NATIONAL INSTITUTIONS AND MANAGERIAL DISCRETION: A TAXONOMY OF 24 COUNTRIES

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INTRODUCTION

Do top managers matter? Organizational scholars have tended to approach this question from polar perspectives. On one side is much of the work in the field of strategic management, which generally proceeds on the assumption that managers, executives, and leaders do indeed matter significantly to the outcomes of their firms (Barnard, 1938; Chandler, 1962). On the other side is work grounded more in organization theory, which tends to instead assume that individual executives are relatively powerless in the face of overwhelming environmental and organizational constraints (Hannan & Freeman, 1977; Pfeffer & Salancik, 1978). In an attempt to reconcile these two competing perspectives, Hambrick and Finkelstein (1987:371) introduced the concept of managerial discretion, defined as latitude of managerial action, as a way to understand whether, and when, executives will have strategic choice (Child, 1972).

While considerable research has explored the firm-level and industry-level factors that affect discretion (e.g. Finkelstein & Boyd, 1998), very little research has considered the systematic impact on discretion arising from national-level factors. Thus, this paper seeks to provide an initial answer to the following research question: *What are the antecedents and manifestations of cross-national differences in managerial discretion?* The primary thesis of this paper is that cross-national differences in three formal institutions – legal tradition, prevailing firm ownership structure, and labor market flexibility – and one informal institution – cultural values – will be associated with cross-national differences in the discretion of public firm CEOs. I construct a taxonomy of 24 high-income countries, based on findings from previous cross-national research into these institutions, and examine the resultant multi-country clustering.

NATIONAL INSTITUTIONS

Although its place in the strategic management literature has traditionally been peripheral, institutional research has a long, rich history in the social sciences (Durkheim, 1893; Veblen, 1909). Institutional arguments focus on the importance of evaluating human behavior, not just in terms of simplifying assumptions such as utility maximization, but in terms of prevailing social beliefs, values, relations, structures, constraints, and expectations (Scott, 2001). Institutional economics identifies that the primary purpose of institutions is to reduce uncertainty (e.g. North, 1990: 25). Socio-economic interaction between individuals and organizations holds the potential for dizzying complexity, were it not for the supporting bedrock of procedure, precedent, and mutual expectation. Institutions provide this bedrock, thus reducing uncertainty. In reducing uncertainty, though, institutions simultaneously, necessarily constrain behavior.

A number of authors have attempted to define institutions. While the language varies somewhat, almost all definitions portray institutions as resilient social structures. For example, Scott (2001: 49) defines institutions as, "multifaceted, durable social structures, made up of symbolic elements, social activities, and material resources." For the purposes of this paper, I

will adopt North's (1990: 4) somewhat simpler, if broader, definition, "*Institutions are any form of constraint that human beings devise to shape human interaction.*"

An executive possesses discretion when his or her chosen actions fall within the "zone of acceptance" of powerful stakeholders (Hambrick & Finkelstein, 1987: 374). In selecting specific institutions to examine, therefore, there are four major criteria. First, the institutions chosen must be reflective of the broad international business environment (Guisinger, 2001). Second, the institutions must significantly affect the major stakeholder groups in a firm. Third, the institutions must be relevant in all countries examined. Fourth, there will be a trade-off between comprehensiveness (more institutions) and parsimony (fewer institutions). Optimizing these criteria results in a group of four national-level institutions: legal tradition, prevailing ownership structure, labor market flexibility, and cultural values. The first three of these may be classified as formal institutions, while the fourth is an informal institution (North, 1990).

Formal Institutions

Legal Tradition. In a comprehensive research stream, La Porta and colleagues (e.g. La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998) have investigated some of the central links between law and finance. This body of work argues that a fundamental cross-national distinction is between a common-law (adversarial) legal tradition, derived from English law (e.g. Australia), and a civil-law (inquisitorial) legal tradition, derived from Roman law (e.g. France). The common law evolved primarily as a way to protect the rights of private property owners against the Crown (Mahoney, 2001). In contrast, the civil-law system developed more as a means of solidifying state power (North & Weingast, 1989).

These different legal origins have, in a path-dependent manner, resulted in different emphases in the current corporate universe. In common-law countries, the rights of property owners (i.e. a firm's shareholders) continue to be privileged over those of other stakeholders. In civil-law countries, executives are required to take into account the interests of all corporate stakeholders, including employees, customers, and society at large. Thus, the legal mandate of a common-law public executive can be largely encapsulated in the phrase, "maximize shareholder wealth". A civil-law executive's mandate cannot be expressed quite as succinctly (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). Common-law executives are therefore legally constrained to pursue a particular end ("maximize shareholder value"), but are given almost free rein in terms of the means available to pursue this end. On the other hand, the constraints on a civil-law public executive exist at the level of means, not ends (cf. Shen & Cho, 2005).

For example, closing down a large domestic manufacturing plant and outsourcing production overseas might theoretically result in a significant increase in firm value. However, such an action might also harm a large number of employees and perhaps even an entire geographic region. Therefore, this action – negatively affecting as it does several key stakeholders – is more likely to be protested, delayed, and possibly shelved entirely in civil-law countries. Overall, then, the more proximal pressure of stakeholder protection (inherent in civil-law systems) will tend to provide greater constraint on discretion than the more distal pressure of shareholder value maximization (inherent in common-law systems). See Table 1.

Table 1 about here

Prevailing Firm Ownership Structure. Ownership structure concerns how, and by whom, a firm's equity is held. At the national level, prevailing ownership structure refers to consistencies in the patterns of public firm ownership that exist across firms. Berle and Means (1932) originally identified the separation of ownership and control in modern corporations. That is, they argued that a firm's primary shareholders (owners) tended to be both widely dispersed and distinct from the firm's managers (controllers), suggesting that managers tend to have quite substantial levels of discretion. However, while prevalent within a U.S. context, the separation of ownership and control varies considerably across the industrialized world (Claessens, Djankov, & Lang, 2000). For countries at one end of the spectrum, most public firms tend to have a considerable proportion of their equity in the hands of a single entity. That entity might be a family (e.g. Korea), the national government (e.g. France), a large bank (e.g. Germany), or a business group (e.g. Japan). For countries at the other extreme, most public firms have a dispersed ownership structure, where large blockholdings are uncommon and control of a firm by a single entity is far less prevalent, (e.g. U.K., U.S.).

In the former case, where ownership is concentrated, CEOs' latitudes of action are far more likely to be constrained (Jensen & Meckling, 1976). If a firm's CEO pursues a course of action that is at odds with the expectations of the firm's major shareholder, the CEO is much more likely to experience resistance than if there were no such major shareholder in place. In contrast, when firm ownership is diffuse, shareholder influence over the running of a firm tends to also be more diffuse, occurring at an arms'-length to the firm. When there are few or no controlling interests in the firm, senior executives will have a greater opportunity to pursue their preferred ends. Note that I am not suggesting that all firms within a particular country will have the exact same ownership structure. Instead, I argue that the central tendency of public firm ownership within a country will position that country somewhere on the continuum of concentrated versus diffuse ownership, with commensurate implications for executive discretion.

Labor Market Flexibility. Labor markets are flexible to the extent to which they permit employees and employers to rapidly alter the scope and nature of their interactions in response to changing economic conditions (Black, 2001). Labor markets are inflexible when employee-employer relations are heavily determined by historical agreements, legislation, and other non-market factors. In terms of executive discretion, the most salient element of labor market flexibility is employment protection, the likelihood that an employee will be retained by the firm, irrespective of economic conditions (Estevez-Abe, Iversen, & Soskice, 2001). Variance in the level of employment protection across countries is a combined function of several inter-related elements, including legislation, enforcement mechanisms, and union representation.

Put simply, the greater the level of employment protection, the lower the level of discretion available to executives. First, high levels of employment protection will most obviously be a major constraint during periods of downturn, as executives will have far fewer powers in terms of employee furloughs and layoffs. Large-scale layoffs, seemingly a mandatory component of the turnaround strategy in Anglo-American firms (Lee, 1997), are considerably less common in many Continental European nations, such as Germany, and continue to create enormous upheaval when they do occur (Gangl, 2003). Second, executives may even find it more difficult to hire individuals in periods of rapid corporate growth. If regulations governing employee hiring practices are particularly onerous, a CEO may find excessive growth almost as difficult to cope with as company downturns. Knowing this, executives are more likely to adopt a risk-averse approach. If an executive knows that it will be cumbersome to hire new employees

and virtually impossible to lay off existing employees, then he or she is far more likely to seek slow corporate growth within narrow, stable limits, and avoid quantum or risky strategic actions.

Informal Institution: Cultural Values

Most research in the area of institutions has focused on formal institutions, from which I argue that legal tradition, ownership structure, and labor market flexibility are fundamental and representative. However, equally important are informal institutions, such as social norms, mores, values, and codes of behavioral conduct. By far, the majority of cross-national work that can be classified as focusing on informal institutions falls within the domain of cultural values. As the nature and extent of discretion is dependent upon powerful stakeholders (Hambrick & Finkelstein, 1987) – in this case, society in general – CEOs from one country will possess greater discretion if societal pressures to conform to particular standards of behavior are stronger than exist in a different country. The most relevant expression of cultural values (for managerial discretion) is House, Hanges, Javidan, Dorfman, & Gupta's (2004) GLOBE dimension of institutional collectivism. Defined as, "the degree to which institutional practices at the societal level encourage and reward collective action" (House et al., 2004: 30), institutional collectivism concerns the normative constraints on unilateral executive action in a society.

Societies characterized by low institutional collectivism will allow greater executive discretion. These societies will tend to permit and promote individual interests and will tolerate unilateral decision-making. Chief executive officers, as a particularly notable symbol of the empowered individual, will be given considerable leeway in deciding upon the preferred direction of their firms. This is not to say that executives will not be held accountable for their decisions in high discretion environments. Indeed, a highly individualistic society may in fact be more likely to attribute individual blame for corporate failure (cf. Krull et al., 1999).

In contrast, CEOs operating in societies characterized by high levels of institutional collectivism will tend to experience less discretion. Members of society, as well as firm employees, middle managers, and executives, will have stronger expectations that important strategic decisions will be the outcome of a consultative process. While one might plausibly argue that such a consensus-oriented process will often result in qualitatively superior decisions, these decisions will tend to take longer to agree upon and implement. In addition, the eventual scope of many consensually-devised decisions can be expected to be less quantum and more incremental in nature, which will also reduce the potential discretion of individual executives.

A TAXONOMY OF NATIONAL INSTITUTIONS

Using the four institutions discussed above and existing data from the literature, I constructed a 24-country taxonomy of institutional constraints on executive discretion (see Figure 1). The institutions were operationalized as follows. Legal tradition is a dichotomous variable, with each country designated as a common-law or a civil-law system (La Porta et al., 1998). Ownership structure, a continuous variable, is the proportion of medium-sized public firms in a country that are not widely held (La Porta, Lopez-de-Silanes, & Shleifer, 1999). Labor market flexibility, a continuous variable, is a weighted index of employment protection within a country (Estevez-Abe et al., 2001). Cultural values, also a continuous variable, is the level of institutional collectivism in a society (House et al., 2004). For each institution, I dichotomized (based on a median split) the available country-level data to generate a 16-cell taxonomy.

Figure 1 about here

Multi-Country Discretion Groups

A central purpose of a taxonomy is to determine whether, across the dimensions of interest, the units of analysis (in this case, countries) show some systematicity in terms of their relation to one another (Bailey, 1994). By dichotomizing each of these four institutional variables, we are left with as many as 16 distinct institutional patterns. However, as Figure 1 reveals, instead of being randomly scattered across all cells in the taxonomy, a number of multi-country groups emerge: 19 of the 24 countries are concentrated into just four cells, and 11 of the cells are completely empty. This proximity suggests that there are underlying substantive factors linking these groups together, and that there are a number of distinct multi-country discretion patterns. Omitting the five countries (Belgium, Denmark, Israel, Korea, and Switzerland) that did not clearly fit into a multi-country group, four groups emerge: the *low-discretion countries* (Finland, Japan, Netherlands, Norway, Sweden), the *rule-constrained countries* (Austria, France, Germany, Greece, Italy, Spain, Portugal), the *norm-constrained countries* (Canada, Ireland, New Zealand, Singapore), and the *high-discretion countries* (Australia, U.K., U.S.).

Low-Discretion Countries. Countries within this group (e.g. Japan and Sweden) possess institutions classified as having low discretion on all four dimensions considered. Thus, executives from these countries have greater formal and informal constraints on their behavior. This suggests that, relative to other countries, the CEOs of firms operating within this country group have relatively less capacity to idiosyncratically shape the outcomes of their firms – for good or for ill – than their counterparts from other countries.

Rule-Constrained Countries. Countries within this group (e.g. France and Germany) have formal institutions that tend to constrain executive discretion and informal institutions that allow greater discretion. This raises the question of which type of constraint, formal or informal, imposes greater inhibition. While it is difficult to isolate the influence of either type of constraint, a number of authors have argued that informal constraints become most salient when the enforcement of formal constraints is weak or lacking (Peng, 2002). Accordingly, formal constraints may be more immediate within developed countries, where the rule of law is relatively strong. Therefore, I argue that CEOs operating within the rule-constrained country group will have more discretion than those operating in the low-discretion group, but less discretion than those in the norm-constrained country group.

Norm-Constrained Countries. Countries within this group (e.g. Canada and Ireland) possess institutional environments that impose weaker formal constraints on behavior, but stronger informal constraints. This country group is in many ways the reverse of the rule-constrained group, which allows informal latitude but imposes formal constraint. As argued above, it is likely that the normative constraints on discretion will be outweighed by the inter-related, reinforcing nature of the multiple legalistic freedoms. Thus, I argue that CEOs operating within the norm-constrained country group will have more discretion than those in the two groups profiled so far, but less than those in the high-discretion group.

High-Discretion Countries. Countries within this group (e.g. U.K. and U.S.) possess the reverse institutional structure to that which exists in the low-discretion countries. Each of the four institutions discussed can be considered more enabling than constraining in this group. Thus, executives operating within this country group will experience not only rule-based latitude in terms of their idiosyncratic actions, but norm-based latitude also, resulting in the most discretion of the four multi-country groups discussed.

REFERENCES AVAILABLE FROM THE AUTHOR

TABLE 1
National Institutions and Managerial Discretion

National Institution	High-Discretion Condition	Low-Discretion Condition
Legal Tradition	Common Law	Civil Law
Ownership Structure	Dispersed Ownership	Concentrated Ownership
Labor Market Flexibility	Low Employment Protection	High Employment Protection
Cultural Values	Low Institutional Collectivism	High Institutional Collectivism

FIGURE 1
A Taxonomy of National Institutions

		High Employment Protection		Low Employment Protection	
		High Inst. Collectivism	**Low Inst. Collectivism**	**High Inst. Collectivism**	**Low Inst. Collectivism**
Common Law	**Dispersed Ownership**			Canada Ireland New Zealand Singapore	Australia U.K. U.S.
Common Law	**Concentrated Ownership**			Israel	
Civil Law	**Dispersed Ownership**				Switzerland
Civil Law	**Concentrated Ownership**	Finland Japan Netherlands Norway Sweden	Austria France Germany Greece Italy Spain Portugal	Denmark South Korea	Belgium