

## **An Exploratory Study on the Link between Managerial Discretion and Managerial Power**

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**Abstract.** In order to clarify the definitions of managerial discretion and managerial power, two concepts that are often confused by extant literature since they are highly correlated and even overlapped with each other, and to further move the research progress forward in the two fields, the paper investigates the distinctions and connections systematically between the two by adopting the method of literature review and logic reasoning. Five main contributions are made by this paper. First, managerial discretion is wider and richer than managerial power in concept definition. Second, managerial discretion is less proactive than managerial power in running mechanism. Third, managerial discretion is mainly rooted in economic science, while managerial power is mainly rooted in management science. Fourth, managerial discretion is usually needed and used in dealing with strategic and innovative issues, while managerial power is usually linked to daily and repetitive issues. The last but not the least, there is an unbalanced interactive mechanism between managerial discretion and managerial power.

### **Introduction**

Managerial discretion and managerial power are two closely related concepts that have been investigated for a long time. Since 1930s, managerial discretion has been proposed as a concept describing CEO's capability of controlling and making use of both firm resources and his own human capital with the purpose of maximizing the individual utility (Williamson,1964)[1]. Later in 1980s, this concept has evolved into a construct that can represent the discretionary action latitude of CEO's reasonable behavior which is formulated during the gaming process between CEO and the stakeholders. Since Bebchuk et al. (2002)[2], managerial power has been proposed as a concept describing the comprehensive results integrated by CEO's legal power, contractual power and non-contractual power, which can further be regarded as the real influencing capability of CEO on firm's operational business and strategic issues.

With the separation of ownership from operation and the rapid enhancement of market competition, managerial discretion and managerial power both receive more and more attentions from the scholars. However, the two are so similar and interconnected that many studies even confuse them or view them as the same concept in nature with different names. For example, from the perspective of measurement method, the measurement of "managerial power" in Bebchuk et al. (2002) and the measurement of "managerial discretion" in Li yougen (2002) are basically designed by the same way. In fact, though both managerial discretion and managerial power are related to the capability of running firm resources, changing the status quo of the firm and even manipulating decision-making issues of the firm, there do exist some specialized and implicit distinctions between the two that are critical to scholars. Therefore, in order to provide a clear foundation for future research in this filed, the paper tries to investigate the link between the two simultaneously by clarifying the similarities and distinctions of their definitions and pointing out the potential link between the two.

### **Literature review on managerial discretion and managerial power**

#### **Research overview on managerial discretion**

The effects of managerial discretion on organizational phenomenon have been widely investigated and further confirmed. First, extant literature argues that CEO compensation is up to the bargaining

power of CEO relative to the board (Lawrence, 1997). Second, managerial discretion has both potential positive and negative effects on firm performance. At the beginning, scholars argue that the higher managerial discretion is, the lower firm performance will be. (Fama, 1980; Pfeffer, Salamcik, 1978 ;). With the development of managerial discretion research, scholars have found managerial discretion does not always damage shareholders interests (Fershtman, Judd, 1987 ;). Considering certain conditions, for example, different ownership attributes (Boycko, Shleifer, 1996), different consistency degree between the objective of firm's final controller and firm performance (Eric, & Sonia, 2003), and different match degree between CEO type and product market competition type (Xiangkang Yin, 2004), firm performance may be improved by higher managerial discretion. Third, there are two opposite views on the relationship between managerial discretion and diversification strategy. One argues that CEO with higher managerial discretion has more discretion to enter into unrelated industries (Miller, Chen, 1994), therefore, firms with higher managerial discretion will be more possible for choosing non-related diversification. Therefore CEO with higher managerial discretion will favor related diversification and non-related diversification strategy at the same time to the same degree (Marris, 1998). Besides, managerial discretion has also been proved to be related with information disclosure (Adams, & Hossain, 1998; Joseph Gerakos, 2007), financial leverage ratio (Erwan Morelle, 2004)[3], R&D expenditure and technology innovation (C.Z. Zhang et al., 2006), ownership mode choice (Qunyong Xie, 2014)[4], stakeholder reactions (T. L. Waldron et al., 2013)[5], export intensity (A. Sahaym et al., 2012)[6], and so on.

### **Research overview on managerial power**

At present, managerial power theory has reached the parity with the traditional optimal contractual theory viewpoint in explaining managerial compensation, though it has been ever the emerging new theoretical viewpoint in this topic (Lu Rui, & Wei Minghai, 2008; Xiong Fenghua, & Peng Yu, 2012). According to managerial power theory, as the economic human being pursuing for the maximization of his own benefits, CEO can manipulate each dimension of managerial compensation by running his power. The operation of managerial power can affect both the forming process of managerial compensation contract and the execution results of such a contract which can finally lead to the deviation of managerial compensation from the logic of the optimal contract (Lu Rui, Wei Minghai, & Li Wenjing, 2008). Therefore, under the perspective of managerial power, managerial compensation is not only the tool of resolving agent problem, but itself is part of such an agent problem.

Specifically speaking, the manipulation effect of managerial power on managerial compensation is investigated mainly from the following four schools. The first school explains and predicts managerial compensation level from the perspective of managerial power, and most of them confirm the positive effect of managerial power on managerial compensation (Thorsten Doscher, & Gunther Friedl., 2011; Jing Chen, Mahamoud Ezzamel, & Ziming Cai, 2011)[7][8]. The second school investigates and explains managerial compensation-performance sensitivity from the perspective of managerial power (Chongwoo Choe, Gloria Y. Tian, & Xiangkang Yin, 2014)[9], and part of them argue that managerial power manipulates managerial compensation-performance sensitivity negatively (Cai Di, Wan Difang, 2011), while the other literature argues there exists a contingent effect between the two (Martin J. Conyon, & Lerong He, 2011)[10]. The third school explains and clarifies managerial compensation gap from the perspective of managerial power, however, they hold very different views on the specialized manipulation mechanism (Bing-Xuan Lin, & Rui Lu, 2009; Ying-Fen Lin et al., 2013)[11][12]. The fourth school investigates and explains mainly the positive effect of managerial power on executive-employees compensation gap (Faleye, Ebru, Venkateswaran, 2010)[13]. The above literature analyzes and investigates the manipulation effect of managerial power on managerial compensation from different dimensions of managerial compensation. The research results have provided deep insights and excellent contributions to future theoretical research and firm practices in the fields of strategic human resource management and corporate governance.

## Comments on the literature of the two schools

Managerial discretion theory originates from 1930s, while managerial power theory essentially originates from 2000s. The former has ever been focused by many economists, while more scholars in management science have paid more attention to the later. There is much richer literature based on managerial discretion theory than literature based on managerial power theory, however, the growth rate of literature based on managerial power theory is much higher than the literature based on based on managerial discretion theory. In general, managerial discretion has been linked to more organizational issues, while managerial power has been linked to a focused topic, i.e. managerial compensation, except for some special studies related to firm strategies, for example, Kong-Hee Kim et al. (2009)[14]. Especially it is true in China. Some scholars have even confused them when managerial discretion and managerial power are used to explain managerial compensation. Some scholars even propose that managerial power is the evolution results of managerial discretion, and further argues that managerial discretion really is “industry-level managerial discretion” and managerial power really is “firm-level managerial discretion”. This view ignores more distinctions and connections between the two.

### The distinction between managerial discretion and managerial power

The paper tries to systematically investigate the distinctions between managerial discretion and managerial power in detail. In our opinion, there are four critical differences between the two similar concepts.

First, managerial discretion is wider and richer than managerial power in concept definition, which can be described as Eq. 1.

$$\text{Concept (Managerial power)} \in \text{Concept (Managerial Discretion)} \quad (1)$$

Managerial discretion can be reached by CEO from three levels of sources, respectively industry environment, and corporate governance and CEO characteristics. Managerial power can be divided into coercive power, reward power, legitimate power, referent power, and expert power (Raven, 1965)[15], among which coercive power, reward power and legitimate power are all actually derived from the structural position inside the firm of CEO, which is a key corporate governance feature, while referent power and expert power are both derived from CEO characteristics, i.e. the nature of CEO himself. Usually CEO with higher power derived from the structural position or/and higher power derived from CEO characteristics will bring higher managerial discretion to himself. Therefore, managerial power derived from the structural position and CEO characteristics actually is critical a component of managerial discretion. Managerial discretion derived from the industry environment is not reflected in the concept of managerial power. At the beginning, managerial discretion derived from the industry environment is the focus, while with the development of managerial discretion research, managerial discretion derived from corporate governance and CEO characteristics, which has a substitutable term called managerial power, is gradually grasp the attention of the scholars. Therefore, we can even view managerial power as one critical dimension of managerial discretion to a certain degree.

Second, managerial discretion is less active than managerial power in running mechanism, which can be described as Eq. 2.

$$\text{Initiative (Managerial power)} > \text{Initiative (Managerial Discretion)} \quad (2)$$

Managerial discretion is mainly delegated by the industry, which is more objective. What is more, the effect of managerial discretion on each organizational issue is realized mainly by persuasive and directive ways which are much “softer”. Specifically in the issue of managerial compensation, CEO with higher managerial discretion would like to guide the board and shareholders to appreciate and

accept his behavior and performance, and then they will evaluate CEO highly and propose a higher compensation to CEO voluntarily. However, according to managerial power theory, CEO with higher power would like to ask or even force the board and shareholders to accept the requirements on managerial compensation.

Third, managerial discretion is mainly rooted in economic science, while managerial power is mainly rooted in management science. Managerial discretion is a concept proposed by economists. As we all know, Macro economics pays attention to the general environment and industry environment factors that can influence economic growth, and Micro economics views firm as a whole unit to analyze the running mechanism of economics, therefore Economics does not analyze the inside factors of the firm. On the other hand, managerial power is actually a concept proposed by management scholars which is usually used to investigate managerial issues inside an enterprise. In general, most research in managerial discretion is under abstract and theoretical assumptions which are far away from the real world, while research in managerial power is under specialized and practical assumptions which are rather similar to the real world. Therefore, the traditional managerial discretion theory removes or ignores the differences among different CEOs and firms, while managerial power theory focuses on specialized differences at firm level and individual CEO level. Viewing all firms and CEOs as the same and constant, managerial discretion theory explores and predicts economic issues at the industry and social level without considering individual differences no matter in capability or in psychology. By recognizing each firm as being specialized and each CEO as being vivid, managerial power theory investigates more practical issues to each firm which can be applied in business management more easily.

Fourth, the last but not the least, managerial discretion is needed and used in dealing with non-routine and innovative decision-making issues, while managerial power is usually linked to daily and repetitive business issues. Eq. 3 describes such difference, in which “Repetitiveness” means the replicability of the ways of dealing with issues faced by managerial power or managerial discretion.

$$\text{Repetitiveness (Managerial power)} > \text{Repetitiveness (Managerial Discretion)} \quad (3)$$

Non-routine and innovative decision-making issues require richer business knowledge, better managerial skills, and more excellent experiences from CEO. In response to this requirement, CEO has to explore all potential benefits of such decision-making issues. During this process, CEO will receive very limited monitoring intensity from the board and shareholders, since, on one side, they have no idea how to monitor such innovative behavior at all, on the other hand, CEO will lower his effort degree and innovative intention significantly when he feels the sense of being distrusted. On the contrary, daily and repetitive business issues require CEO to be more careful, more responsible and more honest which are different. Under this condition, CEO behavior and output are of higher visibility which can be monitored relatively more easily by the board and shareholders. Even CEO feels the sense of being monitored strictly, he will regard this to be rather appropriate instead of feeling being insulted or distrusted. The reasons are, on one side, most withdrawal behavior of CEO will be identified by the board which will bring negative effects, both financial interests and intangible benefits, to CEO, therefore he will not seek out such meaningless adventures, on the other hand, principal-agent mechanisms are systematically and practically designed to treat the group of all CEOs instead of being directed toward some specialized CEO personally (Tim Baldenius et al., 2014)[16]. Therefore, managerial power will and should receive the responding monitoring intensity from the board.

## **The connections between managerial discretion and managerial power**

### **Effect of managerial discretion on managerial power**

First, managerial discretion has positive effect on managerial power. As we know, managerial discretion is delegated by the industry competition environment when CEO takes his position. During the process of applying his managerial discretion, CEO will make all kinds of strategic or innovative

decisions by comprehensively inputting his knowledge, skills, capabilities and efforts. Good performance results due to such decisions and the effort degree observed by the board and the employees will bring CEO higher respect on his good personality, higher prestige on his effort attitude, and better recognition on his professional capability. All these respect, prestige and recognition on CEO will lead to higher managerial power derived from CEO characteristics. If this positive relationship between managerial discretion and managerial power derived from CEO characteristics can continue till to the next tenure of the CEO, CEO will usually get a higher managerial power derived from structural position because he will be delegated more responsibilities and jobs, Therefore, in general, there is a continuous positive effect of managerial discretion on managerial power derived from CEO characteristics, while there is a periodic positive effect of managerial discretion on managerial power derived from structural position inside the firm.

### **Effect of managerial power on managerial discretion**

There are potentially both positive and negative effects of managerial power on discretion. In term of positive effect, the managerial power can manipulate more material resources, human resources and relationship resources in order to get what the firm wants to get under the necessary supervision from the board and shareholders. Since CEO with higher managerial power can do what he or she wants to do relatively freely, then good performance consequences would be more easily to be reached. Therefore, the board has more chances to evaluate highly CEO's capabilities and attitudes and thud will possibly delegate higher managerial discretion to CEO in dealing with innovative and strategic decision-makings. What is more, if CEOs in an industry are averagely empowered with higher managerial power, which naturally lead to the increase of managerial discretion level of the whole industry.

In term of negative effect, there are three potential reasons. The first reason may rely on that too free management behavior derived from high managerial power can also lead to high risk of poor performance. This may lead to discretion in exploring other new opportunities will be reduced. The second reason is that too high CEO power, will receive more vigilance both from the public and the board at a higher possibility. The third reason is that CEO with too high managerial power will usually lead to CEO overload, and thus CEO will has relatively less time and energy to explore new opportunities in a innovative way, which to a certain degree means CEO has a relatively lower managerial discretion in fact.

### **Conclusions**

Managerial discretion and managerial power are two very similar and highly correlated concepts. Many studies have confused the two as the same concepts which has reduced the research validity greatly and even hindered the research progress both in managerial discretion and managerial power. Based on the review on the literature on managerial discretion and managerial power respectively, the paper compares the two concepts from four perspectives and further identifies four main distinctions, and further the connections between the two are discussed. The main conclusions are shown as follows. First, managerial discretion is wider and richer than managerial power in concept definition. Second, managerial discretion is less active than managerial power in running mechanism. Third, managerial discretion is mainly rooted in economic science, while managerial power is mainly rooted in management science. Fourth, managerial discretion is needed and used in dealing with non-routine and innovative decision-making issues, while managerial power is usually linked to daily and repetitive business issues. The last but not the least, there is an interactive mechanism between the two, i.e., managerial discretion has positive effect on managerial power, while managerial power has potentially both positive and negative effect on managerial discretion. The limitation of this paper is that our conclusions are based on theoretical reasoning which needs to be tested strictly by adopting the method of standard empirical study in the near future.

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