Decision Making in the International Market: 
Is Discretion Theory Applicable?

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ABSTRACT

The focus of this paper is to examine and discuss the CEO as one of the three sources of managerial discretion. Environmental influences and the organization itself as sources of managerial discretion are given a brief explanation for informational purposes.

Attention is focused on high and low discretion industries with regard to CEO models, compensation theories are then examined as a factor influencing CEO discretion levels, and the international implications are reviewed.

The Cause of Discretion

Managerial discretion refers to the latitude of options that CEOs have when making strategic choices. [Hambrick & Finkelstein 1987].

High discretion context increase potential CEO impact on organizational outcomes because the constraints common to managing organizations are generally less severe under these conditions. Thus, high discretion context increased the potential marginal product of CEOs and, hence, their ability to influence a firm’s performance. As seen most recently with Cart of American Airlines and Lorenzo of Eastern Airlines. Thus a result, the absolute amount of CEO compensation is expected to be higher the greater the level of discretion. In addition, to the extent that the relationship between managerial discretion and CEO compensation is functional, firm performance should be higher when discretion and pay are aligned then when they are not. [Finkelstein & Boyd 1998]

The three sources of managerial discretion determined by Hambrick & Finkelstein (1987) are: (1) the degree to which environment allows variety and change; (union) (2) the degree to which the organization affects executive actions; (publicity surrounding decision) and (3) the CEO himself or herself. This study will focus its efforts on the effect of the CEO only; however, a brief explanation of other factors is important for informational purposes.
Environmental influences on organizations and CEOs have been well documented within corporations {Scherer 1970}. More variance and profitability can be attributed to CEOs in industries with high advertising intensity, which signals higher discretion than that exhibited in the more commodity-like or low-growth industries {Finkelstein & Hambrick 1990}. Other sources of environmental discretion are demand in stability, low capital intensity, competitive market structures, market growth and freedom from government regulations {Finkelstein 1992}.

The organization itself may possess characteristics that repress or magnify CEO discretion. Two of the most important characteristics are resource availability and inertial forces {Hambrick & Finkelstein 1987}. Resource availability is second in importance behind inertia. Since all strategic initiatives require adequate resources, deficiencies in those resources reduce the CEO’s options. Managerial discretion is thus enhanced by the availability of limited resources {Finkelstein & Hambrick 1990}. (Pending bankruptcy) Inertia, on the other hand, tends to reduce the CEO’s flexibility, especially in large organizations. Organizational size and a strong corporate culture are examples of some of the inertial forces that limit CEO latitude {Boyd 1993}. The conceptual model of discretion and CEO compensation, as developed by Finkelstein and Boyd (1998) can be seen in Table 2. This model pulls together the overall concept of managerial discretion and was the major theory for this study.

Effects of Discretion

The effects of discretion have been significant in both high and low discretion industries with regard to CEO models {Datta & Rajagopalan 1996}. Low discretion situations have shown that CEO positions are figureheads with low involuntary turnover, low relative compensation, stable strategy, and changes in organizational performance tied to changes in task environment. High discretion situations have shown that CEO positions are more dynamic with higher relative compensation, and greater turnover with a less task-orientated environment {Hambrick & Schecter 1983}.

Management discretion serves to weaken the relationship between executive characteristics and organizational outcomes {Finkelstein & Hambrick 1996}. Specifically, in high discretion industries, a significant relationship exists between executive orientation and the outcomes of the organization (i.e. Airlines); however, in low discretion industries it does not exist. Many studies have shown significant differences between high and low discretion firms in things such as firm size. “For example, Miller, Kets de Vries, and Toulouse (1982) found that CEO locus of control was strongly associated with organizational strategy and structure in small firms but not in large firms”{Finkelstein & Hambrick 1996}. Hambrick and Finkelstein (1990) also found a significant relationship between executive tenure and the discretionary level of the organization. In addition, Reinganum (1985) found evidence that the stock market distinguishes between high and low discretionary organizations. Various pieces of evidence support both Finkelstein and Hambricks proposal that discretion affects executive compensation arrangements (Table 2).
Other studies, while not specifically researching managerial discretion, have also found discretionary indicators in other support functions that demonstrated a relationship between CEO pay and firm’s performance {Kerr & Kren 1992} {Gomez-Mejia & Balkin 1989} {Jensen & Murphy 1990}. Specifically, executive discretion is an important construct for helping to bridge the debate regarding the influence of executives on organizational outcomes. Moreover, discretion may be a conceptual lever for improving our understanding of such matters as executive compensation. {Finkelstein & Hambrick 1996}.

**CEO Discretion Levels**

Hambrick & Abrahamson (1995) have empirically tested the distribution of industries that represent high, medium and low discretion levels. This study grew out of an earlier empirical investigation {Finkelstein & Hambrick 1990} that identified a limited number of corporations categorized as high, medium or low discretion. The reason for Hambrick & Abrahamson’s (1995) research was to develop a valid and reliable measure of what constitutes managerial discretion. They concentrated their study strictly on gauging the amount of discretion in a task environment; specifically, an industry {Hambrick & Abrahamson 1995}. Hambrick and Abrahamson utilized a panel of academics familiar with Hambrick & Finkelstein’s concept of discretion. They were asked to evaluate seventeen industries and determine the overall amount of managerial discretion. This same evaluation was also made by a group of security analysts. They then proceeded to test for reliability of individual groups as well as examining consistency between the groups. An examination was then conducted of the associations between the academics ratings and the objective industry characteristics postulated by Hambrick & Finkelstein. Their purpose in taking this last step was to validate the panels’ ratings and to reveal implicit weights that they attached to specific industry characteristics. {Hambrick & Abrahamson 1995}

Hambrick & Abrahamson (1995) utilized a seven-point scale to determine the levels of managerial discretion within the industries. It was determined that industries between six and seven on the scale were high discretion industries. Conversely, industries between one and three were considered low discretion, leaving four through six in the medium discretion range. When examining CEO compensation, we need to at least mention the theory of marginal product. This theory states that an individual should be paid in a way commensurate to his or her incremental value to the organization {Fama 1980}. The mention of marginal product theory is important because it is a key economic determinant of all compensation. However, in evaluating CEO compensation, it is difficult to accurately measure incremental value. There are multiple arguments regarding a CEO’s true ability to affect desired results {Salanick & Pfeffer 1980}. Still, there have been just as many or more valid arguments that insist the CEO is the key figure and makes a definite contribution to the organization’s fortunes {Gomez-Mejia, Wiseman, et al. 1997} {Antle & Smith 1985}.

In our review of management-discretion literature, we found several studies regarding the latitude of action of the CEO and many diversification strategies {Rajagopalan & Finkelstein 1992}, but none have truly considered CEO discretion {Antle & Smith 1986}. A few recent studies have pursued the inter-relatability between risk and compensation; however, most compensation studies focused around agency theory. The few exceptions that added insight in this direction have utilized prospect theory {Gomez-Mejia, Wiseman, et al. 1997} {Sanders 1995}.

**International Implications**

CEO compensation has been studied from many perspectives. Equity theory considers the desire of CEOs to receive compensation that is perceived as fair {Finkelstein & Hambrick, 1988; Finkelstein & Hambrick, 1996; Gomez-Mejia & Balkin, 1992; Adams, 1963}. Expectancy theory suggests that CEOs expect rewards based on effort and performance achieved {Vroom, 1964}. Human capital theory examines the proposition that CEO pay is associated with the profile of the executive {Becker, 1993; Gomez-Mejia & Balkin, 1992; Hogan & McPheters, 1980; Becker, 1975}. Agency theory studies the costs associated with conflicts of interest between principals and agents {Tosi, Katz & Gomez-Mejia, 1997; Tosi, Katz & Gomez-Mejia, 1998; Fama & Jensen, 1983; Fama 1988; Jensen & Meckling, 1976}. Labor market theory scrutinizes the relationship between supply and demand in the labor markets and compensation {Fama, 1980; Fama & Jensen, 1983}. Discretion theory considers the relationship between the relative freedom of
action available to CEOs and levels of performance and compensation (Finkelstein & Hambrick, 1990; Hambrick & Abrahamson, 1995; Hambrick and Finkelstein, 1987; Rajagopalan and Datta, 1996; Murphy, 1999; Wright & Kroll, 2002).

The literature developing these theories relates CEO compensation to a host of variables, such as tenure, human capital, shareholder wealth, risk sharing, incentives, organizational size, duality, board of directors control, agency, internationalization, firm performance, managerial discretion, succession, economics, sales, and industry. To better understand the rationale for the variables proposed to determine CEO compensation, it is helpful to summarize the literature relative to the topic.

F.W. Taussig and W.S. Barker (1925) observed that the organizational structure of American business had changed from personal to institutional. Prior to the early twentieth century, businesses were structured as proprietorships or partnerships, growing larger and more complex. Whereas previously the owner(s) had managed businesses, by the early twentieth century American business had become a more impersonal enterprise that was managed by salaried employees (Taussig & Barker, 1925).

In one of the first systematic studies on CEO compensation, Taussig and Barker reviewed financial data and chief executive compensation from twenty-four industries for the ten-year periods of 1904-1913 and 1905-1914. The results of the study confirmed the theory of profits: wages belong to the employee and profits to the owners of the concern (Taussig & Barker, 1925). The interest stirred by their publication led to more inquiries into the “divergence between ownership and control” and the ways in which it affected American business and management (Berle & Means, 1932, p.228). Authors such as Baumol (1959), Simon (1959), Cyert & March (1963) and Williamson (1964) developed behavioral and managerial theories related to the employee-manager in contrast to the classical entrepreneur or owner model. Alchian and Demsetz (1972) and Jensen and Meckling (1976) viewed the firm as a set of contracts between the various factors of production. Their perspective viewed the firm holding property rights established by contracts with a team of participants each looking out for their own self-interest.

Other authors such as Festinger (1957), Zalznik and Christensen (1958), Patchen (1959), and Adams (1961) followed up on theories of cognitive dissonance, examined compensation effects based on perceptions of “equitable” versus “inequitable” and analyzed the resulting consequences. Employees perceive that they contribute an investment of education, intelligence, experience, training, skill, seniority, age, sex, ethnic background, social status, and effort for which a just return is expected (Homans, 1961). This return includes pay as well as rewards intrinsic to the job, seniority benefits, status, and status symbols (Adams, 1963). Discrepancies between employees’ perceptions of the value of their input and their perceptions of the rewards received results in dissonance and its associated costs. The cost of this dissonance could be modifications in the levels of input or output, change of comparative standards, or leaving the situation (Adams, 1963). Likewise, employers have the expectation of return on their “investment” in the employee. In exchange for their investment of pay, assets, company structure, and company history and name, employers expect a certain level of return from the employee. Discrepancies between expected returns and perceived returns cause dissonance that may result in modifications in benefits provided to the employee or termination of the relationship (Adams, 1963).

According to these writers, employees set some comparative standard against which to determine the equity or inequity of the outputs received versus the inputs provided. Determining how employees establish such comparatives remains largely unsolved; no research has dealt with issues related to the change of these factors over time (Atchison, Belcher & Thomsen, 2002).

Numerous writers have found size to be highly correlated with CEO compensation (Baumol, 1959; Fox, 1980). Simon (1957) argued that the relationship between the size of the firm and salaries paid to executives was due to the natural tendency to maintain salary differentials between levels of management. Mahoney (1979) carried this argument forward by calculating pay differentials on various levels of management to find that a 30% to 40% differential between two levels is normal. Roberts (1959) argued that the proper calculation of marginal revenue produced by an executive would be the revenue earned with the efforts of the executive minus the revenue that would have been earned without the executive's efforts. Therefore, the same efforts with the same level of success carried out in a larger firm would add more marginal revenue simply for reasons of scale. Consequently, executives in larger firms are of higher value to the
firm, and it is natural that they are so compensated (Roberts, 1959). The theoretical underpinnings for this view come from neoclassical economics and relate to measures of job complexity, the employer’s ability to pay, and the executive’s human capital (Agarwal, 1981). Four measures are used to determine job complexity: (1) span of control or the number of persons supervised, (2) functional divisions under the executive’s direct responsibility, (3) management levels or number of management levels under the executive’s indirect supervision, and (4) geographic diversity or the number of states or countries in which the executive operates businesses (Roberts, 1959). The ability to pay was also found as a determinant of executive compensation according to Roberts (1959) because of the relative shortage of executive talent and the fact that each firm has to pay competitive wages in order to attract the best talent. Consequently, the greater the firm’s ability to pay, the better the level of executives the firm is able to hire, and the higher the level of executive compensation (Agarwal, 1981). The third determinant of executive compensation, according to Roberts (1959), is human capital. The quantity and quality of human capital were determined by Roberts based on educational level, field of study, and work experience. Roberts found, in his study, that 80% of the variation between executive compensation could be explained collectively by these three independent variables (Roberts, 1959).

In keeping with classical economic and behavioral theory, numerous writers have sought to show profitability as an important predictor of CEO compensation (Agarwal, 1981; Lewellen & Huntsman, 1970). However, in many cases the linkage was not strong and supported the idea of CEO compensation being only weakly related to firm performance (Lawler, 1971; Redling, 1981; Rich & Larson, 1984). The dangers of size determining executive compensation, more than performance, were highlighted by McEachern (1975). Mere increases in size may not improve the performance of the firm even though small improvements in efficiencies may have significant consequences in large companies.

Numerous empirical studies have examined the differences in the effects between control exercised in owner-controlled firms versus that exercised in management-controlled firms (Salancik & Pfeffer, 1980). Owner-controlled firms tend to have higher profitability (McEachern, 1975) while management-controlled firms tend to over-report earnings (Saloman & Smith, 1979), are more risk-averse (Palmer, 1973), and are more likely to violate antitrust laws (Blair & Kaserman, 1983).

Recognizing the potential effect of control on compensation, Gomez-Mejia, Tosi, and Hinkin (1987) sought to examine whether control by owner or control by management influences the relationship between compensation and performance or compensation and size. They determined that when dominant stockholders control a firm (owner controlled), the CEO’s pay is significantly influenced by performance. The CEO is paid more for performance than for the scale of the operation. However, when a firm is management controlled, there is some relationship between performance and pay, but it is a much weaker link than in the former case and correspondingly, there is a much stronger relationship between CEO compensation and firm size (Gomez-Mejia, Tosi, & Hinkin, 1987).

REFERENCES CITED


