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## Reputation and its measurement An institutional approach\*

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### Abstract

The article deals with the issue of identifying and measuring institutions. As an example, reputation was taken into consideration. The analysis leads to the conclusion that reputation could be treated as an institution and could be measured in the context of its impact on economic outcomes. This measurement can be carried out at three levels of detail: micro, meso and macro, among these the third is the least recognised in new institutional economics.

**Keywords:** institution, reputation, economic outcomes, institutional economics

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### 1. Introduction

A measure of the attractiveness of a research approach is the explanatory and predictive capability of the theories developed within it. The experience of the last dozen or so years has proven many weaknesses in mainstream economics. This explains the growing popularity of heterodox trends, including the institutional approach,<sup>1</sup> which is interesting, as it provides an opportunity to create a wide cooperation platform for a diverse group of representatives of social sciences—not

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<sup>1</sup> The growing importance of the institutional approach can be confirmed by the awarding in 2016 of the Nobel Prize in Economics to Oliver Hart and Bengt Holmström for their contribution to the development of contract theory.

only economists but also sociologists, lawyers, political scientists, ethnologists and social-cultural anthropologists or social psychologists. However, any further development of the institutional approach will depend to a large extent on the ability to develop a research methodology within it that would enable us to go beyond the statement that “institutions are important” and that would allow for a better understanding of the mechanisms of impact that various institutions exert on the behaviour of entities.<sup>2</sup>

When designing the methodology of research relating to the influence exerted by institutions, one of two basic orientations can be adopted. The first one assumes a strong, unbreakable links between institutions creating a specific institutional system the existence of which prevents disaggregation. In such a situation, it would be advisable to study not the impact of individual institutions but rather the relationships between the shape of the institutional matrix and various economic parameters. An example of using this type of approach is research on Varieties of Capitalism (VoC) (cf. Hodgson, 1996; Coates, 2000, 2001; Amable, 2003; Sapir, 2006; Lane & Myant, 2007; Hancké, 2009; Nölke & Vliegenthart, 2009; Farkas, 2011; Bohle & Greskovits, 2012). Another orientation should be adopted if the strength of connections does not impose the necessity of considering the impact of institutions in an aggregate way or when the identified institutions are so autonomous that their impact can be analysed in isolation from other elements of the institutional system (which does not exclude taking into consideration the context of this system). This approach is characteristic, for example, of research on the importance of property rights (cf. Demsetz, 1967; Alchian & Demsetz, 1973; Furubotn & Pejovich, 1974; Pejovich, 1990; Ostrom & Schlager, 1996; Schulz, Parisi & Depoorter, 2002). In this article, the latter of the presented orientations has been adopted. The aim of the article is to conceptualise the phenomenon of the reputation as a significant institution regulating the behaviour of entities as well as to present problems related to the measurement of reputation and its influence. The subject of the analysis, therefore, single, relatively autonomous institution and its impact on the micro, meso and macro sphere. The paper is of a conceptual nature.

## 2. Institutions and their importance

The term “institution” is complex, multidimensional and ambiguous, which means that it has not yet been possible to develop a definition that would be universally accepted. The creation of such a definition is difficult and less likely that this concept occurs in various social sciences, where it is sometimes understood differently. For Thorstein Veblen, seen as the founder of institutionalism, social institutions were “in substance, prevalent habits of thought with respect to particular relations and particular functions of the individual and of the community, while economic institutions were habitual methods of carrying on the life process of the

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<sup>2</sup> The term “entity” in this context refers not only to people but also to organisations or communities, e.g.: groups within an organisation or communities within a state.

community in contact with the material environment in which it lives” (2008, pp. 161, 163). According to Gustav von Schmoller (as cited in Furubotn & Richter, 2000, p. 6), institutions were “a partial order for community life which serves specific purposes and which has the capacity to undergo further evolution independently.” John R. Commons had a more comprehensive view of institutions defining them as

Collective action ranges all the way from unorganized custom to the many organized going concerns, such as the family, the corporation, the trade association, the trade union, the reserve system, the state. (1931, p. 648)

In the approach proposed by this author, institutions were not only cognitive schemes or regulatory mechanisms but could also take the form of organisations that were manifestations of “unorganised forms of action”. Although the current view seems to be that institutions and organisations are separate entities, sometimes also among contemporary authors, there are some approaches indicating that they do not consider this dichotomy. For example, for Avner Greif, institutions are a system of principles, beliefs, norms and organisations (2006, pp. 36–37).

Most scholars dealing with institutions treat them as rules, “formal and informal principles of conduct” (Ząbkowicz, 2015, p. 12). This can be clearly seen in the definition of institutions provided by Elinor Ostrom for whom institutions are

the sets of working rules that are used to determine who is eligible to make decisions in some arena, what actions are allowed or constrained, what aggregation rules will be used, what procedures must be followed, what information must or must not be provided, and what payoffs will be assigned to individuals dependent on their actions. (1990, p. 51)

Douglass C. North strongly advocated strict separation of institutions and organisations. He pointed out that:

institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. (1990, p. 3)

Organisations are players, participants of the game, and according to this author, “conceptually what must be clearly differentiated are the rules from the players” (1990, p. 4). North’s view of institutions as the rules of the game has gained popularity not only in economics but also in other social sciences. This is visible, among others, in the way institutions are defined by economic sociologists. For example, Witold Morawski believes that:

institutions are in fact systems of stimuli and anti-stimuli, which, if well devised, make people—players—conclude that by acting together in a spirit of cooperation, they can increase the pool of winnings. (2016, p. 231)

In the opinion of Piotr Chmielewski, “institutions include formal and informal rules and sanctions related to compliance with these rules, creating a structure for human action and behaviour, i.e. reducing the uncertainty associated with human activity” (2011, p. 258).

Summing up the presented definitional considerations, it can be concluded that institutions are rules or sets of rules that create a structure of incentives and sanctions, ordering the way entities (persons, organisations) interact with each other. Institutions play a very important role in social and economic life. It should be noted that through directing undertaken actions they lead to the formation and consolidation of behavioural patterns and can even affect the form of a mental reflection of the reality that arises in the minds of entities operating in a given institutional environment. As pointed out by Geoffrey M. Hodgson, institutions can “create stable expectations of the behaviour of others. Generally, institutions enable ordered thought, expectation, and action by imposing form and consistency on human activities” (2006, p. 2). Due to this fact, behaviour becomes more predictable, which limits uncertainty and creates conditions for the occurrence of the phenomenon of trust. It can also be assumed that “institutions are a binder linking the past with the future” (Gruszevska, 2011, p. 50). They combine both dimensions in the sense that their shape is usually determined historically, but at the same time, the existing institutions, by creating barriers and incentives, form patterns of behaviour that affect future activities of entities.

### **3. Reputation in the institutional context**

The term “reputation” is as difficult to define as the term “institution”. The reasons for the lack of the possibility to create a commonly accepted definition of reputation are similar—reputation is a complex and multidimensional phenomenon that is the subject of research in various social sciences (economics, management sciences, sociology), which makes it difficult to reach a consensus. At the most general level, it is indicated that reputation is “a set of attributes ascribed to a firm, inferred from the firm’s past actions” (Weigelt & Camerer, 1988, p. 44), or more broadly, it is “a record of past deeds and the characteristics of the individual which can be inferred from these deeds” (Sztompka, 2007, p. 166). Such a general definition of reputation is, however, insufficient. It should be noted that its formation in relation to an entity (regardless of whether it is an individual or an organisation) occurs over a long-term period in which the entity may undertake different actions, signalling different, sometimes even contradictory, characteristics. Recognising reputation as a “record of past deeds” also requires answering the question of where the record is made or who makes it, which would allow us to identify the “creator” of reputation.

In solving the problem of signalling different characteristics, it can be helpful to refer to the definition formulated by Paul Herbig and John Milewicz, who indicated that:

Reputation is the estimation of the consistency over time of an attribute of an entity. This estimation is based on the entity's willingness and ability repeatedly to perform an activity in a similar fashion. (1995, p. 24)

This definition shows that reputation arises only when the actions of the subject are characterised by a relatively consistent pattern. This pattern is interpreted by other entities assessing the behaviour of the subject. Therefore, reputation is not the property of the subject, but it is "attributed" by the evaluators. In the context of the assessment, it is also pointed out that reputation can be stratifying, as entities differ in terms of the outcome of the evaluation.<sup>3</sup>

Reputation is based on the characteristics of the subject signalled by a pattern of his or her previous actions which is consistent over time. This means that reputation is rooted in the past. At the same time, however, reputation refers to the future. Keeping one's reputation requires in fact behaviour consistent with the pattern formed, which raises expectations as to the future behaviour of the subject. According to Dennis Chong, "a person builds a reputation by following a course of action that creates information and expectations about himself among others" (1992, p. 683). In this sense, reputation governs the behaviour of the subject. In the opinion of Tomasz J. Dąbrowski, it is a kind of promise made for the future through consistent actions in the past. If the promise is kept, reputation is strengthened; whereas ceasing to keep the promise would mean weakening reputation, which motivates the subject to keep his or her behaviour in line with expectations. Thus, "reputation links [...] the past and the present with the future" (2016, p. 63).

Summing up the current definitional considerations, one can assume that reputation is a widely shared, quite stable assessment (having a potentially stratifying character), based on a consistent pattern of the entity's activities, including its ability and readiness to meet the expectations determined by this model. References to reputation appeared already in the work of institutionalists: Oliver E. Williamson drew attention to it in the context of governing structures (cf. Williamson, 1991a, 1991b),<sup>4</sup> Paul R. Milgrom, D.C. North and Barry R. Weingast (1990) referred to it as a mechanism co-creating the conditions for limiting opportunistic behaviour. A. Greif (1993) considered reputation in relation to the agency theory, while E. Ostrom (1998) treated it as an important element of the second generation of models of rationality, taking into account the relationship between reputation, trust, reciprocity and the level of cooperation.

Despite such a broad reference to reputation in various contexts and in relation to key theories of institutional economics (especially new institutional economics—the transaction costs theory, contract theory and agency theory), reputation has not been considered as an institution *per se*. One of the reasons for this

<sup>3</sup> The idea of comparing the assessments of individual entities as a reflection of the state of their reputation is the foundation of the creation of all sorts of rankings that result from measuring reputation.

<sup>4</sup> O.E. Williamson referred to the reputation effect even in his Nobel lecture on the economics of transaction costs (2015).

may be the sometimes-raised doubt about the power of influence that reputation has on the actual behaviour of individuals. It is claimed that this impact is not so high due to limitations in access to information on the reputation of individual entities. It seems, however, that this approach does not consider changes in the visibility of reputation caused by new technologies. These technologies drastically reduce the costs of both dissemination and obtaining information, making them practically negligible.<sup>5</sup> Thus, the evaluation contained in reputation ceases to be private information and becomes generally accessible information. It is no longer based solely on previous direct experiences or information exchange within a narrow group but becomes “common knowledge”, which must be considered by entities when making decisions about their future activities.

The basic feature of an institution is to reduce uncertainty and reputation undoubtedly plays such a role. It is a kind of informal behaviour regulator, as it sets expectations towards the manner of the entity’s behaviour and creates incentives to act in accordance with these expectations; there are also sanctions (loss of reputation) when the entity takes actions that are contradictory to expectations. Consequently, the entity’s behaviour becomes more predictable, which is the basis for trusting the entity, and subsequently developing a trust-based relationship.

#### **4. Measuring reputation and its impact**

The complexity of reputation makes it difficult to develop measuring methods. The main problem that requires solving is the lack of one commonly accepted definition of reputation. As T.J. Dąbrowski points out, this fact means that “already at the beginning of work on the measurement method, the basic question arises what should be its subject” (2011, p. 269). A different way of defining reputation will lead to different answers to the question of how to measure it. Most often, for the purpose of measurement, it is assumed that reputation is a widely shared assessment, having a relative character, and thus stratifying the evaluated subjects. This approach forms the foundation of all measurement methods based on the ranking philosophy. According to V.P. Rindova and C.J. Fombrun, “reputational rankings reflect an ordering, a status hierarchy with implications about the superiority and inferiority of its members” (1999, p. 700). The rankings allow one to determine who has a better, and who has a worse reputation. However, they require a high level of recognition of entities so that their reputation is clearly visible to a wide range of evaluators.<sup>6</sup>

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<sup>5</sup> Websites and online platforms that allow for making assessments that are visible and available to all users are such an example.

<sup>6</sup> A wide overview of reputation rankings can be found in Fombrun (2007). The AMAC/WMAC and RQ rankings have the longest history and the greatest recognition. The description of their construction methodologies can be found on the following websites: <http://fortune.com/worlds-most-admired-companies> and <http://www.theharrispoll.com/reputation-quotient>.

The results of reputation rankings usually differ from each other, sometimes quite decisively. Firstly, due to the specificity of reputation, which is a complex and multidimensional construct, and therefore difficult to measure directly, the measurement is primarily indirect—in the rating construction, the characteristics that shape reputation are evaluated. A lack of consent as to what features determine the subject's reputation and, consequently, what should be included in the research, leads to differences in the results of measurements. Secondly, research carried out for ranking purposes includes various groups that evaluate a given subject. The selection of these groups is important, as each of them draws attention to other characteristics that shape reputation. A wider or narrower range of groups included will, therefore, have an impact on the results obtained.

From the point of view of assessing the importance of reputation as an institution, however, it seems that what is relevant is not so much the measurement of reputation itself but rather the study of its impact, especially in the economic sphere. This research in its simplest form would include the relationship between the state of reputation (or change in this state) or its role and economic outcomes achieved. Such research can be conducted at the micro level (individual persons, e.g.: CEOs or individual organisations, e.g.: enterprises or universities), at the meso level (groups of enterprises or entire sectors) or at the macro level (states or institutional systems).

So far, the impact of reputation at the micro level has been best recognised. The results of existing studies generally confirm the beneficial effects of good reputation on the financial performance of enterprises<sup>7</sup> as well as the ability of enterprises to maintain above-average performance over a longer period (cf. Roberts & Dowling, 2002). There are also studies that may indicate a positive impact of reputation at the meso level. An interesting case in this regard is described by P. Sztompka, referring to the results of research conducted by J.C. Coleman (1988) and B.D. Richman (2006), who analysed the New York Community of Jewish entrepreneurs dealing in the diamond trade. These researchers drew attention to the strong ties of trust that exist in this community, determined by the rational pursuit on the part of its individual members of maintaining their reputation. Their shared concern for good reputation means that:

large, multi-million transactions take place here without signing contracts, without notaries, courts, and only directly, verbally. In the evening, one dealer hands another a bag of diamonds worth several million dollars to examine their quality and buy or return the next day. Due to this fact, the entire community saves on transaction costs: salaries of notaries and lawyers, arbitration costs or trial costs, and thus obtains a market advantage and, as a result, a lucrative monopoly. (Sztompka, 2016, p. 288).

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<sup>7</sup> A wide review of research on the relationship between reputation and achieved financial performance can be found, among others, in de la Fuente-Sabaté & de Quevedo-Puente, 2003; cf. Carmeli & Tishler, 2005; Deephouse, 1997; Eberl & Schwaiger, 2005; Dunbar & Schwalbach, 2000.

The greatest challenge seems to be the study of reputation impact at the macro level. From the point of view of examining reputation as an institution, it would be most appropriate to seek the answer to the question about the existence of a relationship between the role played by reputation in the institutional system in a given country or group of countries and various general measures of the level of economic development. It is also possible to focus on narrower issues relating to more specific aspects of the relationship between the importance of reputation in the context of selected elements of the institutional system and less aggregated indicators of economic performance. For example, to examine the relationship between the role of reputation in various corporate governance systems (more on the subject in Adamska & Dąbrowski, 2015) and the level of control costs in these systems.

## 5. Conclusions

The growing popularity of the institutional approach in social sciences, including economics, is largely due to its inclusive nature, whose manifestation is the broad definition of the notion of an institution itself. This allows the concept to be applied in relation to a very wide range of mechanisms regulating the behaviour of entities and excludes the creation of a closed catalogue of institutions. At the same time, the adoption of such a philosophy confronts researchers with the need to determine each time whether a given mechanism is an institution or not. The paper shows that reputation can be regarded as an institution, which opens the way to further research on the role it plays in the economic sphere. At the same time, it has been noted that the scope of this research includes three levels: micro, meso, and macro, indicating the last level as the least-known area.

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