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## The Effect of Ethics on Institutionalization in Coordinated and Liberal Market Economies: Social Legitimacy versus Flexibility

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### Abstract

*The primary concern of institutionalization theorists has been the need for social legitimacy. It is seen that in coordinated market economies, the need for social legitimacy is high. The organizations operating in such fields have to carefully adjust themselves to the requirements of the market. When organizations search for legitimacy, they start to lack flexibility and higher institutionalization may lead to inefficiency; but according to theory, in order to survive, the primary objective of the organization should be “being legitimate”. Ethics institutionalization is another issue briefly held in this paper. It may be offered as a solution for organization that face legitimacy problems within the field they operate. Ethics institutionalization (especially implicit form) is also found to be in a positive relationship with job related outcomes such as job satisfaction, organizational commitment and team spirit (Koonmee et al, 2010). Therefore, it may be argued that, besides increasing legitimacy, ethics institutionalization may also heal internal organizational problems.*

Keywords: *Ethics, Institutionalization in Coordinated and Liberal Market Economies, Social Legitimacy, Flexibility*

### 1. Introduction

The environment and its influences on organizations have been the center of attention in organization theory since late 1950s. During 1970s, the focus has shifted towards understanding the ways in which this influence operates. It is claimed in literature that environments influence organizations by putting demands over them in two ways; they make *technical and economic demands* or they make *social and cultural demands*. While technically dominated environments reward organizations for efficiently supplying goods and services, environments dominated by social demands reward organizations for conforming to the rules and values of society (Hatch, 1997). Therefore, there is an interest in compensating for the hardship of legitimacy. One way to gain legitimacy is being an ethical organization.

In this paper, the reward gained through the adjustment to the ethical rules will be handled for two different types of economies- coordinated vs. liberal market economies- and when organization prefer legitimacy over flexibility will be discussed.

## 2. Theory of Institutionalization Revisited

American sociologist Philip Selznick, the leading figure in institutional theory, claimed that organizations not only adopted to the strivings of their internal groups but also to the values of external society. He defined institutionalization as “the emergence of orderly, stable, socially integrating patterns out of unstable, loosely organized, or narrowly technical activities” (Selznick, 1996). The recognition of external influence on organizations has been one of the main contributions to the institutional theory. Another important contribution has been the addition of social legitimacy. Organizations do not only require raw materials, labor, capital and knowledge but they also require the acceptance of the society in which they operate (DiMaggio and Powell, 1983). The survival of an organization is highly dependent upon this acceptance. According to neo-institutionalists DiMaggio and Powell, there are three different institutional pressures to conform. These pressures are;

- Coercive institutional pressures: The pressure to conform comes from the organization’s dependency on other organizations and the cultural expectations in the society within which the organization functions.
- Normative institutional pressures: The pressure to conform comes from the established patterns by a determined professional community giving legitimacy to its developed activity.
- Mimetic institutional pressures: The pressure comes from the desire to resemble other successful organizations in the field in order to cope with uncertainties (Powell and DiMaggio, 1991).

The responses to these pressures determine the level of institutionalization in an organization. In line with this approach, DiMaggio and Powell emphasize the concept of isomorphism. Isomorphism refers to “a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions” as defined by Hawley (1968). It asserts that organizations match the complexity of the environment with internal structures and systems; an organization that is isomorphic with its environment is in the same form as its environment (Hatch, 1997). Institutionalization states that organizations are not only subject to market conditions but also to institutional pressures, beliefs and expectations. Organizations operating in the same environment, therefore, are expected to face similar pressures and expectations. In order to overcome this obstacle, they will develop similar structural and operational characteristics and become isomorphic (Zucker, 1987).

The three types of pressures described above also determine the fashion of isomorphism the organization will follow. For example, when constrained by governmental or regulative pressures, the organization will follow a coercive isomorphic change. The level of these pressures will identify the extent of isomorphic change within the field.

### 3. Coordinated and Liberal Market Economies

During the late 1980s, the regimes of advanced economies have been divided into two categories; coordinated market economies and liberal market economies. In coordinated market economies, the state plays a framework setting role. These economies include Northern Europe markets such as Germany, Sweden and Switzerland. On the other hand, in liberal market economies, the state plays an arm's length role and is not effective over market coordination. These economies mostly include Anglo-Saxon cultures (Kitschelt, Lange, Marks and Stephens, 1999).

Varieties of capitalism literature puts forward that there is a contrast between these two economies. CMEs (coordinated market economies) have high levels of regulation and institutionalization while LMEs (liberal market economies) have lower levels of regulation; therefore, the practices of organizations are more controlled in CMEs than they are in LMEs (Farndale, Brewster, Poutsma, 2008). The differences in national business systems lead to differences in firm level practices. Therefore, it may be argued that the extent of institutional pressures in any given national context will be dependent on the characteristics of that country (Farndale et al, 2008).

In LMEs, the limited regulation leads to organizational autonomy and diversity of practice (Amable 2003). On the other hand, in CMEs, legislation, institutions and stakeholders are more integrated and the state has a more prominent role than the stock market (Boselie, Paauwe and Richardson 2003). Therefore, in CMEs, there is a tendency to meet the demands of these factors in order to achieve legitimacy. In this sense, it may be argued that in CMEs, there are more powerful sources of coercive institutional pressures when compared to LMEs and organizations operating in CMEs will face a greater deal of pressure for social legitimacy in terms of governmental regulations.

### 4. Professional Ethics and Ethics Institutionalization

Ethics involve normative perspectives about how the organization should act. Ethics are the rules of standards governing the conduct of individuals or the members of a profession (Koonmee, Singhapakdi, Virakul and Lee, 2010). Organizational ethics express the values of an organization irrespective of governmental or regulatory laws and clarify the personal and corporate standards of behavior expected of professionals. When these standards, practices and norms are spread by the profession, then it creates a normative pressure over the organization to change (Cox, 2009). Normative isomorphism, as stated before, arises when organizations are influenced by the same standards of professional practice. For example, doctors follow the same ethical codes and things are done the same way in hospitals (Worth, 2008). Organizations are expected to reflect the norms of the work profession; therefore, the ethics in the field are considered as normative pressures over organizations.

With the effect of globalization, developments in information technology and the scarcity of resources, the views of how a good company is defined have changed dramatically. In the past, financial figures were the determinants of a company performance but nowadays, issues such as social responsibility, quality of work life and ethics have gained attention and are identified as the indicators showing a company's sustainability. Ethical cultures create trust within and outside

corporations. Trust encourages appropriate risk taking and leads to innovation and profitability (Koonmee et al, 2010). Therefore, in order to reduce ethical corruption, positively affect employee behavior and meet the demands of the profession and society, many organizations have attempted to institutionalize ethics. According to Singhapakdi and Vitell (2007) institutionalization of ethics means “the degree to which an organization explicitly and implicitly incorporates ethics into its decision-making processes” (Marta et al, 2011). They explain that “implicitly incorporating ethics means that ethical behavior is implied, or not directly expressed, and is understood to be crucial; explicitly incorporating ethics means that ethical behavior is formally expressed without vagueness”. Implicit forms of ethics institutionalization include ethical leadership, open communication, corporate culture, incentive systems, valued behaviors and management behavior while explicit forms include codes of ethics, ethics seminars, internal control systems and ethics training (Koonmee et al., 2010). Especially the implicit institutionalization of ethics seem as the reflections of normative isomorphic change within the field. The explicit part that follows the implicit may be considered as a more mimetic fashion since the followers will imitate the first-mover in case of shaping codes of conduct and other formal expressions.

Institutionalization and isomorphic actions are usually undertaken in order to attain legitimacy rather than to enhance organizational efficiency or control (Webb, 2008). Therefore, it is important to mention the relationship between legitimacy and institutionalization.

## **5. Legitimacy and Institutionalization**

Organizations are compelled to incorporate the practices defined by prevailing concepts of organizational work that are institutionalized in society (Troyer & Silver, 1999). Therefore, institutionalization requires adoption of these concepts and processes that take on a rule-like status in social thought and action. Neo-institutional theory takes as its core problem the process of legitimation. It proposes that group structures, ranging from organizations to nation states, gain legitimacy when they conform to these accepted practices in their environment (Meyer and Rowan, 1977). When the fields in which organization operate mature and become structured, the organizations within them become increasingly homogenous. In order to gain legitimacy, organizations select these institutionalized practices. According to the theory, organizations require legitimacy in order to survive and so they institutionalize, seeking already accepted organizational forms and activities to build on as a method to increasing legitimacy. Institutionalization, therefore, is the primary process through which organizations acquire legitimacy (Lucas and Lovaglia, 2006). This paper will try to explain the need for social legitimacy within the field when different normative and coercive pressures are in question.

## 6. The Position of This Paper

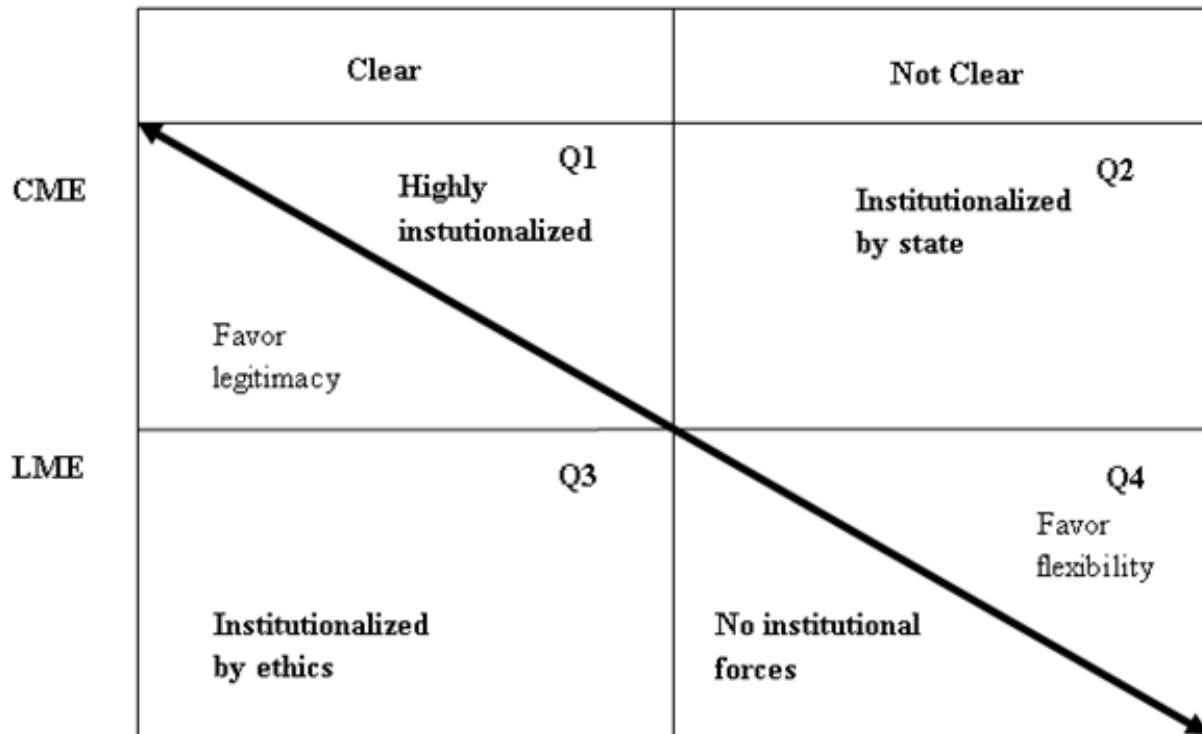
Institutional literature explains the generation and reproduction of habits and routines in social settings (Zucker, 1987). There are many variants of institutional theory but Clegg (1990) suggests that it is important to recognise that there are two distinct ‘types’ of institutional theorists: those who focus on macro isomorphic processes viewing institutionalisation as a property of the environment which restricts options and leads to the increasing convergence of behaviour across an organisational field (e.g., Meyer and Rowan, 1977; DiMaggio and Powell, 1983); and those who focus on micro processes through which practices become institutionalised within an organisation (e.g., Tolbert and Zucker, 1996) (Baptista, Newell and Currie, 2010). In this paper, a macro view is taken into account to understand the dynamics of institutionalization through two sources: the characteristics of the economy and the clarity of ethics in the market. On the other hand, as a consequence of these two sources, a micro process, ethics institutionalization will be discussed. Also, it is aimed to underline the conditions when gaining social legitimacy should be the ultimate goal of the organization.

Within the framework of this paper, the characteristics of the economy and the clarity of ethical norms in the market are considered as two sources of institutionalization. These two sources are introduced as two dimensions and put in a factorial design model. The vertical axis of the model indicates whether the organization operates in a coordinated market economy or liberal market economy; it may also be translated as “the regulation in the market” and it is seen that in CMEs, the regulation and state is more strict than LMEs. The horizontal axis of the model is introduced as the clarity of ethical norms within the market. It implies the degree of a mature understanding of ethical issues that has emerged within the field.

In the model (Figure 1), it is expected that the level of regulation in the market will affect the coercive pressure over an organization to institutionalize through isomorphism. Therefore, it is claimed that in CMEs, there will be greater coercive pressure over the organization compared to LMEs. Organizations operating in CMEs are more likely to engage in institutionalization efforts.

The other predictor of institutionalization is assumed to be the clarity of ethical norms within the market. If the professional ethics are clear and understood, then the organization is expected to face a higher degree of normative pressure to adopt these norms. If such a clearly identified ethical understanding has not yet emerged, then the organization is not expected to undergo a strict normative pressure to change.

**Ethical Norms in the Field**



*Figure 1. The Model*

In the figure, we see four quadrants implying different levels and kinds of pressures over an organization. In quadrant 1, the level of regulation in the state is high; the organization operates in a CME and the ethical norms in the market are clear. This combination leads to a high pressure over the organization to institutionalize. Both coercively and normatively the organization is enforced to change. In quadrant 2, there are no clear ethical norms that compel the organization but CME is still a challenge; therefore, the organization is under a coercive pressure and expected to get institutionalized through regulatory concerns about the state. In quadrant 3, the market is not longer regulated strictly. When there are clear ethical norms in a LME, the organization is expected to be challenged by these normative forces and therefore to become institutionalized through ethics. In quadrant 4, the market is liberal and there is no clear ethical norms that compel the organization; therefore no institutional pressure is observed on the organization and the organization is expected to enjoy flexibility. Here, it is important to mention that, the basic assumption of the model is that the regulations in the market do not contradict with the ethical norms in the field.

The strategy of the organization changes along the diagonal continuum. When the organization faces both normative and coercive pressures as in quadrant 1, the organization has to be concerned about social legitimacy rather than flexibility and in order to gain legitimacy, it has to become institutionalized. The concern for legitimacy decreases through the quadrants. In quadrant 2 and 3, the concern is higher compared to quadrant 4.

In quadrant 3, we see that the organization is challenged by ethics. As introduced before, an organization in that quadrant should make efforts for ethics institutionalization. The organization, at least implicitly, institutionalize ethics in order to meet the demands of the field. A study on ethics institutionalization shows that the primary motivation to institutionalize ethics was the external perceptions of the organization. Organization that want to be seen as socially responsible and that want to improve corporate image are found to engage in ethics institutionalization (Soutar, McNeil and Molster, 1995).

## 7. Conclusion

The primary concern of institutionalization theorists has been the need for social legitimacy. It is seen that in coordinated market economies, the need for social legitimacy is high. The organizations operating in such fields have to carefully adjust themselves to the requirements of the market. When organizations search for legitimacy, they start to lack flexibility and higher institutionalization may lead to inefficiency; but according to theory, in order to survive, the primary objective of the organization should be “being legitimate”. Ethics institutionalization is another issue briefly held in this paper. It may be offered as a solution for organization that face legitimacy problems within the field they operate. Ethics institutionalization (especially implicit form) is also found to be in a positive relationship with job related outcomes such as job satisfaction, organizational commitment and team spirit (Koonmee et al, 2010). Therefore, it may be argued that, besides increasing legitimacy, ethics institutionalization may also heal internal organizational problems. It is important to note that the types of ethics institutionalization are subject to further research. Ethics may also be considered as a coercive pressure if it has an established form within the law. To define and put boundaries to this concept while investigation is important. Organizations should take into account many pressures and the structure of the market they operate in while making their choices. They have to be careful that while trying to institutionalize, they may unfortunately face the challenges of deinstitutionalization.

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