SIGNALING THEORY OF LEGITIMACY

Olga IVANOVA
ICN Business School
13 rue Michel Ney
54037 Nancy Cedex – France
e-mail: olga.ivanova@icn-groupe.fr
tel: +33 (0)3 83 17 37 94

Abstract
The signaling theory of legitimacy is based on the signaling theory in economics and the strategic perspective of organizational legitimacy. When evaluating audiences discount a particular organization based on certain characteristics, the latter can use valid signals of legitimacy to communicate its adherence to the requirements of the stakeholders. The evaluating audiences' discount is called "organizational liability." Two main types of liabilities have been identified – internal (based on characteristics inherent to the organization) and external – based on characteristics of the environment itself. Organizational liabilities are the determinants of the process of legitimation, which in this case represents the process of accumulation of valid signals of legitimacy.

Key words: organizational legitimacy, signaling, liabilities

SIGNALLING THEORY OF LEGITIMACY

The goal of this paper is to propose a signaling theory of legitimacy which is based on the signaling theory in economics and the strategic perspective on organizational legitimacy. When evaluating audiences discount a particular organization based on certain characteristics (internal and/or external), the latter can use valid signals of legitimacy to communicate its adherence to the requirements of the relevant stakeholders' groups. The evaluating audiences' discount is called "organizational liabilities" - the determinants of the process of legitimation.

The requirements that a signal has to meet in order to be defined as 'a valid signal" are: 1) to be observable; 2) to be costly to imitate and 3) carry shared meaning between the sending (legitimacy-claiming) and the receiving (legitimacy-granting) party. Contexts characterized by high level of information asymmetry resulting in adverse selection and moral hazard are the settings in which the use of signals is very important.

The article is organized as follows. First, we examine the postulates of the the signaling theory in economics. Second, we present the specificities of the strategic perspective on organizational legitimacy. And third, we develop the theoretical basis of the signaling theory of legitimacy.

Signaling Theory in Economics

In order to develop the theoretical premises of the signaling theory of legitimacy, we first present the postulates of the signaling theory developed in economics (Spence 1973, 1974).

Signaling Theory Basic Assumptions

In economics, signaling theory relates quality and uncertainty when economic actors with different grades of quality exist in the market. The sellers possess more knowledge about the quality of what (s)he offers than the buyers - a situation known as *information asymmetry* (Akerlof 1970). In environments characterized with information asymmetries, one party can use available signals to reduce the uncertainty about a course of action (Spence 1973, 1974).

The signals are observable characteristics, actions and/or activities that are costly and difficult to imitate as well as subject to manipulation by the sending party. Signaling creates a win-win situation "If individuals were willing or able to reveal their information, everybody [at the market] can be made better off" (Rothschild and Stiglitz, 1976). On the contrary, the absence of signals causes market inefficiency (Eliasberg and Robertson 1988).

Organizations can use signals to communicate certain characteristics or qualities to their evaluating audiences. Not all signals can be used in the communication process between organizations. Signals should be able to convey certain information content between the sending and the receiving party. These signals are called 'valid signals'. Below, we look at the requirements based on which are signals is determined to be valid or not. Thereafter, we discuss the types of signals and the contexts when using signals is important.

Valid Signals

A *valid signal* is a signal that reduces the level of uncertainty between the economic actors (Pollock and Gulati 2007). In order to serve as uncertainty-reducing signal, the latter should fulfill three important criteria. It has to be:

- ***Observable*** – a signal can effectively distinguish one economic actor from another one only if the respective party can view the characteristic and/or the activity possessed by the other party in the exchange process. For example, in the labor market context, an employer can verify the diploma of a candidate (Spence 1973).
- ***Costly*** (implying difficult) to imitate (Spence 1973, Milgrom and Roberts 1986) – a signal will effectively distinguish one economic actor from another one only when the signaling costs are positively correlated with actor's productive capability. If the signal becomes ubiquitous, the actors will not be distinguishable based on it (Spence 1973). For example, in the labor market context, candidates of inferior quality do not possess the skills or abilities needed to earn certain educational degree. Signaling costs can include not only financial outlays but also psychic and other costs (i.e. time) (Spence 1973).

- ***Shared meaning*** **–** this is a condition added to the two above-mentioned characteristics of valid signals in economics. A valid signal has to carry the same (or similar) meaning for the sending (legitimacy-claiming) and the receiving (legitimacy-granting) party. If this condition does not hold, the informational value of the signal is very little, if any.

Besides the labor markets where it originated, signaling theory is applied to many other contexts. Moreover, different attributes are examined as valid signals carrying important informational content which decreases the information asymmetry between the exchange parties. Some examples include: long-term incentive plans (Westphal and Zajac 1998), stock repurchase plan (Zajac and Westphal 2004), certification contest (Wade *et al.* 2006), corporate name change (Lee 2001), media ranking (Rindova *et al.* 2005) CEO stock options (Certo 2003), strategic alliances (Gulati and Higgins 2003), etc.

Depending on the evaluative criteria used, signals can fall into two main groups: (1) based on whether they can be controlled or not by the focal organization (fully-controlled and partially-controlled), and (2) based on their informational content (signals of product/service quality and signals of firm's quality).

Below, we examine the different types of signals.

Typology of Signals

1. *Fully-Controlled and Partially-Controlled Signals*

The *fully-controlled signals* (also called *indices*) are organizational characteristics in the direct control of organizations (Spence 1973). In the management literature, some examples of fully-controlled signals include *board structures* (Certo 2003) and *managerial background* (D'Aveni 1989, 1990; Higgins and Gulati 2003). The *partially-controlled signals* (also called *signals*) are observable organizational characteristics that are largely outside the control of the focal company (Spence 1973).

Even though the partially-controlled signals may result from actions initiated by the focal actor, these signals are provided by third parties who make their own decisions (Pollock and Gulati 2007). Partially controlled signals are as frequently used as the fully controlled signals (Pollock and Gulati 2007), such as: *third-party endorsements* (Gulati and Higgins 2003; Higgins and Gulati 2003, 2006; Stuart *et al.* (1999); *certification contests* (Rao 1994; Rindova *et al.* 2005; Wade *et al.* 2006), and *market reactions* (Rao *et al.* 2001).

2. *Signals of Product/Services Quality and Signals of Firm's Quality*

Based on their informational content, signals can be divided into two main groups: (1) signals of product/service quality, and (2) signals of firm's quality and future prospects. I look at these two categories below. There are several institutions that function as valid signals of product quality – *product guarantee/warranty* (Grossman 1981), *brand name*, *licensing practices* indicating levels of proficiency (i.e. licensing of doctors, lawyers, and barbers) (Akerlof 1970: 499-500) and *minimum quality standards* (Leland 1979), *seller liability* (Heinkel 1981), etc. Signals are not only confined to (output) product quality issues (Lee 2001). They can also communicate the firm's quality and future prospects. In example, *firm's reputation* is used as a signal that provides information about the working conditions in the organization (Turban and Cable 2003).

Signaling is particularly important in specific contexts. Below, we try to outline the specificities of these settings.

Contexts in which Signals are Particularly Important

The informational difference between buyers and sellers exist in many markets (Leland and Pyle 1977). Such markets, for example, are the financial markets between the borrower and the lender, between the IPO and the potential investors, between the entrepreneur and the business angels and/or venture capitalists providing financing (Leland and Pyle 1977), the intermediate markets for outsourcing services. Economists have discovered that the competition on the markets with imperfect information (or asymmetrical information)

between the exchanged actors is very complex (Rothschild and Stiglitz 1976). As a result, many institutions arise in order to decrease the difficulty related to the existing information asymmetry (Rothschild and Stiglitz 1976).

In mature and stable sectors, there is data (collected over many years) on organizations and their actions. In such sectors, when faced with uncertainty, market players can base their decisions on past experience and on potential partner's status and/or reputation (Podolny 1994).

Additionally, professional education and training of institutional investors (i.e. mutual and pension fund managers) and investment bankers serve to diffuse knowledge and skills in standard valuation practices (DiMaggio and Powell 1983). Markets typically rely on this *codified knowledge* and detailed analysis of financial, economic, and market data to reduce information asymmetry regarding inherent quality and to evaluate firms because such information reduces uncertainty (Alchian and Woodward 1988).

However, during the emergence of new industries, investors and analysts lack a codified body of knowledge and industry-specific experience. In these contexts, firms often operate with new and unproven business models and compete against many rival start-ups, all jockeying for early market dominance. Information asymmetry is particularly problematic in new economic sectors because managers have great discretion over scarce financial capital and investors are inexperienced in these domains (Alchian and Woodward 1988).

The situation of information asymmetry means that one party in the economic transaction has superior information than the other party (Akerlof 1970; Rothschild and Stiglitz 1976). There are two forms of opportunistic behavior that can arise from information asymmetry – adverse selection and moral hazard.

1. *Adverse Selection*

Adverse selection is a type of opportunistic behavior based on hidden and/or erroneous information that benefits the seller (Durand and Vargas 2003). The basis for the adverse selection is the qualitative difference in the initial conditions (Sanders and Boivie 2004). The basic idea of the adverse selection principle (or also called "lemon principle") is that the 'bad' products are more likely to be selected than the 'good' products (Akerlof 1970). This leads to pushing the good product sellers out of the market. As a result, if there is no mechanism or institution, which can overcome the information asymmetry (Hughes 1986) the market will fail (Akerlof 1970). In this case, sellers of high-quality products have incentives to develop mechanisms and/or use institutions that will help them sell their products or services at an appropriate price (Hughes 1986). Some suggested solutions are *licensing* (Leland 1979), *imperfect quality testing* (Heinkel 1981), *product warranties* (Grossman 1981) among others.

2. *Moral Hazard*

Moral hazard is a risk of non-compliance of an action by an economic actor or an agent (in agent-principal relationship) (Durand and Vargas 2003). Moral hazard is related to the unobserved or hidden actions that can be undertaken by the economic actors driven by their utility (or profit) maximization (Arrow 1963; Sanders and Boivie 2004). In addition, moral hazard hampers the direct information transfer between economic actors (Leland and Pyle 1977).

Adverse selection and moral hazard are compounded by the uncertainty of new economic sectors. Consequently, when valuing new firms in emerging industries, interested audiences are likely to use secondary sources of information to help identify qualitative differences across firms and their future prospects (Pollock and Gulati 2007; Sanders and Boivie 2004).

Besides new economic sectors in established economies, the problems of adverse selection and moral hazard are typical for markets characterized with greater quality variation (Akerlof 1970). According to Akerlof (1970), these are the markets in underdeveloped countries, including transition economies. These environments are characterized by more dishonesty (Akerlof 1970) due to the overall chaos or lack of institutional framework to guide organizational behavior. When goods are sold in dishonest way on the market, the sellers misrepresent their quality. Thus, the problem for the buyer is to be able to identify the quality (Akerlof 1970). The cost of dishonesty lies not only in the amount by which the purchaser is cheated but also the cost includes the loss from driving legitimate business out of existence (Akerlof 1970).

Organizations are dependent on the various groups of stakeholders for resources (Pfeffer and Salancik [1978] 2003), which ensure their long-term survival ((Pfeffer and Salancik [1978] 2003; DiMaggio and Powell 1983). Hence, organizations are interested in using signals to decrease information asymmetry between them and their evaluating audiences. This can be also perceived as a way to signal organizational legitimacy. In the section below, we look at the theoretical approaches to organizational legitimacy which represent the basis of the signaling theory of legitimacy.

Theoretical Approaches to Organizational Legitimacy

In the field of organizational studies, there are two main theoretical approaches regarding organizational legitimacy (Suchman 1995): *evaluative* (also called *strategic*) adopted by most strategists (Parsons 1960; Thompson [1967] 2003), including population ecologists (Hannan and Freeman 1977, 1984) and resource dependence theorists (Ashforth and Gibbs 1990; Dowling and Pfeffer 1975; Pfeffer and Salancik [1978] 2003; Zimmerman and Zeitz 2002), and *cognitive* (or sometimes called *institutional*) adopted by neo-institutionalists (DiMaggio and Powell 1983, 1991; Meyer and Rowan 1977; Scott 1991, 2001, 2003; Zucker 1977).

The difference in the way the two schools interpret organizational legitimacy comes from the different way they view the organization, the environment and their relationship (Kraatz and Zajac 1997). The strategists adopted a technical perspective that regards organizations as rational actors functioning in a complex environment (Thompson [1967] 2003) "within which a product or a service is exchanged in a market such that organizations are rewarded for effective and efficient control of the work process" (Meyer and Scott 1983: 140). Hence, they emphasize the exchange interdependencies (Meyer and Rowan 1977) in place between the organization and its task environment (Thompson [1967] 2003).

On another side, based on the sociological tradition, new institutionalists regard the organization as being confined by its environment (Tolbert and Zucker 1983) since it is a reflection of the prevailing societal myths (in the form of institutionalized practices and procedures) rather than actors involved in exchanges with their environment (Meyer and Rowan 1977). The organizational environments are perceived as comprised of "cultural elements, that is taken-for-granted beliefs and widely promulgated rules that serve as templates for organizing" (DiMaggio and Powell 1991: 27-28). Thus, neo-institutionalists emphasize the institutional rather than the technical aspect of the organizational environment (Meyer and Rowan 1977). In general, institutional environments have a broader definition – it is the meaning system in which an organization resides (Palmer and Biggart 2005) and it includes norms, standards, and expectations held by relevant constituencies (Kraatz and Zajac 1996).

In addition, in terms of the way the two approaches regard the relationship "organization-environment," the technical environments exercise control on the organizational output while the institutional environments reward organizations for establishing correct structures and processes by conferring them with legitimacy (Scott 1991: 167).

The concept of legitimacy is developed on the borderline between the organization and the environment in which it exists (Baum and Rowley 2005: 6) (see Fig. 1). "Legitimacy provides the linkage between organizational and societal level of analysis" (Dowling and Pfeffer 1975: 131) and helps researchers understand the relationship "organization-environment" by providing some insights on organizational viability and survival (Scott 2001: 158).

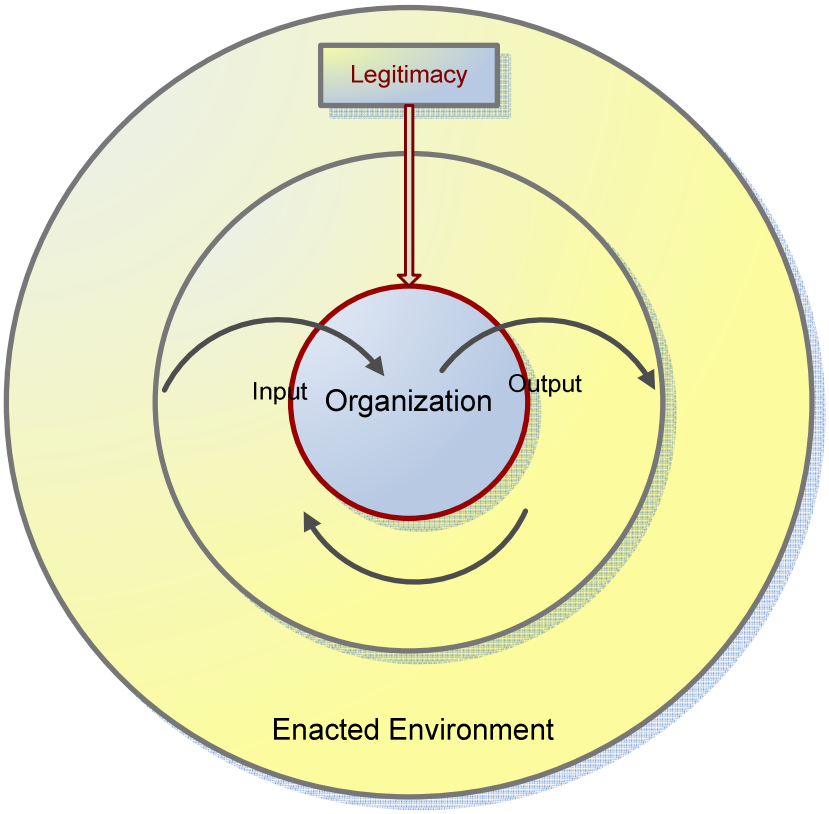

Fig. 1: Interdependence between the Organization and the Environment

There are two main approaches to organizational legitimacy - evaluative and cognitive – discussed in the next section.

Evaluative Approach to Organizational Legitimacy

Since organizations are collective actors claiming to accomplish some specific set of ends, they need public support (Hannan and Freeman 1984). Legitimacy is perceived as an appraisal of organizational actions by the outer societal systems based on the congruence between organizational actions and the value system of the larger super-ordinate system (Parsons 1960: 175). Even though Parsons (1960: 176) states that the process of legitimation does not legitimate the value system of an organization but its actions, the latter themselves reveal the value system of an organization (Dowling and Pfeffer 1975).

Within the evaluative approach to organizational legitimacy, we particularly examine the population ecology and resource dependence view on the concept.

According to *population ecologists*, legitimacy is associated with public approval and it is directly linked to organizational survival (Hannan and Freeman 1984). Legitimacy is regarded as a valuable asset, which can increase the life chances of an organization (Hannan and Freeman 1984).

Indeed, population ecologists associate organizational legitimacy with two organizational characteristics – reliability and accountability (Hannan and Freeman 1984). *Reliability* is defined as the ability to "produce collective products of a given quality repeatedly" (Hannan and Freeman 1984: 153). *Accountability* is related to the ability of organizations to "account rationally for their actions" (Hannan and Freeman 1984: 153). In terms of accountability, organizations are not obliged to have certain processes and procedures in place; they just have to make internally consistent arguments that those exist to ensure the repeated rational allocation of resources (Hannan and Freeman 1984). As a result, the external approval favors inertial organizational structures that can demonstrate reliability and accountability based on reproduction of processes and routines within the organization (Hannan and Freeman 1984).

At the same time, population ecologists perceive legitimacy as a constraint on organizational behavior in more general terms, and on organizational change and adaptation, in particular (Hannan and Freeman 1977). Change undermines the already acquired legitimacy based on the external requirements for reliability of performance (Delacroix and Swaminathan 1991).

In the *resource dependence* tradition, legitimacy is viewed as a valuable resource, which organizations use in order to gain access to other resources required for their activities (Pfeffer and Salancik [1978] 2003). This way they ensure their continuous adaptation and survival (Pfeffer and Salancik [1978] 2003). In addition, some authors claim a relationship between legitimacy and organizational performance since they assume that the attracted resources are positively correlated with profitability (Mazza 1999: 42). Thus, the ultimate sign of legitimate organization is its profit making ability (Mazza 1999: 42).

Since the resource-holders are the outside constituencies of an organization, the latter are the ones that confer organizational legitimacy (Perrow 1970; Pfeffer and Salancik [1978] 2003). It is said that legitimacy lies in the eye of the beholder (Ashforth and Gibbs 1990; Zimmerman and Zeitz 2002). Indeed, "legitimation is the process whereby an organization justifies to a peer or subordinate system its right to exist, that is to continue to import, transform, and export energy, material, or information" (Maurer 1971: 361). Hence, legitimacy is always controlled by the outside of an organization (Pfeffer and Salancik [1978] 2003: 194).

It is interesting to note that legitimacy is known more often when organizational actions are perceived to be illegitimate rather than legitimate (Pfeffer and Salancik [1978] 2003: 194). This is due to the fact that when an actual or potential discrepancy exists between the organizational value system and the value system of the larger super-ordinate system, organizations are subject to sanctions (legal, economic or social sanctions) (Dowling and Pfeffer 1975). Hence, organizations take steps to guarantee that their actions are legitimate (Parsons 1960).

A very important property of organizational legitimacy is the fact that it is socially-constructed (Berger and Luckman 1967), which means that it does not lie in the organization itself. Rather, legitimacy is a condition which the organization has accomplished based on relating with the environment and accepting certain rules and norms of the larger societal system (Pfeffer and Salancik 2003 [1978]: 194). This way the environment exercises certain external control on the organization (Pfeffer and Salancik [1978] 2003: 43).

At the same time, strategists do not agree with the passive view of accepting the environmental control *per se*. They state that organizations can actively manage environmental demands by adopting different strategies in order to alter the environment so that it fits organizational capabilities (Pfeffer and Salancik [1978] 2003: 106).

Strategists regard organizational legitimacy as being *ambiguous* (Pfeffer and Salancik [1978] 2003: 195) and *problematic* (Ahsforth and Gibbs 1990). It is ambiguous because it is not clear how large the part of the social system that supports the activities of an organization should be (Pfeffer and Salancik [1978] 2003: 194). It is also not known by which processes organizations evaluate the legitimacy of organizational actions (Pfeffer and Salancik [1978] 2003: 194). In addition, the mere standards of desirability of the external environment are varying from crystallized to ambiguous (Thompson [1967] 2003: 85).

Legitimacy is *problematic* because of contradicting requirements of different stakeholders' groups, changing norms and values, and difficulty in operationalization of social values (Ashforth and Gibbs 1990). Thus, organizational environments are considered not to be dependable based on changing requirements imposed on the organizations (Pfeffer and Salancik [1978] 2003: 2). When environments change the organizations face the dilemma whether to change with them (Pfeffer and Salancik [1978] 2003: 2). The changing environment creates hurdles for the focal organization in terms of ensuring the needed resources for organization's operations.

Furthermore, strategists view organizational legitimacy as being *retrospective* since organizations review their past actions in the context of the current social values and norms (Pfeffer and Salancik [1978] 2003: 195).

Organizational institutionalists offer a complementing view on organizational legitimacy, which is called cognitive approach to organizational legitimacy.

Cognitive Approach to Organizational Legitimacy

In order to understand the way the institutionalists view legitimacy, it is important to look at the way they regard institutions. The latter are the building blocks of social life. Institutions are comprised of three elements – regulative, normative and cultural-cognitive – that "together with associated activities and resources, provide stability and meaning to social life" (Scott 2001: 48). In general, institutions are resistant to change (Giddens

1984: 24). They also tend to be reproduced and transmitted across generations through certain "carriers" – symbols, relational systems, routines and artifacts (Scott 2001: 48). Furthermore, institutions operate on multiple levels – from the world system to the interpersonal relationships (Scott 2001: 48).

The importance of institutions for understanding the concept of legitimacy lies in the fact that they control and limit social action (Scott 2001: 50). Scott (2001: 50) states that institutions provide the guidelines for social behavior as well as the restrictions by "defining legal, moral and cultural boundaries setting off legitimate from illegitimate activities" (Scott 2001: 50).

Scott (2001: 50) stated that institutions are both a property and a process. They are property at any given time because they represent the state of the social order (Scott 2001: 50). At the same time, the process of institutionalization (and deinstitutionalization) is the process when the institutions are formed (Scott 2001: 50). Legitimacy can also be both perceived as a property (an organization is perceived legitimate) and a process – the process of legitimation.

New institutionalists view legitimacy emerging from the organizational compliance to the expectations of the external socio-cultural environment (Meyer and Rowan 1977; DiMaggio and Powell 1983). Even though the institutionalists emphasize the cultural-cognitive or taken-for-granted aspects of legitimacy (rather than normative and regulative), the elements based on which an organization is proclaimed as legitimate or illegitimate are again externally assessed (Meyer and Rowan 1977). The cultural-cognitive meaning is more likely to be imported from the environment (Scott 1991: 170) since culture is viewed as a "tool kit" from which organizations choose their ends (or purposes) and the strategies to accomplish them (Swidler 1986). This way, organizational actions are understood in the larger socio-cultural environment (Zucker 1977). Hence, Meyer and Scott (1983) and Scott (1991: 170) defined legitimacy as "the degree of cultural support for an organization – the extent to which the array of established cultural accounts provides explanation for its existence."

For the neo-institutional researchers, organizations are driven to adopt practices and procedures defined by prevailing concepts of rationalization, called "myths" (Meyer and Rowan 1977) or "cultural understandings" (Zucker 1977). They may not have anything to do with organizational efficiency or rationality (DiMaggio and Powell 1983) but they tend to persist as part of the objective reality (Zucker 1977) because they are considered "proper, adequate, rational, and necessary" by external constituents (Meyer and Rowan 1977). This is why organizations must integrate them (in the form of structural elements) in order to gain legitimacy and increase their survival chances (Meyer and Rowan 1977). Thus, neo-institutionalists envision a relationship between legitimacy and stability since organizations that do not adopt legitimate elements are more vulnerable to claims that they are "negligent, irrational, or unnecessary" (Meyer and Scott 1977).

It is important to note that for neo-institutionalists, the process of legitimation is the same as the process of institutionalization (Meyer and Rowan 1977; Suchman 1995) since the organizational actions are perceived to be legitimate only when they reflect the highly institutionalized and thus taken-for-granted elements of the societal environment (Meyer and Rowan 1977; DiMaggio and Powell 1991). In fact, institutionalization is perceived as both a process and a property (Zucker 1977). It is the process of transmission of the socially-defined reality among actors (Zucker 1977), which corresponds to the process of legitimation. At the same time, at any point of the process, "the meaning of an act can be defined as more or less a taken-for-granted part of the social reality" (Zucker 1977: 728), which corresponds to the legitimacy property of an organization.

Evaluative vs. Cognitive Approach to Organizational Legitimacy

The basic difference between the two approaches lies in the fact that while the strategists adopt a managerial perspective and view organizations as being able to use actions (Ashforth and Gibbs 1990) in order to get (or maintain and repair) societal support, the institutionalists regard the cultural pressures that sector-wide structuration dynamics generate on organizational actions (Suchman 1995). In other words, strategists view organizations as actively managing their legitimacy by deciding on which strategies to adopt in order to satisfy the sometimes conflicting demands of various stakeholder groups. And the institutionalists regard the manager's decisions being constructed by the same belief systems that determine audiences' reactions. Hence, the latter adopt a more passive view on organizations as merely accepting the norms and expectations imposed by the outer super-ordinate system, which makes organizations in fact choose from a pre-defined set of alternatives.

This is directly related to how the two groups view the process of legitimation. For the strategists, the process of legitimation is when the organizations act in order to increase their perceived legitimacy (Dowling and Pfeffer 1975: 122). For the institutionalists, the process of legitimation and the process of institutionalization (the collective structuration of fields) are the same (Suchman 1995).

The strategic approach views legitimacy as a resource that an organization can manage (Zimmerman and Zeitz 2002). The institutionalists, on the other side, do not view legitimacy as a commodity that can be exchanged but as "a condition reflecting perceived consonance with relevant rules and laws, normative support or alignment with cultural-cognitive frameworks" (Scott 2001: 59). In addition, legitimacy cannot be perceived as an input to the production process like the rest of the resources an organization utilizes in its activities (Scott 2001: 59). It has a rather symbolic value, which has to be displayed or signaled to the interested constituencies (Scott 2001: 59).

Even if the above-mentioned differences between the evaluative and cognitive approach to organizational legitimacy do persist, the line between them is not a clear-cut since a rapprochement is observed between

institutional theory on one side and population ecology and resource dependency on the other side (DiMaggio and Powell 1991: 32). A very good example is the shift in studies reflecting the institutional tradition – while the early works viewed the environment as imposing structures on individual organizations, the latter ones emphasize differences among organizations in the way they respond to the institutional pressures (Scott 2001: 151). Indeed, all the theories regarding legitimacy are converging on the ideas that "organizations actively participate in the social construction of the environment" but their ability to exercise strategic choice is constrained by the socio-cultural environment, in which they exist (Lawrence 1999: 161).

In accordance to the converging theoretical approaches, Suchman (1995) adopted an integrative approach to organizational legitimacy, integrating both the evaluative and cognitive dimensions of legitimacy. He also explicitly acknowledged the role of the different social constituencies in the legitimation dynamics by stating that "legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within socially constructed system of norms, values, beliefs, and definitions" (Suchman 1995: 574).

Even though there is a trend towards bridging the gap between the evaluative and the cognitive approach, for the purpose of this study, we adopt a strategic approach to organizational legitimacy. We assume that it is the managers to decide which characteristics to acquire or use in order to communicate in a meaningful way their conformity to the evaluating audiences' expectations.

Therefore, for the purpose of this study, organizational legitimacy is defined as *a perception that an organization adheres to the evaluating audiences' requirements and expectations. It is achieved based on the use of valid signals of legitimacy.*

Based on the above-presented signaling theory in economics (Spence 1973, 1974) and the strategic perspective of organizational legitimacy (Ashforth and Gibbs 1990; Dowling and Pfeffer 1975; Oliver 1991), we propose signaling theory of legitimacy. In the section below, the basis theoretical premises of the theory are discussed.

Signaling Theory of Legitimacy

The signaling theory of legitimacy states that when facing liabilities, organizations can use valid signals of legitimacy in order to demonstrate and/or communicate their conformity to evaluating audiences' expectations. Based on the evaluation of the signals, legitimacy can be granted or not, which consequently increases or decreases the survival chances of organizations, respectively (see Fig. 2).

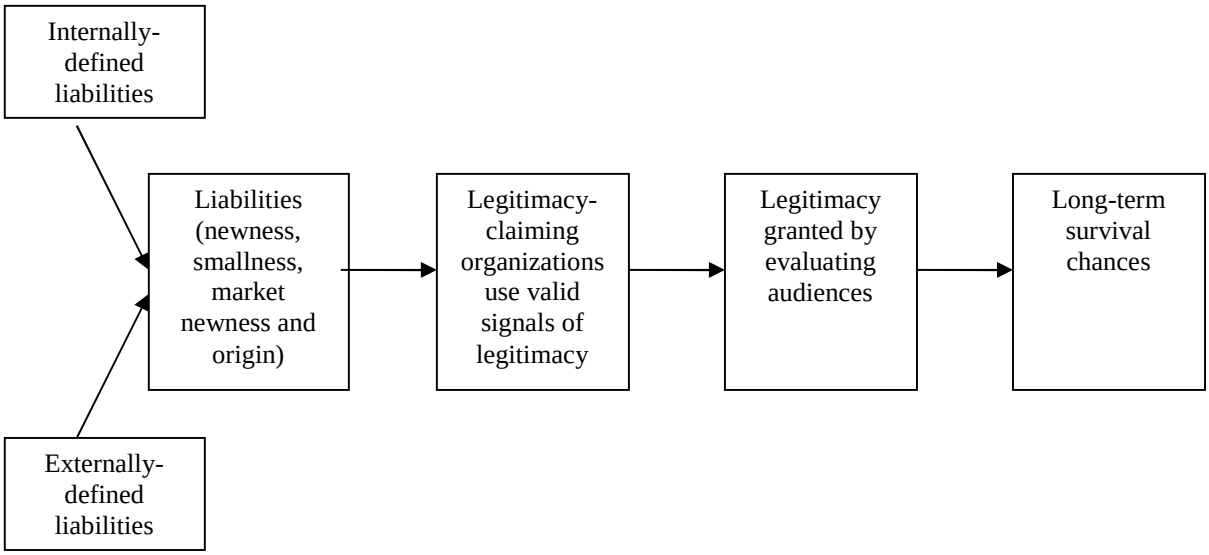

Fig. 2: Signaling Theory of Legitimacy

In developing the signaling theory of legitimacy, we first define the concept of organizational liability. Then, different types of liabilities are presented. Afterwards, we discuss the consequences of legitimacy and we conclude with the implications of the theory itself.

Organizational Liabilities

In general, a liability is the state of being liable or likely to experience something undesirable (Oxford Dictionaries Online). Arend (2004) defined strategic liability as "those resources that damage and destroy a firm's ability to generate rents." When an organization faces a liability, it experiences a certain type of disadvantage in comparison to its potential competitors. In this study, organizational liability is defined as "the discount the evaluating audiences place on a particular organization in comparison to potential competitors." The source of the liability can be inherent to the organization (internally-defined liabilities) or external to the organization (externally-defined liabilities).

We use *evaluating audiences* as a general term to address all groups of stakeholders that are interested in the organization under scrutiny. Depending on the concrete industry and position of the organization in the value chain, the importance of the different stakeholder groups varies.

The basic premises of the signaling theory of legitimacy are that by signaling their conformity to stakeholders' expectations, organizations can overcome the liabilities they face and increase their survival chances. The signaling theory of legitimacy contributes to the strategic perspective of organizational legitimacy since any organization (no matter the type of liability it faces) can create a portfolio of signals in order to communicate its fit with the requirements of the evaluating audiences. Organizations are not passive actors accepting their condition (i.e. new and small ventures) – they can indeed improve their fit with the stakeholders' expectations by utilizing valid signals of legitimacy.

Types of Liabilities

Going back to Fig. 2, organizational liabilities can be internally- and externally-defined. The *internally-defined liabilities* are based on certain characteristics inherent to the organization, such as age (liability of newness) and size (liability of smallness). The *externally-defined liabilities* are derived from the environment in which the organization evolves, such as liability of market newness based on the fact that the organization is new to the market and liability of origin based on the instability of the environment in which an organization evolves.

The *liabilities of newness* (Stinchcombe 1965), *smallness* (Freeman, Carroll and Hannan 1983) and *foreignness* (Zaheer 1995) are well-discussed in the literature. Certo (2003) added a new type of legitimacy – *liability of market newness* – which he used regarding organizations that undergo an IPO. Herein, it is suggested that *liability of foreignness* is a sub-type of the liability of market newness since it reflects only an organization that moves between two specific layers of the environment – i.e. from national to international. Liability of market newness is a broader term referring to organizations that move not only from one environmental layer to another one but also the ones that enter new markets in general (i.e. due to a diversification strategy).

As it was mentioned earlier, the *liability of origin* (Bartlett and Ghoshal 2000) is related to the discount that evaluating audiences (both domestic and foreign) place on an organization due to its context of origin. Liability of origin is a complex phenomenon that is associated with the importation of instability from the environment in which an organization functions. The discount can be placed not only by organizations that have originated outside the transition environment but also by organizations that evolve in the transition environment itself. The reason for this is that all actors that interact with organizations evolving in transition environments experience elevated transaction costs (Meyer 2001).

The type of organizational liability and the type of evaluating audiences directly reflect on the type of legitimacy sought. The latter determines the types of signals it is appropriate to use in order to efficiently communicate the conformity to the stakeholders' expectations. In example, faced with liability of origin, organizations in transition environments can signal their legitimacy by using two sets of signals – signals of functional (demonstrating their resources and competencies) and signals of relational legitimacy (demonstrating their reliability as partners). The traditional typology of legitimacy (regulative, normative, cognitive and coming from the industry) is not meaningful in transitional contexts since it is directly linked to institutions, which are not well developed in this type of settings.

Organizations may seek legitimacy for many reasons (Suchman 1995). Below, we examine the reasons why an organization will engage in the process of legitimation.

Consequences of Organizational Legitimacy

Suchman (1995) poses the important question "legitimacy for what?" and tries to establish the difference between what is legitimacy and the consequences of legitimacy. In general, Suchman (1995) distinguishes between two sets of reasons – continuity versus credibility and passive versus active support (Suchman 1995).

1. *Being Worthy vs. Being Understood*

The first set of reasons is associated with an increased "stability and comprehensibility of organizational activities" (Suchman 1995: 574). An organization may want to acquire legitimacy in order to be perceived as more worthy (Suchman 1995). For example, this may happen when the organization faces high level of environmental uncertainty or when the organization is young (liability of newness) and small (liability of smallness). As it is a valuable resource, legitimacy increases the chances that an organization will be granted other resources from interested stakeholders and thus, it influences in a positive way its survival chances. This way, organizational stability goes up. The increased stability later will act against the organization as it will be transformed into inertia. But from the moment of granting legitimacy, organizational worth increases.

Another consequence of granting legitimacy is the fact that an organization is understood by its external evaluators. The organization wants to be evaluated by the audiences not only as more worthy (for resource granting purposes) but also as "more meaningful, more predictable and more trustworthy" (Suchman 1995). This is an important condition, which ensures that an organization is comprehensible and thus there is a need of it in the larger societal framework. If the organization does not fit the meaning framework, it will be considered as not needed and then its survival will be threatened.

2. *Passive Support vs. Active Support*

The second set of reasons why an organization seeks legitimacy is associated with whether it looks for active or passive support (Suchman 1995). These two terms "active support" versus "passive support" are associated with the level of legitimacy threshold that an organization needs to reach in order to be proclaimed as legitimate. This level depends on how involved is the audience. Thus, an organization which wants passive support has to reach a minimum threshold level of legitimacy. As Suchman (1995) puts it an organization may need just to be "left alone" by some group of stakeholders.

An organization requires an active support from audiences that are not only passively interested in the way the organization is doing business but also actively involved in the process of elevating expectations towards the organization as well as the process of assessment. In this case, an organization will need to reach a higher threshold level of legitimacy.

As Suchman (1995) states the two sets of reasons basically show the same thing – when an organization wants a passive support, this can be associated with the condition in which the organization is merely willing to "make sense" or gain comprehensibility. And when an organization wants an active support, it wants to be perceived as being worthy and/or valuable (Suchman 1995). As an important resource, legitimacy makes organizations in general and their structures and processes in particular understood and perceived as worthy (Scott 2001). No matter what is the reason why an organization engages in the process of legitimation, if granted, legitimacy will increase its life chances.

The process of legitimation implies that "organizations act to increase their perceived legitimacy" (Dowling and Pfeffer 1975: 122). Herein, we perceive the process of legitimation as being the process of accumulation of signals. Since any process has its determinants, Dowling and Pfeffer (1975) have identified what determines the process of legitimation. Those determinants create discomfort in the organization and this way they exercise pressure on it to change. In fact, an organization has to experience misfit with the environment in order to undertake the process of legitimation.

According to Dowling and Pfeffer (1975), the *determinants of organizational legitimation* include: changing societal norms and values (institutional change), competitive dynamics between the focal organization and other actors functioning in the same field (selection pressures), organization's methods of operation and organization's output (input-output mechanism and its fit with the organizational environment).

For the purpose of this study, we assume that the determinants of the legitimation process are the liabilities they face, which have been already discussed. Based on the liabilities faced, organizations engage in the process of accumulation of signals of legitimacy. The latter can be considered a source of legitimacy or also called *antecedents of organizational legitimacy*.

An *antecedent of organizational legitimacy* is an organizational characteristic based on which an organization can be evaluated by external audiences. At any particular point in time, these characteristics can be viewed as results of certain processes. The characteristics can be inherent to the organization (i.e. age) or it can be granted to the organization by association with other actors in the field (i.e. a certificate by a reputable organization). In the latter case, the source of legitimacy lies in the relationship with the external entity, which at the same time can be an evaluating stakeholder group. Depending on the result of the assessment process of the organizational characteristics, an organization can be granted legitimacy.

The process of external assessment is subjective - each stakeholder grants legitimacy depending on the weight of importance it gives to a certain source and the particular needs it experiences at the moment of evaluation. The latter reflects how the organization granting legitimacy fits with its own environment. These two conditions

are interrelated – in example, if an organization experiences pressing needs for certain input, it may give a higher weight to the organization that can provide it and grant legitimacy in an easier manner. Since organizational legitimacy lies in the eye of the beholder (Ashforth and Gibbs 1990), the weight allocated to each characteristic is subjective as long as the evaluation process is individually accomplished by the interested stakeholder and the latter did not rely on somebody else's previously-done evaluation.

Not all organizational characteristics can be used as sources of legitimacy. Only characteristics with signaling value attached are considered sources or antecedents of legitimacy. For this reason, they have to be observable, costly to imitate and share common meaning between the legitimacy-claiming and legitimacy-granting entities. Since the congruence of the rules, norms and beliefs of an organization with those of the environment has to be communicated from the sending to the receiving party and understood by the two parties the same way, the signals have to "make sense" (institutional perspective). Organizational legitimacy is a multi-faceted construct and each source/characteristic will signal certain aspects (or dimensions) of it.

Conclusion

Based on the signaling theory in economics and the strategic perspective on organizational legitimacy, herein we propose the *signaling theory of legitimacy.* Organizations facing liabilities (newness, smallness, market newness and origin) can employ valid signals of legitimacy to demonstrate their adherence to the stakeholders' requirements and expectations. They use of portfolio of signals to support their claims in order to be granted legitimacy. This enhances their chances to survive in the long run.

The processes of legitimacy claiming and legitimacy granting are different. They comprise the communication process between organizations based on shared meaning. The development of shared meaning is a process that corresponds to the process of institutionalization or the creation of institutions (formal and informal) within an environment. The signals are institutions that help the legitimacy-claiming and the legitimacy-granting entities interpret in the same (or at least in a similar way) the positioning of an organization. Without institutions, the communication process between organizations is impeded. Therefore, claiming and granting legitimacy becomes very difficult, if not impossible.

This study focuses on communicating meaning between the legitimacy-claiming and legitimacy-granting entities based on portfolio of signals. Any organization can choose among many alternatives in building its portfolio. The challenge is to pick the most appropriate signals, which implies very good knowledge on the evaluating audiences' requirements and expectations.

The signaling theory of legitimacy is presented in the Figure 3.

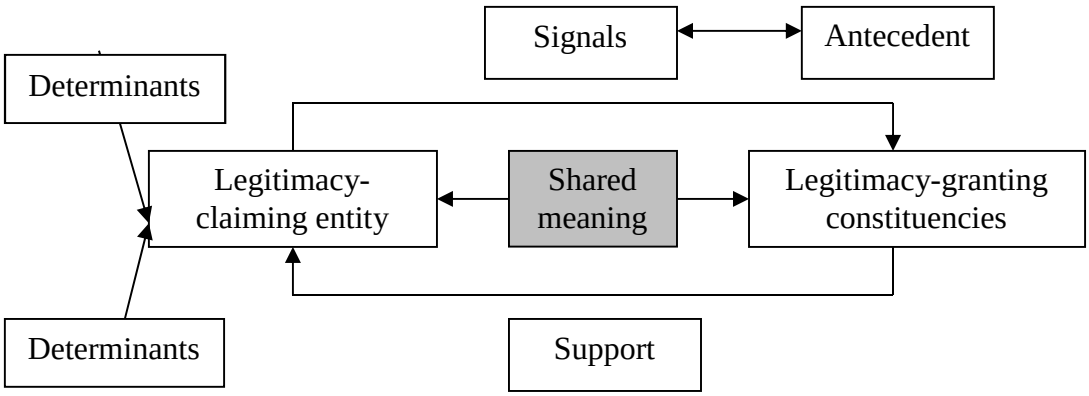

Fig. 3: Signaling Theory of Legitimacy

The signaling theory of legitimacy enhances the signaling theory in economics. Valid signals need to be 1) observable, and 2) costly to imitate. We added a third requirement: it has to carry a similar informational content (based on the institutions developed within the context) for the sending and the receiving party, which is even more important in uncertain environments.

The signaling theory of legitimacy is important to explain the difficulties organization face when they move from one layer of the environment (i.e. national) to another one (i.e. international). Organizations evolving on the same environmental layer develop over time the same interpretation of signals. A challenge to the similar interpretation of signals occurs when an organization moves from one layer of the environment to another one.

In addition, the signaling theory of legitimacy can be used to explain the difficulties organizations face when they operate in highly dynamic and unstable environments as well as environments going through institutional transitions. Such environments experience low level of institutionalization meaning that signals may not be understood the same way by all actors. Or the process of meaning construction of institutions has not been completed yet. Furthermore, in such environments, there might be noisy signals - signals whose informational value is deterred based on certain unlawful practices. As a result, the communication based on signals between organizations is impeded. The organizations themselves can be confused in how to claim their organizational legitimacy. Often, they act upon sporadic opportunities and scarce information.

Signaling theory of legitimacy increases our understanding of the communication process between the organization and its evaluators. The weight evaluating audiences place on the signals is higher than on corporate communications since the former are proxies for certain internal organizational characteristics or processes. Plus, while the corporate communication is fully controlled by the organization, one part of the signals is partially-controlled. The informational content of the partially-controlled signals is more reliable for the evaluating audiences.

Organizations are prone to signal adherence to the evaluating audiences' expectations when they face liabilities. The liabilities determine not only the need to signal legitimacy but also the type of legitimacy sought. Indeed, the concept of organizational liability can be further explored and its content enriched. Researchers can study the relationship between the liabilities faced by organizations and the types of legitimacy they attempt to acquire.

Finally, a signaling theory of legitimacy was proposed in order to address the link between the liability experienced by an organization and the need to signal its legitimacy or the adherence to the evaluating audiences' expectations.

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