

Individual Behavior in Cases of Institutional Misfit

The Dirty Hands of IMP-Group Members.

- Competitive Paper -

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The analysis of change within firms, relationships, or networks now has a prominent role in several streams of work related to the IMP-Group. The knowledge about what kind of structure or strategy to adopt under certain conditions has certainly been growing over the last few years. However, inefficient and ineffective organizational designs (institutional misfits) can easily be found in reality (North 1990). They can pose a serious threat to any firm or organization. It seems that many organizations have problems to change according to the recommendations of normative theory. The simple question remains, why is that the case? It seems worthwhile to analyse the nature of institutional misfits, to explain the persistence of inefficient institutional designs and to derive managerial implications that help to overcome these misfits.

A study carried out among members of the IPM-Group is trying to find out how individuals – researchers, doctoral students, professors - behave if they perceive that their organizations - universities, business schools etc. - show inefficiencies. It is argued in this study that the analysis of the behavior at an

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individual level helps to explain the persistence of inefficient organizational structures as well as the drivers of organizational change.

Institutional Misfits

In the study we are looking at just one part of an organization: its rules and regulations. Douglas North calls them “institutions” and claims that they shape human interaction. If they structure human behavior in such a way that the organization’s efficiency is enhanced, we call this an institutional fit. If, however, the existing rules and regulations are preventing members of the organization to carry out the necessary activities, we call this an institutional misfit. Once the existence of institutional misfits is acknowledged, the analytical task becomes that of describing the process by which new designs may be adopted and misfits overcome (Roberts and Greenwood 1997, 349)..

One of the most important reasons for inefficient institutional designs is the fact, that a changing and dynamic environment creates the need to adjust implemented governance structures continuously. A fit between the characteristics of a transaction and an institutional governance structure can therefore quickly develop into an institutional misfit. Unfortunately, it is not possible within the framework provided by transaction-cost theory to describe and analyse the process by which new institutional designs are adopted (Kay 1992, Dugger 1983). Even Williamson (1988, 1992) explains that transaction-cost theory is weakest with respect to its explanation of how organizations adopt governance structures over time. He acknowledges that refinements and extensions of the original organisational failures framework are desirable. It is argued here, that such an extension of transaction-cost theory is possible and that the obstacles to the use of transaction-cost analysis in the research of institutional change can be overcome.

Individual Patterns of Behavior

Based on Hayek’s (1972) idea that complex social phenomena may best be analysed by discovering and explaining ‘patterns’ of individual behavior, four behavioral options are discussed in this paper for cases in which an individual perceives an institutional misfit. In addition to Hirschman’s (1970)

„exit“ and „voice“ the author claims that the option of doing nothing at all („silence“) and the option of „dirty hands“ as discussed in Sartre’s drama (Sartre 1948), are of outstanding relevance when trying to understand institutional change of inertia.

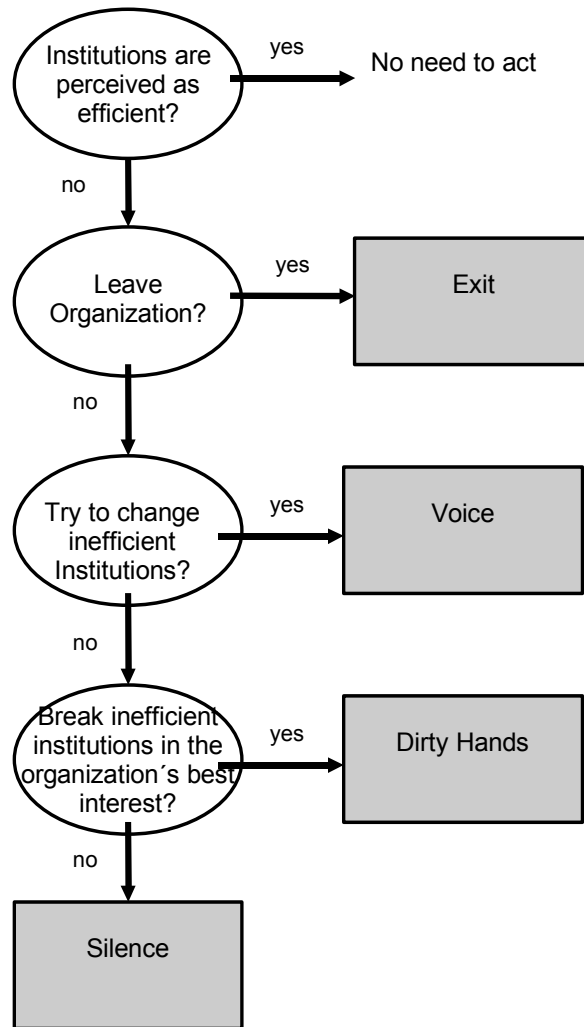


Figure 1: Behavioral options in cases of perceived institutional misfit

The choice of the *exit*-option is what economists usually expect when a party or person is not satisfied with an offer or condition. Inefficiency due to the existence of institutional misfits can result in a change in the “price” for membership in an organization and will lead to a change in demand. Individuals who experience such a “price-increase” might just leave the

organization and become a member elsewhere. Thus, resources are allocated by the “invisible hand” of the market.

Hirschman discusses *voice* as a residual and an alternative to exit (Hirschman 1970, p. 30): “Voice is here defined as any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests, including those that are meant to mobilize public opinion”.

If an individual perceives an institutional misfit and does not react in any way, we may call this behavior „*silence*“. Whereas Hirschman expects that “some [individuals] may simply refuse to exit and suffer in silence, confident that things will soon get better” (Hirschman 1970, S. 92), transaction-cost theory offers a more convincing explanation: If the individual perceives an institutional misfit and remains silent, one out of two reasons can apply. Either he or she benefits from the institutional misfit (and enjoys the benefits) or he or she suffers from it, but exit and voice are not feasible.

Another option, that has so far been neglected in economics, involves *dirtying the hands* of the actor (breaking the inefficient rules) in order to better achieve the organization’s purposes. Although the problem of dirty hands has up to now not been dealt with in economics, the problem is known in political science and philosophy. Two definitions give a first impression of what type of behavior researchers in the field of political science usually associate with the term:

Problems of dirty hands “are cases where politicians act *in our name* and *on our behalf*, where what they do would be universally condemned except that in so doing they avoid great harms or secure great goods, and it is clear both that there is no other conventionally permissible way of doing so and likelihood of success is high” (Oberdiek 1986, S. 42).

“Among political acts are some for which there are good political reasons, as that important and worthy political projects would fail without these acts, but which are acts which honourable,

scrupulous etc. people might, *prima facie* at least, be disinclined to do” (Williams 1978, S. 59).

Apart from the details mentioned in the definitions it is quite obvious, that dirty hands and opportunism (as actual behavior) share some characteristics and that they differ with respect to other aspects. What they have in common is that both behavioral options involve the breaking of rules. But whereas opportunism usually describes a kind of behavior that improves the net-benefits of the actor at the expense of other individuals, the option of dirty hands aims at improving the *organization's* performance as well as the individual's net-benefits.

The dirty hands option might be risky or costly for an actor. Therefore an individual would only choose this option, if the option will increase the individual's "returns". This will usually be the case, if the individual's identification with the goals of the organization is high. High performance of the organization then is perceived as a benefit and therefore offsets the costs of dirty hands.

An Explanation of Behavioral Patterns based on Transaction-cost Theory

The two dominant variables of the organizational failures framework that our explanation of behavioral patterns is based on are the *small numbers situation* and *opportunism (or rather "loyalty" in different degrees)*. *Small numbers* refers to different kinds of dependency. The term *loyalty* has been chosen to distinguish between the (invariable) behavioral *assumption* of opportunism and a behavioral *variable*. *Loyalty* is a variable that ranges *from opportunism to identification* with the organization.

"Small numbers"

Most economists recognize that the terms that are available in a contract depend on the number of bidders. Transaction-cost theory accepts this description of ex ante bidding competition but insists that the study of contracting be extended to include ex post features (Williamson 1985, p. 61). Williamson holds that a condition of large numbers bidding at the outset

does not necessarily imply that a large numbers bidding condition will prevail thereafter. Whether an ex ante large numbers situation is transformed into a small numbers situation depends on whether the transaction is supported by transaction-specific investments. Usually, however, there is more to a small numbers situation as perceived by the member to an organisation than just investments. Social ties between colleagues exist and organisation-specific know-how develops. The research on organizational commitment deals with many sources that lead to close ties between individuals and organizations, creating a small numbers situation. Becker (1960, p. 33) described commitment as a tendency to engage in “consistent lines of activity” based on the accumulation of “side bets” that would be lost if the line of activity were discontinued. An example for “side bets” are pension benefits that would be lost if the member of an organization would resign and leave the organization.

„Loyalty“

In transaction-cost theory opportunism refers to the strongest form of self-interest (Williamson 1985). It has to be emphasized here, that there is a difference between *opportunism as a behavioral assumption* and *opportunism as an actual behavior*. The assumption extends the generally accepted assumption that actors are guided by considerations of self-interest and includes self-interest seeking with guile. According to transaction-cost theory different types of institutions are to be viewed as solutions to different economic problems. Nevertheless, opportunism is not assumed to vanish in the presence of efficient institutional arrangements. Opportunism is rather seen to be discouraged because the institutional designs make it too costly to engage in opportunistic behavior.

The support for the framework provided by transaction-cost theory has been matched by considerable criticism (e.g. Knapp 1989, Heide and John 1992). The assumption of opportunistically inclined decision-makers has been criticized for being simplistic. The conceptions can even be misleading in that they do not contemplate the extent to which personal relations or attitudinal ties between parties discourage opportunistic behavior, apart from

institutional arrangements. Even Williamson remarks: “Where personal integrity is believed to be operative, individuals located at the interfaces may refuse to be part of opportunistic efforts...” (Williamson 1985, p. 62). Other critics of the opportunism assumption claim that transactions are often embedded in concrete personal relations and social structures (Granovetter 1985). In some cases a strong identification with the organization and its aims develops. Attitudinal ties between parties consist of positive attitudes, a psychological attachment to the goals of the organization and to the own function in this organization (Allen and Meyer 1990; Gundlach, Achrol and Mentzer 1995). It has been described in terms of affective commitment, value congruence, or psychological attachment (Allen and Meyer 1990). Hirschman (1970, p. 77) also mentions “that special attachment to an organization known as loyalty”. Under such circumstances opportunistic behavior is viewed as the exception rather than the rule. In other words, opportunism becomes a variable that is dependent on variables such as the attitudes or the degree of embeddedness. The term loyalty has been chosen to distinguish the *invariant behavioral assumption of opportunism* from a behavioral assumption that is dimensionalized *along a continuum running from opportunism to identification* with the other party. The loyalty-dimension therefore has much more in common with Williamson’s earlier treatment of behavioral norms (Williamson 1975, S. 26). It follows that the behavior towards institutions or institutional misfits is not only influenced by the number of alternatives an individual perceives but also by the degree of an individual’s loyalty. Both, small numbers and loyalty, have an influence on the individual costs and benefits associated with the behavioral options.

Based on these ideas it is possible to conclude that, whenever an individual is dependent, its bargaining power and therefore its influence to further institutional change will be limited. Opportunism on the other hand – at the extreme pole of the loyalty dimension - has a negative impact on the willingness of an individual to bear the costs usually associated with any change of institutions whereas a strong loyalty results in a high willingness to change institutions and to bear the necessary costs of change.

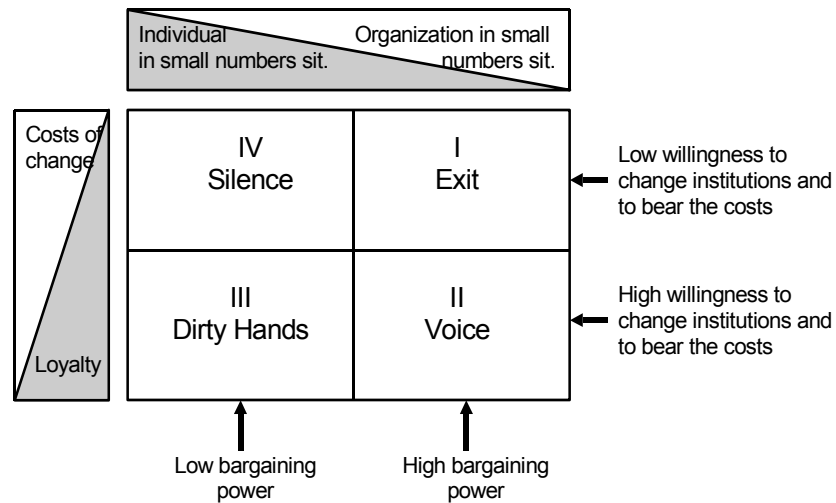


Figure 2: Factors influencing the choice among different behavioral options

Extending this logic by integrating the fact that also the organization may be dependent on employees and the fact, that the costs of institutional change may vary from high to low (see figure 2), four hypothesis have been derived in order to explain the individual choice among the different behavioral options.

- Hyp. 1: The higher (lower) an individual's loyalty towards an organization (ranging from opportunism to strong identification), the more likely will he or she chose *voice* or *dirty hands* (*exit* or *silence*) as a behavioral option.
- Hyp. 2: The higher (lower) an individual's costs of changing inefficient institutions the more likely will he or she chose *exit* or *silence* (*voice* or *dirty hands*) as a behavioral option.
- Hyp. 3: The higher (lower) an individual's dependence on its organization (individual's small numbers situation), the more likely will he or she chose *silence* or *dirty hands* (*exit* or *voice*) as a behavioral option.
- Hyp. 4: The higher (lower) an organization's dependence on its member (organization's small numbers situation), the more likely will the individual chose *voice* or *exit* (*dirty hands* or *silence*) as a behavioral option.

Empirical Test and Results

A first empirical test carried out among members IMP-Group during the IMP conference held in Dublin (professors, assistant and associate professors of organizations such as universities and business schools) shows good support for the model. Confirmatory Factor Analysis was used to determine the extent to which a number of items is explained by one of the four factors (loyalty, costs of change, individual's small numbers situation, organization's small numbers situation). The measure of sampling adequacy (MSA = .81), and correlations and partial correlations among the variables in a reduced set indicate the appropriateness of factor analysis for the revised set of variables. Using the relative explanatory power as expressed by their eigenvalues, four factors explaining 66.7 % of variance were derived. After applying an orthogonal (varimax) rotation, it was possible to interpret factors as the above mentioned determinants of individual behavior (see figure 3).

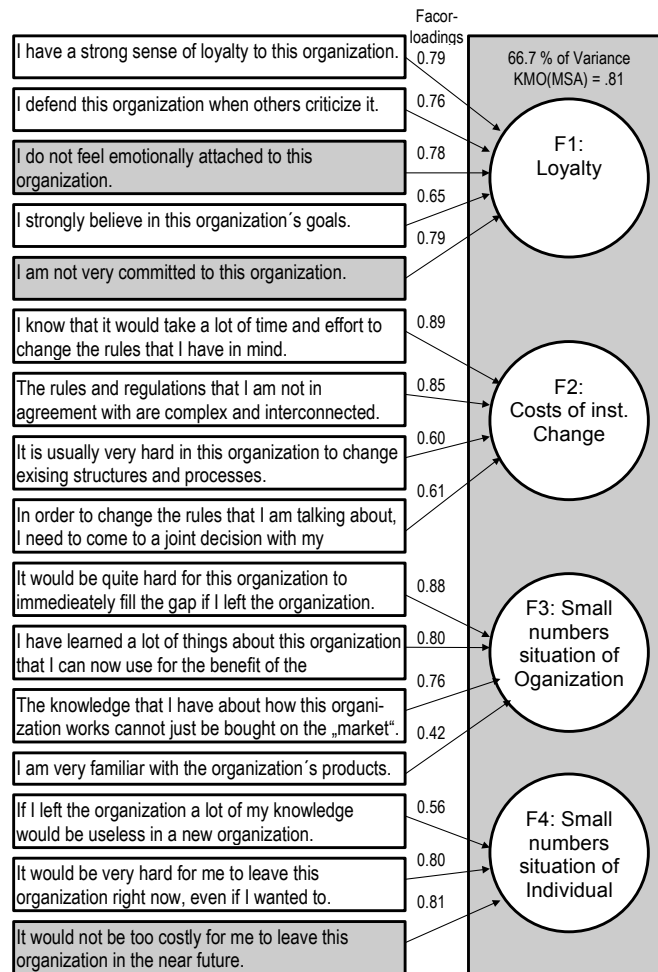


Figure 3: Structure of Separating Factors

The factors were then used as independent variables for a Discriminant Analysis, whereas the actual behavior of the individuals (exit, voice, dirty hands and silence) was used as dependent variable. To determine the predictive ability of the discriminant functions, a classification matrix was constructed (see figure 4). The classification matrix helps to assess the group membership prediction accuracy. In our case 76,54 % of the cases was correctly classified indicating a good prediction accuracy.

Actual Group	Number of Cases	Predicted Group Membership			
		I	II	III	IV
Group I Exit	7	6 85,7%	0 ,0%	0 ,0%	1 14,3%
Group II Voice	37	1 2,7%	27 73,0%	9 24,3%	0 ,0%
Group III Dirty Hands	21	2 9,5%	5 23,8%	14 66,7%	0 ,0%
Group IV Silence	16	0 ,0%	1 6,3%	0 ,0%	15 93,8%

Percent of "grouped" cases correctly classified: 76,54%

Figure 4: Assessing Group Membership Prediction Accuracy

Conclusion

Although some limitations of the study must be acknowledged, (e.g. no hold-out group was used to test the discriminant function), the study has important implications. It shows, that transaction cost analysis might be helpful even with respect to its explanation of *how* organizations adopt governance structures over time. It also has some strong implications with respect to preventing an organisation from getting trapped in institutional misfits. Knowledge about the reasons why individuals behave in certain ways towards institutions might help managers (or politicians) to design incentive structures that will prevent the persistence of inefficient organizational structures.

The key is the individual behavior towards inefficient institutions. We need to understand the individual (not the organization) as the ultimate unit of analysis of research in the field of institutional change. The focus of this paper was on behavior in cases of institutional misfit. It was the purpose of the study to show that transaction-cost theory can be extended to include a variety of behavioral options toward institutions. An integration and extension of the work done by Williamson and by Hirschman may help us to identify the behavioral options that an individual might consider in cases of institutional misfit. The understanding of the behavioral patterns and the factors influencing the individual choice among different options is a first step in the analysis of the process of institutional change.

The paper suggests that the existence of a small or large numbers situation and the degree of loyalty are important factors influencing the costs and benefits associated with different patterns of behavior. However, the consequences of specific behavioral options are not known well enough in order to derive specific managerial implications. It is quite clear that the choice of the silence-option could end up hazardously for an organization. Although the knowledge about an institutional misfit is available in an organization, individual cost-benefit-calculations prevent the organization from recovering. On the other hand, silence might be better for an organization than exit under certain circumstances. If the most conscious members leave, the organization loses the creative potential that is necessary to improve its performance. Furthermore, if the exit-option is used frequently, the speed of deterioration might increase. On the other side, if the organization can easily replace the members who have left the firm, it might not respond to this sign of protest. Therefore the effect of the different behavioral options on the organization will depend on the organization's responsiveness to different types of behavior. Almost no attention has been paid to analysing the responsiveness of organizations to different kinds of behavior so far.

The result of voice and dirty hands seems to be even more difficult to predict. In both cases the members of the organization are highly motivated to correct potential misfits. Voice and dirty hands are patterns of behavior that produce creative ideas that might help the organization to overcome a misfit. But whereas the voice-option can be interpreted as an official complaint, dirty hands involve some type of under-cover activity. The breaking of inefficient regulations might still have a positive effect on certain activities. On the other hand, dirty hands can easily increase the uncertainty in an organization. After all, a reduction of uncertainty is the main function of institutions, let them be efficient or not.

The consequences of certain types of behavior to the organization will be an important field in the research on institutional change. Another necessary

research topic will be the aggregation of different types of behavior. As humans differ in their characteristics, it can be expected that they do not react identically in the case of an institutional misfit. Furthermore what seems to be a misfit to person A might seem to be a perfect fit to person B. Individual perceptions might therefore play an important role in the process of change.

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