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# **How Formal and Informal Institutions of Middle Eastern Countries Influence Managerial Discretion: An Empirical Investigation**

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**Abstract:**

Managerial discretion is the focal theme bridging the clash between two schools of thoughts; whether executives have greater influence on their firms' outcomes or other factors restrain their actions (Hambrick & Finkelstein, 1987). It is argued that constraints come from inertial, normative and environmental forces (e.g. DiMaggio & Powell, 1983). Of these restraints is the institutional environment in which a firm is headquartered. Our paper falls within this research stream and provides an extension for Crossland and Hambrick (2007, 2011) work. We investigate the national level of discretion in new cross-cultural contexts, provide deeper understanding of its concept, and shed the light on undiscovered discretion's antecedents and consequences. We adopt a quantitative approach in which questionnaires represent our data collection instrument. We anticipate that in high discretion countries firms tend to follow what Miles & Snow (1978) labeled 'Prospector' strategy as opposed to low discretion countries in which firms incline to implement a 'Defender' strategy.

**Keywords:** *Managerial Discretion, Strategic Orientation, Informal Institutions, Formal Institutions and CEO Effect.*

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## **1. Introduction**

Do executives matter? Organizational theory, population ecology and neoinstitutionalism scholars, on one hand, believe that inertial, normative and environmental forces constraint executives' actions (e.g. Hannan & Freeman, 1977; DiMaggio & Powell, 1983). On the other hand, strategic management academics assure greater effect of executives on organizational fate and form (e.g. Wiersema & Bantel, 1992; Sanders, 2001; Hambrick & Quigley, 2014). Within this divide, Hambrick & Finkelstein (1987) introduced managerial discretion as a new theoretical concept shifting the debate from 'whether' to 'when' executives matter. Managerial discretion refers to the latitude of strategic actions (Hambrick & Finkelstein, 1987), in other words the leeway executives have to implement strategic initiatives. Since then, a growing body of investigations began to discover its various constructs. The bulk of this research stream has focused mainly on: the industrial (e.g. Hambrick & Abrahamson, 1995; Carpenter & Golden, 1997; Hambrick et al, 2004; Sahaym et al, 2012), organizational (Boyd & Salamin, 2001; Kim, 2013) and individual's (e.g. Roth, 1992; McClelland et al, 2010) antecedents. While this greater emphasis on micro constructs, the institutional paradigm has been significantly ignored. In this consideration, Crossland & Hambrick (2007, 2011) were first to integrate the national-level framework with discretion, in which they examined the variance degrees of discretion across several OECD countries. Despite this attempt, the research on national level of discretion is characterized by a dearth of investigation in terms of its antecedents, consequences and validity in other cross-cultural contexts.

Consequently, does this difference apply to other countries? What is the impact of discretion (national-level) on firms' outcomes, particularly strategic orientation? All these questions and others remained unanswered. Accordingly, our research aims to enhance, enrich and improve our understanding on discretion by uncovering new precursors and consequences.

## **2. Literature Review**

Earlier studies have concentrated on discretion's three core dimensions: managerial individualities (e.g. Roth, 1992; Carpenter & Golden, 1997; McClelland et al, 2010), internal organization (e.g. Rajagopalan, 1997; Finkelstein & Boyd, 1998; Boyd & Salamin, 2001; Quigley & Hambrick, 2012; Kim, 2013) and industry (e.g. Haleblan & Finkelstein, 1993; Magnan & St-Onge, 1997; Datta & Rajagopalan, 1998; Peteraf & Reed, 2007; Keegan & Kabanoff, 2008; Finkelstein, 2009; Hambrick & Quigley, 2014). These efforts could be classified into diverse categories:

First, studies that looked at the antecedents of discretion such as: Hambrick & Abrahamson (1995), Carpenter & Golden, (1997), Key, (2002) and Hambrick et al (2004). Findings indicated that product differentiability, market growth and demand instability as industry features enhance the level of discretion. But, industry legal constraints, commoditization and powerful external forces (e.g. supplier power) diminish discretion. In terms of organizational factors, it has been shown that resource availability and slack intensify discretion. However, organizations' capital intensity, size, age and powerful inside forces (e.g. shareholders) have negative effects. Moreover, it was empirically tested that aspirational level, tolerance for ambiguity, cognitive complexity, internal locus of control and power base play an important role in strengthening the degree of discretion provided to executives (mainly CEOs). Whereas, executives' commitment to the status quo and external locus of control are barriers limiting their latitude of actions.

Second research category, (e.g. Miller et al, 1982; Singh & Harianto, 1989; Abrahamson & Hambrick, 1997; Datta & Rajagopalan, 1998; Finkelstein & Boyd, 1998; Keegan & Kabanoff, 2008; Finkelstein, 2009; McClelland et al, 2010; Graffin et al, 2011; Sahaym et al, 2012; Hambrick & Quigley, 2014) reviewed the consequences of discretion. In here, researchers found that higher discretion leads to greater: accounting adjustments, CEO effect on performance, CEO compensation, CEO compensation alignment with performance, use of golden parachutes, initiative strategies (e.g. exports, strategic changes, new market entry) and changes in CEO behaviour (innovativeness, risk taking, pro-activeness). In addition to that, discretion causes changes in CEO commitment to the status quo, homogeneity within industries and changes in financial implications (debt usage, discipline from debt).

The third category could be labeled as studies employing discretion as an intermediary variable (e.g. Lieberman & O'Connor, 1972; Finkelstein & Hambrick, 1990; Hambrick et al, 1993; Halebian & Finkelstein, 1993; Magnan & St. Onge, 1997; Buchholtz et al, 1999; Datta et al, 2005; Goll et al, 2008; Preston et al, 2008; Campbell et al, 2012; Messersmith et al, 2013). In this vein, scholars mediated discretion forces (e.g. industry, individual and organizational characteristics) between independent (e.g. CEO power, locus of control, firm performance, industry type, strategic persistence, strategic conformity, tenure, power, compensation, etc.) and dependent variables (e.g. firms' outcomes including financial performance, strategy and CEO behaviour) in order to illustrate the significant effect of discretion.

Furthermore, some have attempted to go beyond the industry boundaries and investigated the influence of the institutional environment (e.g. Gedajlovic & Shapiro, 1998; Makhija & Stewart, 2002; Crossland & Hambrick, 2007, 2011; Crossland & Chen, 2013; Rabl et al, 2014). The seminal work of Crossland & Hambrick (2007, 2011) tested the effect of national institutions on CEO discretion levels across 15 countries. They empirically found that informal (individualism, uncertainty tolerance and cultural looseness) and formal (ownership structure, legal origin, employer flexibility) institutions significantly affect the level of discretion available to CEOs in a particular country. More importantly, they argued that discretion varies widely from one country to another according to the level of constraints exerted by its institutional environment (Crossland & Hambrick, 2007, 2011). That being said, in countries where discretion is high, executives' effect on firms' outcomes increases (Crossland & Hambrick, 2011).

The latter stream explored the antecedents of discretion on a new scale, the institutional environment. However, some additional investigations such as: the consequences of discretion at the national level, validity of these findings in a different context and other antecedents of discretion are still unexplored.

### **3. Gaps Identification & Contribution**

Despite the increased number of work on managerial discretion, significant gaps remain present particularly within its institutional paradigm. As such, researchers have the opportunity to fill in these holes and this represent our core purpose.

In essence, higher discretion at the national-level leads to greater CEO effect on firm's performance (Crossland & Hambrick, 2011) and higher CEO dismissal sensitivity (Crossland & Chen, 2013). It also indicates that executives have more accountability, greater comfort with uncertainty, higher power and a more risk taking behaviour (Makhija & Stewart, 2002). These findings represent discretion

consequences so far, but some other implications on organizational outcomes remain unknown. For instance, Miles and Snow (1978) well-known strategic typology have presented several firms' strategic orientations including: *Prospector strategy* (firms pioneering in product & market development); *Defender strategy* (companies having no or little market & product development); *Analyzer strategy* (mid-point between the previous two); and finally *Reactor strategy* (firms possessing inconsistent strategies). These strategies can be employed by firms in order to efficiently reflect and adapt to their environment. Since executives have greater effect on firms' outcomes (Hambrick & Quigley, 2014), then, by taking into consideration the various national discretion level, what would be the impact of CEOs on firms strategic orientation. None of the previous studies has considered such link; accordingly, our work scrutinizes the relationship between national discretion levels and firms' strategic orientation. Our main argument resides in the notion that in high discretion countries CEOs possess greater leeway over their strategic choices and actions, and as organizations' competitive strategy tends to be influenced by the level of discretion available in the industry (e.g. Rajagopalan & Finkelstein, 1992). Then, we argue that CEOs of firms headquartered in high-discretion countries are more likely to follow 'Prospector' strategy as opposed to their counterparts in low-discretion environments, which are more suited to excel a 'Defender' strategy. Moreover, as 'Analyzer' strategy is the mid-point between prospector and defender, thus we argue that CEOs leading firms located in countries with moderate discretion levels tend to lean more toward implementing 'Analyzer' strategy. Lastly, we are omitting the use of 'Reactor' strategy due to its consideration as a strategic failure (e.g. Miles & Snow, 1978; Rajagopalan, 1997).

Moreover, it is worth to note that almost every study that tackled discretion has been conducted on developed countries (e.g. US, UK, etc.). But, in our case, we chose to look at new institutional environments that have been ignored by other scholars either due to accessibility issues or interests. Thus, by looking at Middle Eastern markets that are characterized by different informal and formal institutions, we would be able to enrich the discretion concept.

#### **4. Methodology**

##### Sample

As previously mentioned, our main focus is to analyze discretion in new cross-cultural context, the Middle East. Hence, we look at: Kingdom of Saudi Arabia (KSA), Lebanon and the United Arab Emirates (UAE) as our main context. Despite their belongingness to the Arabian cluster, these nation-states significantly vary in terms of their national institutions (e.g. culture, governance, etc.), hence, providing fertile ground for assessing the various effect of national institutions on discretion. Additionally, even in cross-cultural studies (e.g. Hofstede, 2001, House et al, 2004) these countries have been neglected and characterized as being similar in their institutional environment as the rest of Arab countries. Therefore, our contexts also involve a cross-cultural contribution and contradict the view that Arab countries are all the same.

##### Discretion Measures

Instead of measuring discretion proxies, like most of preceding studies did, either industry, executive or organization (e.g. Finkelstein & Boyd, 1998; Boyd & Salamin, 2001; Peteraf & Reed, 2007; Finkelstein, 2009), we adopt a direct measure alike to

Crossland & Hambrick (2011). These scholars have estimated discretion degree using two expert panels (international fund managers and academics) having extensive international experience in terms of professional work or research. Seeking discretion scores from external parties is more reliable in this case as we are measuring discretion at the macro level, meaning managers are not influenced by the internal dynamics of their firm. It is worth to note that some researchers (e.g. Carpenter & Golden, 1997) have attempted to directly measure discretion by surveying executives about their perception of discretion. But, such approach leads to biased responses as executives exaggerate their potency on firms' outcomes (Hambrick & Abrahamson, 1995), this would result in assuring a greater degree of discretion, which might not necessary be the case.

Thus, we sought discretion scores from a panel of experts compromised of management consultants working in high profile consultancy firms (e.g. McKinsey & Company, Strategy&, BCG, etc.). These participants are classified according to hierarchical position and the country in which they are based. In other words, we obtained discretion scores only from consultants based in UAE, KSA and Lebanon and occupying the following positions: principals, partners, senior partners, directors or executive directors. These individuals possess extensive knowledge and expertise enabling them to provide valid responses. Discretion scores are gathered via online questionnaires based on seven-point Likert scale in which we ask participants to rate in their perception the degree of discretion provided to CEOs of public firms (publicly listed) headquartered in a particular country.

#### Institutions & Other Measures

Besides, we sought informal institutions measures from GLOBE study, a recent and more developed cross-cultural model, by House et al (2004). House and colleagues (2004) generated scores for 9 informal institutions in 62 societies by surveying domestic firms operating in three different industries. However, they did not generate any scores for UAE, Lebanon or KSA. Thus, we employ the 'Beta Survey' of the GLOBE to assess the impact of 7 informal institutions (collectivism, uncertainty avoidance, power distance, future orientation, performance orientation, humane orientation and assertiveness). Our approach is identical to House et al (2004) but with a more stratified sampling. We circulated 135 questionnaires in each country to middle managers and employees working for domestic firms that operate in five industries: Banking, Retail (non-food), Real Estate & Construction, Medical Appliances and Fast Moving Consumer Goods (FMCG). We chose such sampling to lower the effect of organization culture and industry norms. Our main objective is to get country scores, thus participants were either nationals of the country we are surveying or have been there for more than 10 years.

Finally, for the other set of variables, the data collection is as follows:

- For formal institutions, we obtained scores from La Porta et al (1999) and other works (e.g. Ali et al, 1991; Guisinger, 2001; Ali, 2009) in order to operationalize legal origin and ownership structure.
- Firm performance and CEO effect are obtained using accounting based and market-based measures including: return on asset (ROA), return on invested capital (ROIC), return on sales (ROS), market to book value (MTB), etc. (e.g. Bertrand & Schoar, 2003; Crossland & Hambrick, 2007, 2011).
- Firm strategic orientation is assessed using objective measures such as: ratio of R&D to sales, MTB, annual sale change (%), marketing to sales ratio,

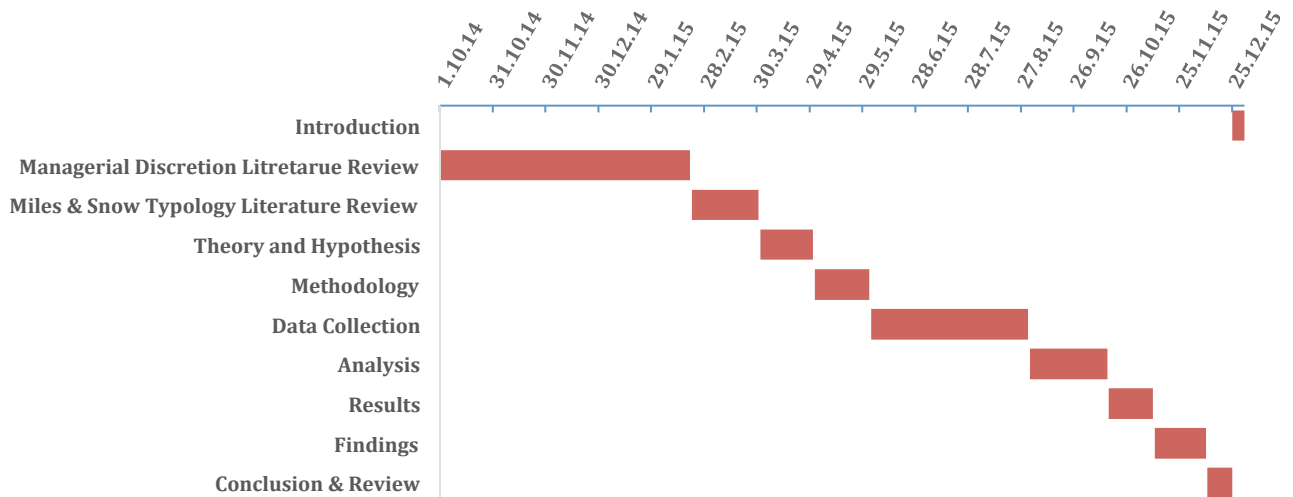
capital intensity and ratio of employees to sales. This is consistent with previous studies (e.g. Ittner et al, 1997; Bentley et al, 2013).

## 5. Conclusion

The discretion’s institutional framework remains an understudied research domain despite some prior endeavors (e.g. Crossland & Hambrick, 2007; 2011). This stream of research deserves supplementary investigation particularly in terms of the validity of previous findings and in relation to the consequences associated with such framework. Our attempt is expected to shed fresh lights in the strategic management field by enhancing the understating of discretion, providing the validity of its national constructs and exploring some new consequences.

## 6. Schedule

We expect our research to take circa one year for completion subject to a six months extension if necessary. A planned timeline is illustrated in the below chart.





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