WHY DO CEOS MATTER MORE IN SOME COUNTRIES THAN OTHERS? MANAGERIAL DISCRETION AT THE NATIONAL LEVEL

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INTRODUCTION

Managerial discretion (Hambrick & Finkelstein, 1987), or latitude of action, concerns the impact that senior executives have on the behavior of their firms. Building on recent work that find CEOs may have a greater impact on firm performance in some countries than others (Crossland & Hambrick, 2007), this paper seeks to demonstrate the construct validity of managerial discretion at the national level.

Drawing on new institutional theory, I argue that the degree of discretion available to senior executives in a country – particularly to CEOs of public companies headquartered in that country – is greatly shaped by the country's informal and formal institutions. Institutions are societal "rules of the game" (North, 1990: 3), or consensually-devised constraints on human behavior. I develop hypotheses regarding the role of national institutions in shaping discretion. I discuss the impact of two informal institutions – a country's norms regarding autonomous actions and its norms regarding unpredictability – and two formal institutions – legal tradition (common vs. civil law) and employer flexibility. In a final hypothesis, I focus on the consequences of discretion, arguing that managerial discretion will be, in turn, positively related to the magnitude of effect that CEOs in a country have on the performance of their firms.

On the empirical front, this paper relies on multiple data sources and analytic stages. Using several prior researchers' measures of national institutions, I relate these measures to country-level managerial discretion scores, which were generated using an academic panel with expertise in cross-national business. I then relate these country-level discretion scores to multiple indicators of CEO effects on firm performance, derived from a ten-year sample of 746 public firms headquartered in 15 different countries.

THEORY DEVELOPMENT AND HYPOTHESES

National Institutions and Managerial Discretion

Hambrick and Finkelstein (1987) introduced the concept of managerial discretion as a way to resolve the ongoing debate about whether executives have much influence over firm outcomes (Child, 1972). These authors argued that executives vary widely in how much discretion they have; and, logically, executives can only affect outcomes to the extent they have leeway in their choices and behaviors. According to Hambrick and Finkelstein, discretion is present to the extent that there is: a) an absence of constraint, and b) considerable means-ends ambiguity. I examine several national-level institutions that will affect managerial discretion.

Norms Promoting Autonomy. Those societies in which autonomy-enhancing, individualistic values are most prevalent will allow senior executives broader latitude in terms of actions characterized as radical. The zone of acceptance of powerful stakeholders will be wider, and there will be greater support for a unilateral decision-making style. Accordingly, CEOs – among a society's most powerful individuals – will be encouraged and expected to impart their own idiosyncratic stamps on their organizations' forms and directions (or re-directions).

Hypothesis 1: The more that a society's norms promote autonomy, the greater the discretion available to CEOs of firms headquartered in that society.

Norms Tolerating Unpredictability. Societies with greater tolerance for unpredictable actions, and the uncertainty associated with those actions, will provide broader zones of acceptance for executives and thus greater discretion. Such societies will permit senior executives to consider and implement wider ranges of actions. A given action (e.g., substantially altering the scope of a company) may not be perceived as particularly radical or objectionable in these societies.

Hypothesis 2: The more that a society's norms favor or tolerate unpredictability, the greater the discretion available to CEOs of firms headquartered in that society.

Legal Tradition. In societies with a common-law legal tradition (cf. La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998), the rights of private property holders -- specifically shareholders -- tend to be privileged over the rights of other stakeholders. However, in civil-law countries, a firm's decision-makers experience far greater pressure to simultaneously address the interests of non-shareholding stakeholders -- including customers, suppliers, employees, government, and the broader social environment. A common-law CEO's task is, therefore, largely one of "maximizing shareholder wealth." There is no such direct corollary for a civil-law CEO (Johnson et al., 2000). CEOs in common-law countries must therefore pursue a particular end ("maximize shareholder wealth"), but they are given considerable leeway in how to go about this objective. In contrast, the restrictions on a civil-law CEO are much more proximal (and therefore more limiting). They are means-based, not ends-based (cf. Shen & Cho, 2005). Strategies and policies are allowable only if they meet with acceptance by, or at least balance the needs of, multiple constituencies. In sum, the CEOs of public firms headquartered in common-law countries will tend to have greater discretion than CEOs of firms headquartered in civil-law countries.

Hypothesis 3: Societies with a common-law legal tradition (compared to societies with a civil-law legal tradition) will provide greater discretion to CEOs of firms headquartered in that society.

Employer Flexibility. Employers have flexibility to the extent that they are legally allowed to easily alter the composition and deployment of their employee populations (Black, 2001). Flexibility is lacking when the relations between an employee and an employer are dictated heavily by non-economic factors such as legislation, claims to permanent tenure, and historical contracts. The less employer flexibility in a country, the less discretion available to CEOs. Restrictions on hiring new employees and firing existing ones will result in CEOs being much more cautious and incremental in their growth strategies.

Hypothesis 4: The more that a society confers flexibility on employers, the greater the discretion available to CEOs of firms headquartered in that society.

Managerial Discretion and CEO Effects on Firm Performance

In countries where managerial discretion is limited, CEOs will have minimal influence over company outcomes. With limited ranges of choices, CEOs will rarely place their distinctive marks on their firms. Conversely, in countries where managerial discretion is more abundant, CEOs will have more influence over performance outcomes. Allowed to take distinctive actions that depart from those of their predecessors and peers, CEOs in high-discretion countries have an increased likelihood of delivering extreme performance. When smart or lucky CEOs take actions that depart widely from those of their predecessors or peers, they have a disproportionate chance of delivering highly positive results. When foolish or unlucky CEOs take distinctive actions, they are more likely to put their negative imprint on their firms.

Hypothesis 5 (H5): The greater the level of managerial discretion in a society, the greater the variance in firm performance attributable to CEOs.

METHODS

I selected for study fifteen countries for which I was able to obtain sufficient firm-level and national institutional data, and which have significant numbers of publicly-traded firms: Australia, Austria, Canada, France, Germany, Italy, Japan, (South) Korea, The Netherlands, Singapore, Spain, Sweden, Switzerland, United Kingdom, and United States. I drew a sample from the 2006 Forbes Global 2000, an annual listing of the 2000 largest public firms in the world. My final sample comprised 746 firms from 15 different countries, representing 27 different industries. My sample frame was 1997-2006, a total of 7019 firm-years of data. See Table 1 for mean national-level managerial discretion scores.

Table 1 about here

Measures

I operationalized *norms promoting autonomy* and *norms tolerating unpredictability* with, respectively, Hofstede's (2001) country-level scores for the cultural values of individualism vs. collectivism and uncertainty avoidance. *Legal tradition* was operationalized by using La Porta et al.'s (1998) common-law vs. civil-law dichotomy. Each country was coded as having either a common-law legal tradition (coded as 1) or a civil-law legal tradition (coded as 0). *Employer flexibility* was operationalized by using the reverse of Botero et al.'s (2004) country-level scores on the "Employment Laws Index".

Following Hambrick and Abrahamson (1995), I used an expert panel to measure country-level *managerial discretion*. I searched the Social Science Citation Index for all authors of articles published in eight highly-cited management journals from 1997 to 2006, with the terms "cross-national," "cross-cultural," "international," "countries," or "nations" in their titles, keywords, or abstracts. I contacted those scholars who had authored or co-authored at least four of these articles, for a total of 73 individuals. Of these, 26 (36%) agreed to participate and provided usable responses; these 26 individuals comprised the expert panel. Each panelist was first given a short description of managerial discretion. Then, each panelist was asked to rate, on a 1-7 scale, the degree of discretion available to CEOs in any of the 15 countries with which they felt sufficiently familiar. Each country received between 14 and 26 discretion ratings (mean = 21.5). ICC(3,k) for the sample was 0.90.

To calculate *CEO effects*, I used four different measures of firm performance: return on assets (ROA), return on invested capital (ROIC), return on sales (ROS), and market-to-book (MTB) ratio. I used a 4-level nested HLM model (cf. Hough, 2006) of years (level 1) within CEOs (level 2) within firms (level 3) within industries (level 4). For instance, ROA in a particular firm-year was modeled as a grand mean (γ_{0000}), with random effects for industry k (α_{000k}), firm j (β_{00jk}), CEO i (δ_{0ijk}), and year t (η_{tijk}), and an overall error term (ε_{tijk}). Total ROA variance is therefore equal to the sum of the variance for each of the random effects:

$$\mathrm{Var}(\mathrm{ROA}_{tijk}) = \mathrm{Var}(\alpha_{000k}) + \mathrm{Var}(\beta_{00jk}) + \mathrm{Var}(\delta_{0ijk}) + \mathrm{Var}(\eta_{tijk}) + \mathrm{Var}(\varepsilon_{tijk}) \qquad (1)$$

I ran this HLM model for each performance measure in each country (a total of 60 separate analyses). From each such analysis, I generated two indicators of CEO effects on performance in a given country. *Absolute CEO effect* is the simple magnitude of the variance attributable to CEOs in a given country sample (net of all other factors: industry, year, company, and error). Absolute CEO effect is equal to $\mathrm{Var}(\delta_{0ijk})$ in equation 1 above. *Proportional CEO effect* is the variance attributable to CEOs divided by the total magnitude of variance in the country sample. Proportional CEO effect is equal to $\mathrm{Var}(\delta_{0ijk})/\mathrm{Var}(\mathrm{ROA}_{tijk})$ in equation 1. I examined both of these measures because they each tell an incomplete story about CEO effects.

Analyses

To test the hypotheses relating national institutions to managerial discretion (H1-H4), I used fixed-effects regression analysis. The independent variable for each regression was the respective set of national institution scores and the dependent variable was all of the expert panelists' individual ratings of country-level managerial discretion (a total of 291 distinct ratings). To test the relationship between country-level managerial discretion and executive effects on firm performance (H5), I again used fixed effects regression. Here, the 291 panel-generated discretion scores were the independent variables, and the respective country-level CEO effects measures were the dependent variables.

RESULTS

Norms promoting autonomy was positively and significantly related to managerial discretion ($\beta = 0.024$, $p < .01$), supporting H1. Norms tolerating unpredictability was positively and significantly related to discretion ($\beta = 0.015$, $p < .01$), supporting H2. Common-law legal tradition was positively and significantly related to discretion ($\beta = 1.101$, $p < .01$), supporting H3. Finally, employer flexibility was positively and significantly related to discretion ($\beta = 0.970$, $p < .01$), supporting H4. I also tested the effects of all four national institutions simultaneously. In this model, two predictors continued to show significant relationships with managerial discretion: norms promoting autonomy ($\beta = 0.016$, $p < .01$) and legal tradition ($\beta = 1.058$, $p < .01$). This provides further support for H1 and H3. However, this test failed to provide further support for H2 and H4.

Moving to H5, managerial discretion was positively and significantly related to absolute CEO effects for ROA ($\beta = 0.84$, $p < .01$), ROIC ($\beta = 3.08$, $p < .01$), ROS ($\beta = 2.39$, $p < .01$), and MTB ($\beta = 0.50$, $p < .01$). Managerial discretion was also positively and significantly related to proportional CEO effects for ROA ($\beta = 1.69$, $p < .01$), ROIC ($\beta = 2.24$, $p < .01$), ROS ($\beta = 0.92$, $p < .01$), and MTB ($\beta = 2.14$, $p < .01$). Therefore, I found strong support for Hypothesis 5.

Figure 1 illustrates the relationship between national-level managerial discretion and CEO effects. Figure 1a shows the relationship between discretion and the absolute CEO effect index. To create this index, I converted absolute CEO effects for each of the four performance variables to z-scores, then summed the z-scores. Figure 1b shows the relationship between discretion and the proportional CEO effect index. The line in each graph represents the fitted values for the respective regression model. As can be seen, there is a substantial positive association between a country's mean discretion score and the magnitude of CEO effects on performance (measured two different ways) in that country.

Figure 1 about here

REFERENCES AVAILABLE FROM THE AUTHOR

TABLE 1
Mean National-level Managerial Discretion Scores, Based on Expert Panel Data

Country	**Managerial Discretion**
United States	6.08
Australia	5.72
United Kingdom	5.61
Canada	5.50
Netherlands	5.07
Switzerland	5.06
Italy	4.89
Spain	4.79
Sweden	4.59
France	4.53
Singapore	4.53
Austria	4.47
Germany	4.31
South Korea	4.17
Japan	3.69

FIGURE 1
Managerial Discretion and Executive Effects on Firm Performance

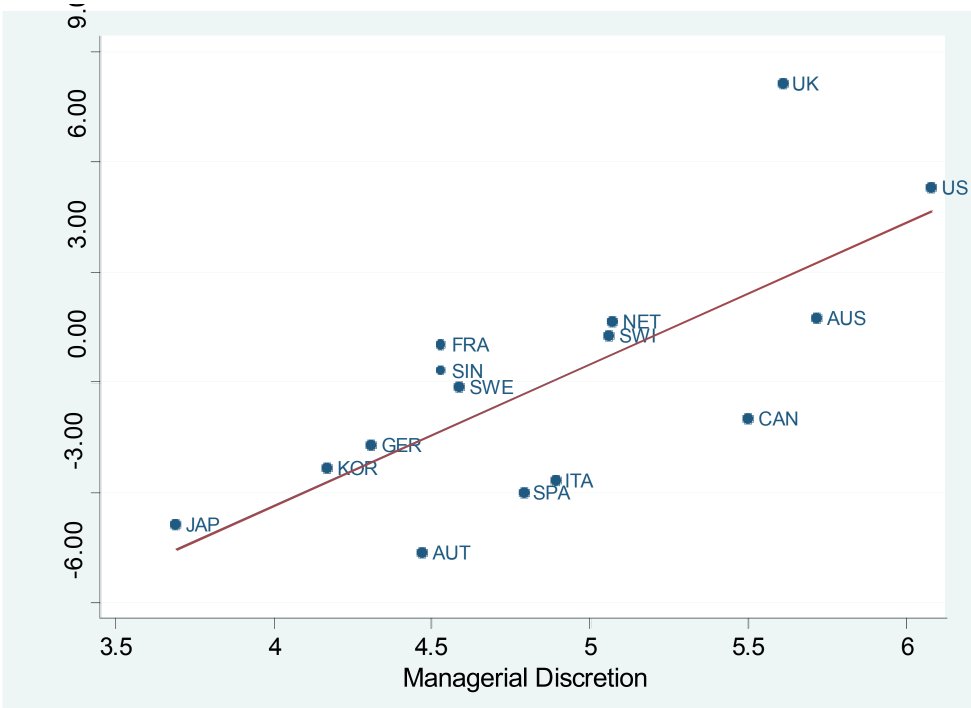

Figure 1a: Absolute CEO Effect

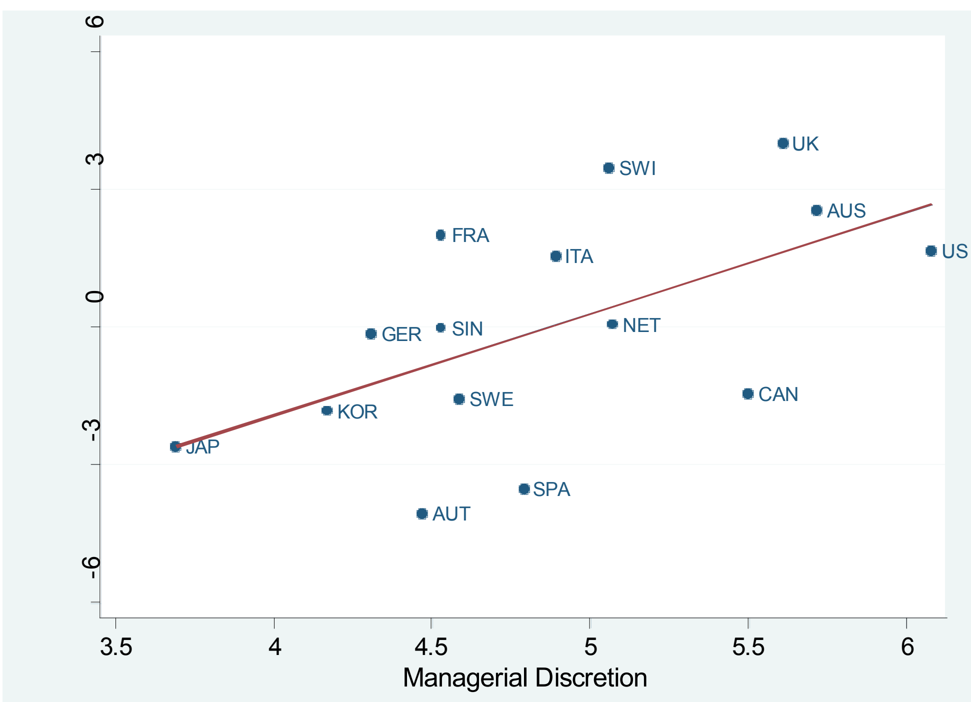

Figure 1b: Proportional CEO Effect