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How and when do firms translate slack into better performance?☆

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ABSTRACT

Many studies have tested the impact of organizational slack on performance, and yet little is known about how managers make use of slack, and in what circumstances it is most beneficial. We show that the managers of firms with higher levels of slack tend to over-invest, which will have a negative impact on performance, but at the same time they may innovate, which will subsequently have a positive impact. Our results also indicates slack is more beneficial when the firm has many profitable investment opportunities. We show that different types of slack influence performance differently, the total effect of available slack on performance being positive, whereas that of recoverable slack on performance being negative.

1. Introduction

Organizational slack can cause many forms of strategic behavior such as growth initiatives (Mishina, Pollock, & Porac, 2004), greater innovation efforts (Chen & Huang, 2010; Nohria & Gulati, 1997; Troilo, Luca, & Atuahene-Gima, 2014), more acquisitions–at higher prices (Wan & Yiu, 2009), more resource expropriation (Du, Kim, & Aldrich, 2015), and more risk taking (Bromiley, 1991). The ultimate impact of organizational slack on performance is still not known as the results of studies carried out to date differ based on the type of slack examined (Bradley, Shepherd, & Wiklund, 2011; George, 2005; Mousa, Marlin, & Ritchie, 2013; Tan & Peng, 2003), and on the economic environment of the firm (Wan & Yiu, 2009).

Nohria and Gulati (1997, p. 604) define organizational slack as the 'pool of resources in an organization that is in excess of the minimum necessary to produce a given level of organizational output.' Firms might have, for example, too many employees, excessive cash, or idle capacity (Bourgeois, 1981; Nohria & Gulati, 1997).[1] Managers can redeploy resources not directly needed for current operations. They might use them to cross-subsidize an unprofitable division, to pay a take-over premium, or for perquisites. In addition, majority shareholders may expropriate these resources. Some of these expenditures may provide little benefit to the firm (Jensen, 1986; Lau & Eggleton, 2003), and so represent the so-called 'slack as inefficiency' view (Daniel, Lohrke, Fornaciari, & Turner, 2004, p. 566). Alternatively, slack resources may be used to protect the core business against competitors, difficult economic conditions or other environmental shocks, or

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[1] Slack is conceptually different from free cash flows, which have been defined as 'cash flows in excess of that required to fund all projects that have positive net present values' (Jensen, 1986, p. 323). Free cash flow is a resource with no future positive benefit (i.e., no positive net present value (NPV) projects available within the firm), whereas organizational slack is not currently needed to produce the present level of output.

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to re-orientate firm strategies by investing in product or market innovation. This is the 'slack as a resource' view (Daniel et al., 2004, p. 566). Integrating these views, the basic tenet of this paper is that organizational slack is not in and of itself either beneficial or harmful, but that its impact depends on how managers use it and whether or not it is needed. This means that managers may use a euro of slack for a good cause or for a bad cause dependent on their options, or incentives.

Budgetary slack is a more narrow, micro-level concept than organizational slack (see Lau & Eggleton, 2003). It captures the managerial perception of budget target difficulty. The budgetary slack literature focuses on antecedents of slack such as participation in the budgeting process, information asymmetry and budgetary control style. Most studies attempt to address why slack exists. While there are some exceptions (e.g., Davila & Wouters, 2005; Merchant & Manzoni, 1989; Van der Stede, 2000), the literature on budgetary slack treats slack as a waste of resources which needs to be controlled. In contrast, the organizational slack literature focuses predominantly on the positive consequences of slack, such as innovation (Mousa & Chowdhury, 2014; Nohria & Gulati, 1997) and growth (Mishina et al., 2004). In essence, organizational slack studies begin at the point at which budgetary slack studies end, and they answer the question of how managers use slack.

Budgetary slack is often expressed in terms of a plan or target (Lukka, 1988), but the type of resource is rarely specified. The organizational slack literature on the other hand distinguishes between different types of slack based on the ease of their redeployment, with different types or configurations having potentially different impacts on performance (George, 2005; Huang & Li, 2012; Mousa et al., 2013). It holds that available slack is not yet absorbed into operations, as in the case of excess liquidity, and so can be easily retrieved for alternative uses. In contrast, recoverable slack has been absorbed into operations, as overhead expenditures such as sales promotion, support IT staff, utilities, and consultant fees for instance, leaving managers with fewer options should resources be needed quickly. Organizational slack studies primarily examine the impact of slack on objective financial performance measures, more specifically on accounting performance.[2] Of the 66 studies included in the meta-study of Daniel et al. (2004), p. 73% used return on assets. In some studies return on sales, return on equity, or return on investments have been used. Thus the impact of slack on other financial performance measures, such as shareholder returns, or more broadly organizational effectiveness, is unclear. To understand how slack influences a firm's shareholder return would require addressing how investors and financial analysts view slack–which is beyond the scope of this paper. In the present study we look only at accounting performance.

Of all the different paths how slack can have an impact on performance we consider two paths that have an opposing impact on performance. We test whether managers use slack to overinvest in unprofitable projects or allows them to innovate in new products, markets or processes, and ultimately the impact of these types of investments on firm performance. Managers are better able to translate slack into higher firm performance when they have many profitable projects from which to choose, that is, when the investment opportunity set (IOS) is large. If managers have many unused resources but few feasible projects, the likelihood of resources being squandered goes up. Importantly, such processes are often not conscious choices but the result of a loss of control, managers that become more optimistic, and a lower opportunity costs for resources. Managers may, for instance, acquire unneeded assets, invest in unprofitable divisions, or engage in unwise take-overs. In contrast, when the economic environment of the firm affords many opportunities for investment, they are more likely to innovate.

Based on an archival data-set of 46,463 firm years (6930 US firms over the 1989 to 2010 period), our empirical results show the different ways in which the two slack types, available slack and recoverable slack, can channel into performance. First, we find that more available slack leads to less overinvestment and also to more innovation. Recoverable slack, however, leads to more overinvestment, but it also leads to more innovation. Hence available slack has a positive direct impact on firm performance, and also a positive indirect impact on performance through a reduction in overinvestment. In contrast, recoverable slack has a negative direct impact on firm performance and a negative indirect one through an increase in overinvestment. Further, the positive impact of available slack on performance is stronger for firms with many profitable investment opportunities.

Prior literature has focused primarily on the direction of the slack-performance relationship, and on whether it is linear or non-linear. We show that slack can be beneficial and harmful at the *same* time. Prior studies have mainly studied one mechanism at the time, predominately the role of innovation (e.g., Troilo, et al., 2014; Lungeanu, Stern, & Zajac, 2015; Mousa & Chowdhury, 2014; Marlin & Geiger, 2015), that influences the slack performance relationship. Studies that analyze multiple and opposing forces in this relationship are scarce. This study's main contributions are therefore that it examines *when* slack has a positive impact on firm performance and *when* it has a negative one, and *how* managers translate slack into positive or negative performance. In addition, this study shows that different types of slack impact performance differently, and demonstrates empirically why.

In Section 2 we provide a conceptual overview and develop our hypotheses. In Section 3 we describe the data and our empirical methods. We present the sample and our empirical results in Section 4. Finally, in Section 5 we summarize our findings and discuss the implications of the study.

[2] An exception is Hambrick and D'Aveni (1988), a study of the impact of organizational slack on organizational failure.