effects. As an example of their results, Lieberman and O'Connor found that 15% of the variance in profit margin was due to CEO effects. Subsequent studies within this domain also employed a variance-partitioning methodology, generally finding that between about 5% and 20% of variance in profit margins, for instance, is due to CEOs (e.g. Weiner & Mahoney, 1981; Thomas, 1988).

Arguing that *when*, not *whether*, CEOs matter was the real issue, Hambrick and Finkelstein (1987) subsequently introduced the theoretical concept of managerial discretion as a way to reconcile the two polar views concerning executive influence. Discretion, or latitude of action, exists when a) there is an absence of constraint and b) means-ends ambiguity is great, i.e., when a manager has many plausible alternatives that lie within the "zone of acceptance" (Simon, 1947) of powerful stakeholders. Hambrick and Finkelstein (1987) argued that discretion stems from three sets of factors: environmental, organizational, and individual. However, while subsequent empirical work (e.g. Hambrick & Abrahamson, 1995) supports the importance of managerial discretion as an explanatory construct, this work has equated environmental determinants of discretion only with industry characteristics. There has been no consideration of the influence of higher-order, macro-environmental forces on managerial discretion. In turn, there has been no attention to this important question: Do managers matter more in some macro-environments than in others?

## **HOW MANAGERIAL DISCRETION DIFFERS UNDER THREE NATIONAL SYSTEMS**

I introduce the term *national system* to collectively describe the complex milieu of inter-related social and economic factors that characterize the nation-state within which a firm is principally located, or headquartered. Three central, inter-related national system factors that are expected to have a substantial impact on executive discretion are national values, firm ownership structure, and board governance practices.

### **National Values**

Cultural values exert strong influences on individual actions and perspectives, as well as on national institutions (Huang & Van De Vliert, 2003). Systematic differences in national values will thus lead to significantly different degrees of constraint on executive decision making and behavior (Davis, Schoorman, & Donaldson, 1997). I argue that two particular national values will be especially relevant in shaping executive discretion: individualism vs. collectivism and uncertainty avoidance (Hofstede, 1980).

The national value of individualism vs. collectivism influences the degree to which unilateral executive decision making is permitted and expected by society, which in turn shapes executive discretion. In individualistic cultures, members of society favor personal needs over those of the group, are higher in self-reliance, and make decisions more quickly; those in collectivistic cultures tend to be concerned about, and consult, their in-group, and they make slower, more consensus-based decisions (Hofstede, 2001). Of the 53 countries in Hofstede's (1980) original data, the U.S. ranked 1<sup>st</sup> in individualism with a raw score of 91, Germany ranked

15<sup>th</sup> with a score of 67, and Japan ranked 22<sup>nd</sup> with a score of 46 (second-lowest among major industrialized countries). Uncertainty avoidance is the degree to which members of a culture employ rules, rituals, and technology to buffer the effects of an unpredictable future (Hofstede, 2001). A national value of uncertainty avoidance constrains executive discretion, insofar as stakeholders have little tolerance for unexpected, unconventional, or risky executive actions. Of Hofstede's (1980) 53 countries, Japan ranked 7<sup>th</sup> in uncertainty avoidance with a raw score of 92, Germany ranked 29<sup>th</sup> with a score of 65, while the U.S. ranked 43<sup>rd</sup> with a score of 46. The consistency in the patterns of these two value dimensions leads to the following assertion:

*Assertion 1: National values in the U.S. confer more managerial discretion than do national values in either Germany or Japan.*

### **Firm Ownership Structure**

Two aspects of corporate ownership structure – ownership concentration and shareholder diversification – differ substantially across countries in ways that greatly shape executive discretion. Agency theory argues that widely dispersed ownership allows managers to have substantial control over corporate policies and practices, while leaving owners with relatively weak influence (Jensen & Meckling, 1976). Widespread shareholder diversification will tend to be associated with highly entrepreneurial, risky strategic decision making, as investors seek share-price gains but without much concern for company failure (Shleifer & Vishny, 1997).

In the U.S., public firms overwhelmingly have very widely dispersed share ownership (Lee & O'Neill, 2003), to the point where the academic definition of a “blockholding” is as low as five percent of shares (e.g. Bethel & Liebeskind, 1993). Heightening this discretion is the widely diversified nature of most U.S. shareholders (Kogut, Walker, & Anand, 2002). In contrast, public firm ownership in the German system tends to be stable and concentrated in the hands of relatively undiversified shareholders (Dietl, 1998). Banks play a central role in the German governance system, typically controlling over 25% of the votes of large companies, through both shareholdings and debtholdings (Organization for Economic Cooperation and Development, 1995). German banks, the prominent owners of firms, act more like other organizational stakeholders, such as employees and managers, in their concern for avoiding losses or failure – due to the negative effects of those losses on debt repayment (Gorton & Schmid, 1996). Finally, ownership of Japanese public firms is also typically stable and concentrated – not in the hands of individuals or specific firms, but in the collective hands of firms within a business group, sometimes called a *keiretsu* (Gerlach, 1992). This network of affiliation exerts considerable control, and it limits the choice of products, markets, suppliers, and customers available to the executives of individual firms (Berglof & Perotti, 1994). This leads to the following assertion:

*Assertion 2: Ownership structures in the U.S. confer more managerial discretion than do ownership structures in either Germany or Japan.*

### **Board Governance**

In a national system that places primary emphasis on shareholder value, such as the United States (Guillén, 2000), the boards of public companies supposedly provide the mechanism for shareholders to influence the actions of those companies (Shleifer & Vishny,

1997). Although the boards of U.S. companies ostensibly exist as monitoring tools of shareholders, this potential constraint on executive discretion is greatly diluted by two common practices: widespread CEO/board chair duality (Finkelstein & D'Aveni, 1994) and the level of CEO control over board member appointment (Lorsch & MacIver, 1989). Public company boards in Germany also provide the primary means through which key stakeholders attempt to influence company decision making; but, unlike the U.S., board governance in Germany is relatively powerful. Through a two-tiered board system (Gorton & Schmid, 1996) and legally mandated employee representation (Dore, 2000), German boards constrain the actions of CEOs far more strongly than their U.S. counterparts. In Japanese firms, the actual board of directors provides little constraint on CEO discretion, as Japanese boards tend to be heavily populated with company managers and serve a mostly ceremonial role (Ahmadjian, 2003). However, some constraint does occur at the business group level via informal influences, particularly through the top executive of the main bank (the group's most central firm and a consistent lender to keiretsu firms) (Weinstein & Yafeh, 1995). These contrasting levels of executive constraint due to board governance lead to the following assertion:

*Assertion 3: Board governance practices in the U.S. will confer more managerial discretion than will governance practices in Germany or Japan.*

These three assertions lead to the following hypothesis:

*Hypothesis 1: The variance in firm performance attributable to CEOs will be greater in U.S. firms than in German and Japanese firms.*

## METHODS

This study used annual data over the 15-year period, 1988-2002, for an industry- and size-matched sample of 309 public companies, 103 from each of the three countries: Japan, Germany, and the United States. Companies came from one of eight industry categories, which each contained at least six firms: construction; chemicals; drugs, cosmetics, and health care; electrical and electronics; financial services; food and beverages; machinery and equipment; and utilities. All company performance data were gathered using the Datastream Advance 4.0 database. For each company, and for each year, I obtained data on return on assets (ROA), return on sales (ROS), and sales growth.

I then determined the top executive in each firm for each year from 1988 to 2002, for a total of 4635 firm-years. In addition to company annual reports, I used several sources to gather CEO data. U.S. data were collected from Moody's (Mergent) Industrial Manual, Standard & Poor's Register of Corporations, Directors and Executives, and the Dun & Bradstreet Reference Book of Corporate Management. Japanese data were collected from Moody's (Mergent) International Manual, and Toyo Keizai's Japan Company Handbook and Japan Company Datafile. German data were collected from Moody's (Mergent) International Manual, and Bayerische Hypotheken-und-Wechselbank's *Wegweiser Durch Deutsche Aktiengesellschaften* (Guide to German Stock Corporations). Overall, there were 229 CEOs in the U.S. sample, 299 CEOs in the German sample, and 300 CEOs in the Japanese sample.

Consistent with recent work that used variance-partitioning analysis to determine the sources of firm performance (e.g. McGahan & Porter, 1997), I calculated a random effects model separately for each country. In this model, the variance in a particular performance variable, say

ROA, was calculated as an additive linear function of the variances of year, industry, year \* industry, company, CEO, and error. I used the PROC VARCOMP program in the SAS statistical package to analyze these models using the restricted maximum likelihood method

## RESULTS

Table 1 presents results from the main analysis, in which I identified the amount (in percent) of variance explained by the contextual variables and by the CEOs. In support of Hypothesis 1, the variance in performance attributable to the CEOs was substantially greater in the U.S. sample than the other two country samples for all three performance measures. Turning first to ROA, we see that the percent of variance explained by the CEO was 27.59% in the U.S. sample, 22.92% in the German sample, and 7.38% in the Japanese sample. By converting these partial  $R^2$ s into partial  $r$ 's (by taking their square root), and applying the Fisher Z-test for differences between correlation coefficients, we find that the variance explained by the CEOs in the U.S. sample was significantly greater in the Japanese sample ( $p < .01$ ) but, not in the German sample.

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Results for ROS strongly supported Hypothesis 1; the percent of variance attributed to the CEOs was 29.91% in the U.S. sample, 20.17% in the German sample, and 14.90% in the Japanese sample. This figure for the U.S. sample was significantly greater than for the other two country samples (both at  $p < .01$ ).

Results for sales growth also conformed to the hypothesized pattern; CEOs accounted for 10.54%, 2.33%, and 0.00% of variance in the U.S., German, and Japanese samples respectively. The variance explained by CEOs in the U.S. sample was again significantly greater than in the other country samples (both at  $p < .01$ ). In sum, then, Hypothesis 1 was strongly supported. Across three different measures, the amount of variance in performance explained by CEOs was consistently greater in the U.S. sample than in either the German or Japanese samples.

## DISCUSSION

The results of this study indicate that U.S. CEOs have a greater influence on firm performance than their German and Japanese counterparts. Thus, the results point to the importance of considering how managerial discretion emanates from conditions in the macro-environment, including national systems, in addition to more proximate industry-level factors such as are typically examined (Hambrick & Abrahamson, 1995). Other interesting findings emerged also, the most notable of which was a substantial, unhypothesized difference in CEO effects between Germany and Japan. Japanese firms lagged markedly behind U.S. and German firms in the magnitude of CEO effects. In fact, the difference in CEO effect between Germany and Japan was greater than that between the U.S. and Germany.

While there are several possible explanations for this finding, it may be ultimately traceable to the overwhelming influence of national values on corporate decision-making and management (e.g. Triandis, 1994). Specifically, the low level of executive discretion observable in Japanese firms corresponds with that country's very strong values of collectivism and uncertainty avoidance. This interpretation suggests that, even though Japanese governance

might seem to allow executive discretion (such as through relatively weak boards), cultural tendencies toward inclusiveness, consensus, and risk-aversion all impose inherent limitations on discretion. If national values are exceedingly important in shaping executive discretion, we could correspondingly expect that, in the U.S., even when boards *are* powerful, they still confer a great deal of discretion to CEOs – out of a strong belief in the benefits of individual initiative, accountability, and self-determination.

## CONCLUSION

Questions regarding the degree to which top executives matter to company performance continue to occupy the interest of business observers, both managerial and academic. In this study, I sought to investigate one of the more intriguing puzzles within this domain: Why are there such significant differences in CEO celebrity and compensation, between the United States and other major industrialized nations such as Germany and Japan? Results suggest that there are national-level, macro-environmental factors that differentially shape the amount of discretion available to top executives in these three countries. These different levels of discretion indicate at least one reason for the preoccupation with CEOs in the U.S.: They matter more, for better and for worse, to the performance of their firms. While I leave to others the question of whether these differences in discretion justify differences in CEO compensation, this study does offer a hint of rationality in the seemingly irrational world of CEO celebrity.

## REFERENCES AVAILABLE FROM THE AUTHOR

**TABLE 1**  
**Partitioning of Variance in Performance**

Variable	Country	Percent of Variance Attributable to:						
		Year	Industry	Yr * Industry	Firm	CEO	Error	Total
ROA	U.S.	3.73	9.57	7.81	4.57	27.59	46.73	100.00
	Germany	1.08	6.19	19.42	2.45	22.92	47.93	100.00
	Japan	12.71	8.76	13.87	5.62	7.38	51.67	100.00
ROS	U.S.	2.29	9.12	15.37	2.57	29.91	40.74	100.00
	Germany	1.68	1.28	16.27	0.00	20.17	60.59	100.00
	Japan	4.03	5.65	9.99	4.80	14.90	60.64	100.00
Sales Growth	U.S.	4.74	0.00	6.55	4.21	10.54	73.96	100.00
	Germany	28.35	0.00	5.92	2.67	2.33	60.73	100.00
	Japan	44.84	0.00	1.23	5.05	0.00	48.89	100.00

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