Institutional Change in Times of Crisis: Corporate Practice as a Driver of Incrementalism

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Abstract

This article presents and discusses a theoretical approach to understanding the role of corporate practices in shaping institutions in times of crisis. It thereby makes an important step towards addressing a major shortcoming of the literature on institutional change—the overwhelming emphasis on institutional change as a politically driven process—and offers an explanation for the modest mode of institutional change after the global financial crisis. Major shock events leading to incremental change is a situation acknowledged by recent scholarship, but the processes and driving forces behind it have neither been fully theorized nor empirically studied. I argue that mechanisms of bottom-up change are powerful drivers of change in times of crisis, when corporations are likely to engage in mimetic isomorphism as a means of reducing uncertainty. Several propositions are outlined as to how crises affect corporate practices and in turn change processes, which may guide future empirical research.
Introduction

Scholarship on institutional change has made significant advances over the last decade. Incrementalist approaches have shown that change does not only occur in short bursts during times of severe crisis, as the traditional ‘punctuated equilibrium’-based models conceived (Krasner, 1984), but also in small adjustments that accumulate into transformative change over time (Mahoney and Thelen, 2010a; Streeck and Thelen, 2005b). The recognition that discontinuous change can arise without a shock event has thus begun to sever the all-too-often presumed link between the type of event and the outcome. Coming full circle, though, we also need to explore and understand under what circumstances shock events do not trigger significant change. To be sure, the literature has begun to acknowledge this possibility, but neither fully theorizes the processes and driving forces behind it nor empirically studies it. Now, for the first time in decades, however, we have the need and opportunity to study such a scenario.

Whether we should be surprised by it or not, little substantial regulatory change has materialized in consequence of the global financial crisis (GFC). Empirical evidence of changes in financial market regulation after the crisis suggests that governments enacted ‘fire fighting’ legislation to stave off a deepening of the crisis, but produced few substantial reforms towards long-term change and reigning in of financial markets (Mayntz, 2012). What this points to is the need to understand why some crises fail to trigger radical change and how we can explain continued incremental change throughout a severe economic crisis. Rather than attempting to explain the absence of radical change, which is ultimately a political question largely contingent upon the historically unique circumstances of a given crisis, this paper contributes to theorizing incremental change in times of crisis. This is important, as there are gaps in our understanding of what drives incremental change under such circumstances.

Incremental change can be created from the ‘top down’ or from the ‘bottom up.’ The former refers to change originating in the political arena, where policymakers, corporations, and other actors effect change to laws and regulations—formal institutional change preceding informal institutional change on the corporate practice level. ‘Bottom-up’ change, on the other hand, describes more subtle ways of how changes in practice lead to institutional change outside of the political arena, for instance through shifting the interpretation of a rule or exploiting gaps in regulatory frameworks.

The political arena is an unlikely source of incremental change at the height of a crisis, when policymakers’ attention and resources are tied up with enacting emergency legislation aimed at stabilizing the economy, leaving little concern with corporate law issues and how financial market or corporate governance reforms could reduce the likelihood or volatility of future economic crises. Those concerns rise to the top of the political agenda at a later stage of the crisis, once the economy
has stabilized and policymakers have the resources to address the issues. By this time, however, the window of opportunity for swift and sweeping reform is drawing to a close as political salience fades and corporate actors regain power (Culpepper, 2011). In other words, limited resources and agenda setting mean that policymakers have to choose their battles carefully during a crisis. Resources and willpower permitting, they may decide to tackle a small number of salient issues in a meaningful way before the window of opportunity closes. Consequently, the political arena is more likely to aim for substantial change in a very limited number of issues than to produce incremental change across a large number of issues. If this is the case and we fail to observe radical change arising from policymakers, the other source of incrementalism—‘bottom-up’ change—remains as a key driver.

Bottom-up change arises from changed patterns in the behavior of those subject to a rule—corporations in the case of company law issues, such as financial market regulation or corporate governance. The role of corporate practices as both drivers and obstructing forces of institutional change is one of the current issues in institutionalist research (Mahoney and Thelen, 2010a; Hall and Thelen, 2009; Streeck and Thelen, 2005b; Jackson, 2010; Deeg and Jackson, 2007). Exploring how situations of crisis affect these bottom-up processes of change is crucial to not only make sense of the GFC, but also an important step towards a more dynamic understanding of institutional change in general.

In this paper, I argue that mechanisms of bottom-up change are powerful drivers of change in times of crisis, when companies are likely to engage in mimetic isomorphism as a means of reducing uncertainty. Institutions are often understood to be uncertainty-reducing devices, giving firms an interest in maintaining the status quo in order to keep taking advantage of institutional arrangements. In times of severe crisis, however, some institutions that are seen as instrumental in causing the crisis may lose the power to reduce uncertainty and instead become a cause of uncertainty. In the case of the GFC, this applies primarily to informal rather than formal institutions—systemic, irresponsible risk-taking behavior of financial firms received a larger share of blame for causing the crisis than regulatory failure. Consequently, certain institutionalized practices and the companies mainly associated with them become discredited and a source of uncertainty, prompting other corporations to defect from them. In the first instance, this is likely to cause a splintering of practices, before new best-practice leaders emerge that other companies may imitate. Such mimetic isomorphism has an uncertainty-reducing function, making it an appropriate and likely reaction in times of crisis. Where the law allows a broad range of behavior or where an institution is governed entirely on the firm-level, all that is needed for significant changes in corporate behavior to occur is the accumulation of critical mass—a process that is accelerated through mimetic isomorphism.

For shifts in corporate practices to also affect formal institutions, policymakers, regulators or courts, depending on the issue, may need to recognize the
change as a legitimate form of compliance. Crises offer a conducive environment for this process, as corporations converging on new best practice can make a credible case to lawmakers that lessons have been learned and no deep reforms are needed. Policymakers, whose agendas are dominated by macro-economic concerns rather than the specifics of, say, corporate governance legislation, can then point to those corporations as examples of effective self-regulation, freeing them of the effort to legislate more heavily (Mayer, 2013). Hence, crises may enhance the influence of corporations through bottom-up processes of change—unlike in the political arena, where crises tend to lower the power of corporate actors.

The paper proceeds as follows. First, financial market reforms in the UK after the GFC are discussed in order to illustrate the modest extent of regulatory change in the country. The second section discusses the literature in terms of how current models of institutional change can explain the incremental response to the GFC. Third, I develop the argument that bottom-up mechanisms of institutional change can be important drivers of change in times of crisis. In this section, several propositions are outlined as to how crises affect corporate practices and in turn change processes. In the concluding section, a path for future research is outlined.

**Major crisis, modest reforms**

The most immediate governmental responses to the GFC were concerned with economic ‘fire-fighting’ to save financial and industrial corporations deemed ‘too big to fail,’ reduce the fallout from the financial crisis onto other parts of the economy, and to “save the market from itself” (Gamble, 2009, p. 97). Governments approached these challenges in different ways, following a variety of ideological stances. The US approach of stimulus spending combined with quantitative easing followed a two-pronged fiscal and monetary approach, while the British government pursued a more monetarist approach. Such immediate emergency measures need to be conceptually separated, however, from permanent regulatory changes, intended to fix the perceived underlying issues that caused the crisis and place the economy on a steady footing in the long-term. Empirical evidence of changes in financial market regulation after the crisis suggests that governments enacted emergency legislation to stave off a deepening of the crisis, but produced few substantial reforms towards long-term change and reigning in of financial markets (Mayntz, 2012).

A widely used way of categorizing policy change is based on whether it affects “the overarching goals that guide policy in a particular field, the techniques or policy instruments used to attain those goals, and the precise settings of these instruments” (Hall, 1993, p. 278). First-order change is the most incremental type of change, with the goals and instruments of a policy remaining unchanged. When the hierarchy of goals underlying a policy remains largely intact, but the way they are attained is changed, it is referred to as second-order change—a modest mode of change. Third-order change involves a change in the fundamental goals a policy seeks to achieve,
hence requiring a ‘paradigm shift’ to take place (Blyth, 2013). This type of change is considered radical change in this article.

The UK case serves as an empirical illustration of modest change in reaction to the GFC. With its laissez-faire style of capitalism the UK may be disinclined towards heavy regulation, but the country’s strong economic reliance on the banking and financial services sector also means that it stands to lose considerably should its financial market come to be seen as unstable and risky. Significant reforms could therefore be reasonably expected in order to preserve the country’s role as one of the world’s major financial centers. In the UK, two important examples of the type of limited change after the crisis are the splitting of the Financial Services Authority (FSA) and the reforms initiated by the Independent Commission on Banking (ICB).

Rhetorically positioned as a fundamental change to the regulatory oversight system governing financial markets in the UK, the British government’s decision to abolish the FSA and distribute its powers among existing and newly created bodies can hardly be characterized as radical change. The government blamed the FSA’s failure to foresee and prevent the 2008 financial crisis on the agency’s broad focus and the inherently conflicting goals and regulatory cultures that come with it (Parker and Masters, 2010). The Financial Services Act 2012 handed macro and micro risk oversight responsibilities to the Bank of England and its new subsidiary, the Prudential Regulation Authority (PRA), and consumer protection to a new, independent agency, the Financial Conduct Authority (FCA). While splitting the agency removes some conflicts of focus and interest, it leaves the FCA in charge of overseeing both retail and wholesale financial service companies as well as to maintain the integrity of the financial market—a broad task arguably still fraught with competing objectives (Hogg, 2010). Hence, the FSA reforms are modest second-order change at best, as the new regulatory bodies reflect a change in supervision and enforcement instruments without addressing underlying issues fully or a meaningful change in policy goals.

Launched around the same time as the FSA split, the Independent Commission on Banking, chaired by Sir John Vickers, produced its final report in September 2011 (Vickers et al., 2011). The ICB’s headline recommendations to the UK government are the creation of a ‘ringfence’ to separate retail from investment banking activities, higher capital requirements, giving preference to depositors in case of insolvency, and more competitive retail banking. Most of these recommendations, as well as a tougher oversight and certification regime for senior bank staff that makes reckless mismanagement a criminal offence, have become law through the Financial Services (Banking Reform) Act 2013, albeit only in broad-brush terms. Details on the functioning of the ringfence, for instance, remain to be determined through secondary legislation before the target implementation date of 2019.
While certainly a significant reform package at first glance, it is difficult to call it truly radical. For one, the long timeframe and leeway in implementation open the door to interest group pressure and a potential watering down of the legislation’s actual impact. Secondly, none of the changes are of the third order. Some elements, in particular the higher capital requirements and stronger consumer protections, are best characterized as first-order change, as they primarily change instrument settings. The central part of the reforms, the ringfence, should be seen as second-order change—it introduces a new policy instrument while remaining committed to the belief in market forces solving the problem by not forcing a full separation of retail and investment banking, but hoping that firms change their behavior or split themselves up for commercial reasons. There are several conceivable and realistic ways in which the reforms could have been more far-reaching, including a full separation of retail and investment banking (see the Glass-Steagall Act of 1933 in the US), a ban on proprietary trading by banks (see the Volcker Rule in the US), or even a complete overhaul of the banking system by adopting Limited Purpose Banking (Kotlikoff, 2012). Those types of change, that do not merely tweak policy instruments or their settings, but the underlying thinking and goals, are what make radical, third-order change.

Explanations of the limited reforms emerging from the GFC have focused on the political process and the unique circumstances surrounding the crisis. Mayntz (2012) highlights the atypical interest group formation before the crisis that thwarted the formation of group opposed to the status quo. Hence, when the GFC hit, there was no united social bloc to offer an alternative. Rather, “there were experts and regulators who would have preferred stricter regulation, but they remained voices crying in the wilderness” (Mayntz, 2012, p. 14). This lack of coherent support for tighter regulation might be a result of the largely unopposed rise of finance capitalism and the neo-liberal narrative in the 1990s, which was paradoxically fueled by center-left parties in the US and UK (Cioffi and Höpner, 2006; Schnyder, 2011).

Such political accounts aimed at explaining the surprising resilience of neo-liberalism (Schmidt and Thatcher, 2013; Crouch, 2011) are important, but limited by their post-hoc attempt of explaining the ‘surprising’ circumstances that stood in the way of the more drastic reforms that ‘should have been.’ The problem with this approach is twofold. First, it is based on the idea that crises are constructed politically and resolved politically, making it difficult to predict any particular outcome. While the particular circumstances of every crisis are surely unique, it starves us of the opportunity to create general insights into how economic crises affect processes of institutional change. After all, the overriding commonality of crises is that they are situations of severe uncertainty, which actors have to cope with in one way or another. While we may not be able to predict the specific outcome of this process, we can conceptualize how actors reduce uncertainty and how it influences the processes and mechanisms established in the institutional change literature. The second problem with political explanations of change is that they tend
to ignore or downplay the role of economic actors, i.e. corporations and their practices. Without doubt, political actors hold the formal power to change formal institutions—laws and regulations—but, as the literature has come to acknowledge, corporate actors have not only considerable influence over the creation and change of formal rules, but also over how these rules are interpreted and shape corporate practice. The starting point for this paper is therefore the literature on institutional change, as it offers general propositions on the process of institutional change and how various actors influence it.

The state of the institutional change literature

The incrementalist view of institutional change has brought with it the realization that change does not only have to result from external shock events, but that endogenous forces may also transform institutions through gradual adjustments—a source of institutional change previously neglected due to short time frames and treating institutions as causes of change (Mahoney and Thelen, 2010a; Streeck and Thelen, 2005a). This raises the question what exactly those endogenous forces are that can effect institutional change.

One line of thought, which can be termed the ‘top-down’ view, holds that party politics and interest group alliances, e.g. between investors and managers, are the main impetus for change. Hereby, policymakers are seen to produce formal institutional changes, which are then implemented in practice on the firm level. In other words, formal change precedes informal change. Amable and Palombarini’s (2009) ‘neorealist’ model of institutional change, for instance, is based on political power and alliances. They predict institutional change if and when it meets the interests of political leadership. This conception is reminiscent of the traditional model of self-interested political actors, who want to guarantee their political survival and reelection. In a similar vein, Cioffi (2010) conceives of corporate governance reforms as a political game between political parties and interest groups. Corporate interests play a somewhat larger role here, but their influence is said to have waned with rising political salience of corporate governance over the past decade as a result of a series of corporate scandals. Because firms squandered their influence over policymaking, they are only seen as background noise in Cioffi’s politics-centered approach.

Actor-centered institutionalism (Mayntz and Scharpf, 1995; Scharpf, 1997) marked an important step towards considering the role of corporations more fully, as it emphasizes all actors that are relevant to a certain field of regulation or policy. Rather than only looking at state actors, it takes both state and economic actors into account. Rooted in the political sciences, actor-centered institutionalism focuses on processes rather than outcomes and recognizes structure (political system) as well as rules (institutions). The rule-making process is shaped not only by political structures, but also dominant interests of actors, which are in turn shaped by their
institutional context. Thus, the approach regards institutions both as explanatory variables and as something to be explained; they do not determine outcomes, but are a constraining and enabling context (Mayntz and Scharpf, 1995, p. 43). While not theorizing specific methods of influence and remaining constrained in a number of ways, actor-centered institutionalism clearly has made a strong case for taking firms seriously as actors shaping their institutional environment.

This call for intensifying the focus on the firm level is also reinforced by several other authors. Hall and Soskice’s (2001) influential “Varieties of Capitalism” framework, while not mainly concerned with institutional change, shows that in order to understand a nation’s institutional set-up, we need to focus on the firm-level and how various actors coordinate their activities. Jackson (2010) argues that to move beyond broad typologies of institutions, we should examine the identity and constellation of actors in a contextualized way. The actor-centered approach does just that and therefore represents a promising path forward in the quest to “see institutionalization as dynamic and actor-centered social process, recognizing the duality of structure and agency, as well as the material and cognitive aspects of institutions” (Jackson, 2010, p. 66). Thelen’s recent work has similarly emphasized the importance of corporate actors in change processes (Mahoney and Thelen, 2010b; Hall and Thelen, 2009; Streeck and Thelen, 2005b).

Proponents of the ‘bottom-up’ perspective contend that the ones most affected by an institution hold a considerable degree of power that goes beyond accepting or rejecting policymaker-decreed change. Firms change their practices first, which become institutionalized and legitimated by lawmakers to reflect corporate practice—informal change therefore preceding formal change. The basis for bottom-up change are “the ‘gaps’ or ‘soft spots’ between the rule and its interpretation or the rule and its enforcement” (Mahoney and Thelen, 2010a, p. 14). On an individual level, exploiting these gaps hardly is powerful enough to cause institutional change. Once a few powerful actors start acting in similar ways and gather critical mass, however, they can trigger change in their own institutional field and possibly even connected fields (Mahoney and Thelen, 2010a, p. 30).

While the gap between rules on paper and their interpretation and conversion into practice forms the basis of bottom-up approaches, it is not without criticism. Amable and Palombarini (2009, p. 126) see it as a “confusion between rules and practices,” which they argue “leads to the overestimation of the importance of the interpretation made by firms in the process of institutional change” and the neglect of the unilateral power of the state. While there can be little doubt that policymakers are formally endowed with the power to create, change and abolish formal institutions in the form of law, regulations and policies, a black-and-white view of rules and practices is hardly as clear-cut in reality. For one, it neglects rule-like practices as embodiments of informal institutions—ways of doing things not mandated by law or regulation, but often subject to consequences when not being followed. An example could be cross-shareholding systems that make access to financing from the banks at
the center of the network much more difficult if firms leave the network. Secondly, as Culpepper (2005, p. 178) argues, rules are not relevant for their own sake, but for the way they systematically shape behavior. More importantly, however, it ignores the advances made in the literature towards recognizing the various ways in which corporate practices influence rules.

The literature differentiates four mechanisms of bottom-up change: reinterpretation, defection, displacement, and preemption. Reinterpretation of the law, or ‘conversion’ in Streeck and Thelen’s (2005a) terminology, is hinged upon firms exploiting ambiguities in the law to interpret it in a favorable way, or pursuing a judicial strategy where they expect a decision in their favor, thus creating new legal precedent (Funk and Hirschman, 2012). Interpretations and expectations of the law become even more important when new ambiguous legislation is passed. In such situations, firms look towards each other in search of best practice in complying with the new law: “These field-wide efforts to reduce environmental uncertainty lead organizations to develop common signals of compliance - such as formal policies and procedures - even when they are not legally mandated” (Funk and Hirschman, 2012, p. 5).

Defection refers to large-scale deviance, or several powerful firms ignoring a rule or regulation, which may contribute to an institution’s exhaustion (cf. Streeck and Thelen, 2005a). Over time, the rule might cease to be enforced or taken off the books entirely. It is usually assumed that firms prefer stable institutional environments, which would counter the idea that firms intentionally destabilize legal institutions they have learned to deal with. Funk and Hirschman (2012) argue that firms are willing to cause destabilization when it promises to further their interests or when another related field is already destabilized. These ‘cascades of change’ are thus more likely the tighter the connection between two fields.

Displacement refers to ‘dormant’ institutional forms, i.e. “possibilities of action that institutions neither prescribe nor eliminate,” replacing the dominant form (Streeck and Thelen, 2005a, p. 20). These secondary logics of action may come from exogenous sources in form of imported institutional forms, or from reactivating “suppressed historical alternatives” (Streeck and Thelen, 2005a), which in a crisis could mean the reactivation of more prudent approaches. Finally, displacement can result from innovating around the law, taking advantage of policy drift (cf. Streeck and Thelen, 2005a), for example to design new financial investment products not covered by existing legislation.

Preemption is not so much a method for changing formal institutions as it as a way of inhibiting the formation thereof through self-regulation on the firm level. Issues may be kept outside of formal regulation entirely through setting up industry-wide sets of rules along with professional bodies that can enforce those rules and sanction transgressions (Culpepper, 2011). An example for such ‘self policing’ would be the Institute of Chartered Accountants in England and Wales (ICAEW), which has
the right to first address its members’ lapses, before they are conferred to the governmental accounting disciplinary board.

Empirical evidence for bottom-up change is fairly new and sometimes limited to specific cases, but nonetheless convincing and deserving of close attention. Schnyder (2010) points to evidence of cases where firm practices change before legal changes were made to reflect them (Coffee, 2001; Cheffins, 2000), as well as firm practices defying legal changes (Culpepper, 2005; Culpepper, 2007). In some cases, firms may even adopt practices symbolically, but subvert them substantively, in order to respond to institutional pressures and signal compliance to other actors. Westphal and Zajac’s (2001, pp. 220-221) work on this phenomenon, termed corporate decoupling, shows that “firms are more likely to avoid institutional pressures for change using tactics such as decoupling when those institutional pressures conflict with the interests of actors who hold power in the organization.” They find that corporations are more likely to engage in decoupling when decision makers (CEOs) have more power vis-à-vis the board, are more aware of opportunities for decoupling, and benefit from it personally. Crucially, the signaling function of symbolic practices works even when actual practices differ. This is an important finding, as it highlights that the publicly projected practices of corporations can influence other actors—investors, peers or even policymakers—regardless of whether they represent actual corporate practices.

Seeking to integrate insights from both top-down and bottom-up perspectives of change, the literature has come to embrace a reflexive approach, whereby change is a result of the interaction between a variety of actors (policymakers, political parties, firms, labor unions, etc.), who are in constant dialectic adjustment with their institutional environment. Recognizing that both rule-makers and rule-takers can be powerful drivers (or inhibitors) of change raises the question how the power between the two is balanced. The perhaps most prevalent line of thought argues that the balance of power shifts depending on the issue in question and whether said issue is ‘politically salient.’ This idea is based on the assumption that policymakers ultimately have the power to enact whatever policies they wish, but that they neither have the resources nor inclination to do so in every case. Instead, when an issue is of low importance to the public at large and thus has low political salience (Schattschneider, 1960), policymakers tend to follow the wishes of those most affected by a policy—in case of finance, corporate governance, and labor relations issues often those of corporations. When saliency is high though, it can act as a “stimulus for action by key players, driving the search for solutions to problems, though not determining outcomes” (Gospel and Edwards, 2012).

Taking this concept into account, Culpepper (2011) sees power shift between party politics and interest groups on the one hand, and managerial interests on the other, depending on an issue’s political salience. Culpepper argues that party politics and interest group coalition-driven perspectives of legal change are flawed as they “treat corporate control like any other high-profile battle in democracies, where
public opinion and legislative votes are the most valuable currencies” (Culpepper, 2011, p. 3). With low political salience of the issue, though, pressure for change is unlikely to come through these avenues. In areas of low political salience, such as regulation on corporate control, firms heavily influence policy due to “their superior lobbying capacity and the deference of legislators” (Culpepper, 2011). Conversely, when an issue becomes politically salient due to an economic crisis or corporate scandal, the more politicians start paying attention to public opinion and business interests lose power. The dynamic nature of political salience makes this approach an important contribution towards contextualizing theories of institutional change.

So, how capable is his model of explaining the incremental to modest mode of change after the global financial crisis? Given the crisis’ severity and level of public outcry and anger directed at corporate governance failures (Adams, 2009; Kirkpatrick, 2009; David Walker, 2009), political salience of a range of financial market regulation and corporate governance issues was certainly high. In this case, Culpepper’s model predicts the power of business interests to decline, allowing policymakers to implement far-reaching changes to answer the public demand for reform. As discussed earlier, the financial market and corporate governance reforms enacted in the UK are incremental or modest at best, raising the question what may have stopped policymakers from pursuing more radical reforms. At its heart, this is a political question that shows the limits of Culpepper’s model. Primarily concerned with the political arena, his model is logically sound in explaining how power shifts between different actors in times of crisis, but the nature of political processes means that their outcomes are difficult to predict. While this drawback may be hard or even impossible to rectify, another question can and needs to be addressed: how bottom-up drivers of change are affected by severe crises.

The dynamics of power shifts in bottom-up change processes may be the opposite of those in top-down policymaking and enhance the power of corporate interests in times of crisis. Here, political salience could increase the influence of corporations, if changes in aggregate firm behavior are seen as effective self-regulation. This will depend on whether other actors, mainly policymakers and opinion leaders, see the changes in corporate behavior as desirable and sufficient—if they do, the bargaining power of businesses vis-à-vis policymakers is increased as they can point to having made corrections to their behavior and argue against heavy-handed regulatory change. Policymakers, especially those of a pro-business disposition, may be willing to accept such ‘self-regulation’ in lieu of formal regulation, freeing their agendas at a time of competing priorities (Mayer, 2013). Bottom-up processes of change could therefore be an important driver of change in times of crisis.

Discussion
A focus on firm practices necessitates an understanding of the behavior of corporate actors in times of crisis. Studying their behavior in detail needs to be subject of a larger empirical enquiry, but the literature offers a useful point of departure: the uncertainty caused by situations of crises and how actors aim to reduce it. Institutions are often understood to be devices reducing uncertainty in economic exchanges by limiting actors’ leeway for opportunistic behavior, thereby reducing transaction costs (North, 1984; North, 1990; Williamson, 1981). Under normal circumstances, firms thus have an incentive to work towards maintaining those institutional arrangements, both to reduce the chances of opportunistic behavior of others, but also because they benefit from exploiting the status quo of the institutional set-up for their own gain.

In times of severe crisis, however, different factors come into play. For one, institutions that are seen as instrumental in causing the crisis may lose support from the public, policymakers, or even the firms affected. With mounting normative pressure to reevaluate and change the institutions, actors may start to defect from them, turning the institutions from uncertainty reducing into uncertainty-causing devices. In the case of the GFC, this applies primarily to informal rather than formal institutions—systemic, irresponsible risk-taking behavior of financial firms received a larger share of blame for causing the crisis than regulatory failure. Consequently, certain institutionalized practices and the companies mainly associated with them become discredited and a source of uncertainty, prompting other corporations to defect. In the first instance, this is likely to lead to a splintering of practices, as the defecting companies pursue various alternatives to the previously engrained practice.

More generally, times of severe crisis can be understood as situations of Knightian uncertainty, i.e. “situations regarded by contemporary agents as unique events where the agents are unsure as to what their interests actually are, let alone how to realize them” (Blyth, 2002, p. 9). Hence, crises spread a ‘great confusion’ of sorts, leaving actors without their usual compass directing them on what behaviors are appropriate or even in their interest. One important way firms regain their footing is through following the lead of large, successful companies—role models that are seen as ‘best practice’ examples of how to cope with the crisis and the uncertainty surrounding it. Called mimetic isomorphism, this process tends to occur for its uncertainty-reducing properties: “Individuals and organizations deal with uncertainty by imitating the ways of others whom we use as models. The underlying logic is often one of orthodoxy: We seek to behave in conventional ways, in ways that will not cause us to stand out or be noticed as different. Also involved are status processes. We attempt to imitate others whom we regard as superior, as more successful” (Scott, 1995, p. 45). Westphal and Zajac (2001) discuss evidence showing such behavior in the face of institutional uncertainty among firms with network ties to each other. Organizational isomorphism is of course not limited to situations of crisis but occurs for different reasons in a number of forms. Organization studies has shed light on the question why firms often exhibit similar behavior despite the large
variety of institutional contexts and possible behaviors, with explanations generally focusing on legitimacy, reduction of uncertainty and taken-for-granted practices (Meyer and Rowan, 1977; DiMaggio and Powell, 1991). The variation of corporate practices after a severe crisis can therefore be expected to show a pattern of initial spread and increased heterogeneity, followed by convergence on the practices of a small number of new role models.

Proposition 1a: Institutions and corporations discredited due to crisis become a source of uncertainty, initially leading to larger variation of practices.

Proposition 1b: Once new role models emerge, corporations start to mimic their behavior in order to blend in with perceived best practice. This leads to a convergence of corporate practices.

Patterns of mimetic isomorphism are likely to be related to internationalization processes, both through MNCs as conduits of mimetic isomorphism and through determining which national business model is considered best practice. Dominance effects establish an international hierarchy of economies, whereby “those in dominant positions have frequently evolved methods of organising production or the division of labour which have invited emulation and interest” (Smith and Meiksins, 1995, p. 256). Smith and Meiksins argue that such borrowing of what is perceived to be ‘best practice’ is intensified with increasing global economic integration. This implies that the effect is stronger in highly internationalized sectors, say the financial sector or in mass manufacturing of consumer goods, than in other, less integrated sectors.

An important vehicle for the diffusion of the best practice of the time are MNCs, who transplant their home practices to host countries, albeit with some local ‘flavor’ to make them compatible with local legal and normative requirements. Dominance effects “create pressures to diffuse best practice, but competition between dominant countries means there is never a single model of this, and uneven development ensures that there is a turnover in practices” (Smith and Meiksins, 1995, pp. 258-259). Dominance effects exist at all times, but severe crises may create a new hierarchy of economies. As some economies suffer more than others, the previously dominant model may become discredited and replaced by an economic model that fared better throughout the crisis. Since the 2008 financial crisis and the ensuing global economic downturn, Germany has often been heralded as a new role model, having performed better than most other advanced capitalist economies. Some governments such as the British, have voiced their aspirations to become more Germanic, i.e. export-led economies with strong apprenticeship and training systems (Volkery, 2013; Groom, 2013). This perhaps signals that the German economy and by extension the practices of German firms have climbed the hierarchy to replace the Anglo-Saxon style of capitalism as the role model. A crisis can ‘dethrone’ the clear
dominator, but a new single best model may not immediately emerge. In this case, the ideological affinity actors have towards one or the other contender, sectoral differences, and general ambiguity may lead to increased heterogeneity of practices. The following propositions can therefore be made regarding international influences on patterns of mimetism:

**Proposition 2a:** Mimetic isomorphism is stronger in highly internationalized sectors.

**Proposition 2b:** Crises may establish a new hierarchy of dominant economies, creating new role models both in terms of economic policy and associated corporate practices.

We can identify three types of mimetic isomorphism relevant in times of crisis: within-group mimetism, outside-of-group mimetism, and cross-border mimetism. The first type, within-group mimetism, is similar to Abrahamson’s (1991) fad perspective, referring to companies copying the behavior of their immediate peers. Explanations of this behavior have focused on gaining legitimacy by adhering to emergent norms (DiMaggio and Powell, 1991; Meyer and Rowan, 1977) or on economic interests by avoiding the risk that competitors might gain a competitive advantage through an innovation (Abrahamson, 1991). Reputation-based explanations, whereby firms imitate others with better reputations than their own (DiMaggio and Powell, 1991) have also been advanced for political actors, showing that policy diffusion in the US spreads after highly-reputed states implement a new policy (Jack L Walker, 1969). As mimetic isomorphism occurs for legitimacy, status or reputational reasons at all times and therefore reduces heterogeneity of firm behavior within a peer group, changes in firm behavior induced by within-group mimetism are likely incremental.

Outside-of-group mimetism corresponds to Abrahamson’s (1991) fashion perspective, whereby fashion-setting organizations such as consulting firms, business schools or business mass media promote certain administrative technologies as part of their business. Organizations adopt their recommendations because of the trust they inspire, the knowledge they exude, and the reach they have. The practices promoted by these opinion-leaders are not necessarily efficiency-enhancing, but serve an innovation-signaling purpose that tends to lead to rejection over time as they lose their innovative edge. In times of crisis, this driver of mimetic isomorphism is also likely to be highly relevant. Consultancies, business media, business associations and other opinion-leaders provide guidance and advice on how to react to the crisis or how to ensure compliance with legislation that may be under particularly close scrutiny by regulators after the crisis. It is in the business interest of consultancies, advisory bodies and the specialist media to sell advice that is far enough from common wisdom to be perceived as a ‘product’ or ‘solution,’ yet not too unorthodox as to be perceived as unfeasible or to attract unwanted regulatory
scrutiny. Hence, this type of mimetism bears a larger potential for shifting firm practices in a radical way than within-group mimetism.

With increasing global integration of business and trade, mimetic processes are not limited to the nation-level. MNCs may not have any domestic peers, making it likely that they orient themselves towards their international peers and international opinion-leaders. If the crisis triggers a reshuffling of the hierarchy of economies, new political and corporate role models may emerge and become a template for governments and firms further down the hierarchy to imitate. Where firms import practices through cross-border mimetism, friction with home-country institutions can be expected. Practices imported from other institutional contexts may be very different from domestic norms, but to what extent they may run afoul of domestic rules will depend on the home-country’s regulatory system. The UK’s ‘comply or explain’ approach to corporate governance regulation, for instance, is much more permissible to deviant behavior than other, more prescriptive systems. Two factors give cross-border mimetism the largest potential for radically changing firm practices. The first is the potentially large difference in the institutional systems of the role model and imitator. The second factor is the institutional disconnectedness of MNCs that results from their global orientation placing them beyond the reach of any single government. In exceptional circumstances, Hage and Mote (2008, p. 313) argue, institutionally disconnected organizations have “the capacity to transform [their] institutional environment with discontinuous changes in normative patterns or institutional rules.” The three types of mimetic isomorphism and their relative power to change corporate practices can be summarized through the following propositions.

**Proposition 3a:** Changes in firm behavior induced by within-group mimetism are likely incremental, as firms within the same group are already relatively similar.

**Proposition 3b:** Outside-of-group mimetism has the potential to shift firm practices in a more radical way than within-group mimetism.

**Proposition 3c:** Cross-border mimetism has the largest potential for radically changing firm practices.

If times of crisis and uncertainty lead to changes in corporate practices due to mimetic isomorphism, the question arises how this impacts the institutional environment. How firms may have the power to change institutions through their practices is fairly straightforward when it comes to informal institutional arrangements that firms themselves are the ‘guardians’ of. As changes in corporate practice spread and reach critical mass, they may become institutionalized on the firm level and contribute to change in informal institutional arrangements. Culpepper (2011) points to the example of French firms’ own undoing of takeover
protections during the 1990s, when firms created institutional change by eroding ownership concentration and cross-shareholdings. However, change to informal institutions does not necessarily come easily. Normative pressures make deviant behavior not only costly, but also frowned upon by peers. A critical mass of firms changing their behavior—either defecting from an existing informal institution, or converging on a new practice—is therefore a necessary precursor to such changes taking hold.

Corporate practices can affect formal institutions in a number of ways, most importantly through the four mechanisms of bottom-up change discussed earlier. While change occurs through these methods of bottom-up change at all times, they are affected by crises in a number of ways. First and foremost, crises and processes of mimetic isomorphism accelerate the formation of critical mass, which forms the basis of any method of bottom-up change. Organizational interpretations of formal rules, once they reach ‘critical mass’ within a field or are followed by a small number of highly influential firms (Funk and Hirschman, 2012), become institutionalized among corporations and eventually recognized as legitimate ways of compliance. This process, often termed ‘endogenous legal change,’ can be summed up as “everyday organizational practices, routines, and structures subtly influence legal thinking, legal categories, and legal logic” (Edelman et al., 2011, p. 890). Secondly, crises may make bottom-up change less visible and increase its chances of success. Governments will prioritize the most salient issues on their agenda, which are likely to be emergency countermeasures to the crisis, crowding out other matters of lower priority (Kingdon, 1995). This may open a window of opportunity to establish new forms of compliance ‘under the radar,’ i.e. while governments are occupied with other problems. Indeed, even if an issue is politically salient, it may work in favor of corporate interests, as corporate change may be seen as effective self-regulation by policymakers, as discussed earlier.

Each of the four methods of bottom-up change is also affected in more specific ways by situations of crisis. (1) A severe crisis may not only be the trigger that leads to firms reinterpreting existing law, it may also be the catalyst for new legislation that is particularly ambiguous and hence vulnerable to reinterpretation. Reinterpretation could therefore be more likely and more successful in a crisis. (2) Defection from previous norms and institutionalized practices could be a reactionary response where practices are discredited or delegitimized by the crisis, for example high-risk behaviors blamed for contributing to the crisis. In this case, defection would serve to reduce public and regulatory backlash to corporate behavior. Crises could also be an opportunity for active rather than reactionary defection. Firms may, for example, deviate from norms on employee relations or even formal labor regulations during a financial crisis, arguing that labor protections harm their competitiveness and threaten more job losses if the firm goes bankrupt entirely. Situations of crisis therefore represent an opportunity for firms to defect from established institutions under the guise of a ‘desperate times call for desperate
measures’ mantra. In itself, a crisis may not be sufficient to overcome the corporate preference for a stable institutional environment and cause defection, as uncertainty stands in the way of forming new goals and interests. If related fields are already destabilized, however, defection could become more likely. (3) Displacement can be triggered by the import of institutional forms via cross-border mimetism, or if practices are discredited, prompting a return to previous patterns of behavior. (4) Existing forms of self-regulation may become threatened in times of crisis, if they are perceived as ineffective and contributing to the crisis. Rising political salience could therefore block preemption as a method of bottom-up change. At the same time, however, crises also present an opportunity for preemption. If firm-level change is swift in countering the perceived issue, either through industry-body guidance or convergence through mimetic isomorphism, regulators may see it as a sign of effective self-regulation and hence forego formal regulatory change. Taken together, the following propositions regarding how crises affect bottom-up change can be made.

**Proposition 4a:** Crises are likely to affect informal institutions in the first instance, if and where pressures against deviant behavior can be overcome.

**Proposition 4b:** Resource and agenda-setting constraints during severe crises could allow bottom-up change to occur ‘under the radar’ of policymakers and regulators, hence increasing its chances of success.

**Proposition 4c:** Resource and agenda-setting constraints may also increase the power of corporate interests vis-à-vis policymakers, if change in firm behavior is seen as effective self-regulation.

The impact of bottom-up change on formal institutions may be enhanced in times of severe crisis due to institutional ‘softening.’ Institutional strength can be seen as comprising of two dimensions—enforcement and stability (Levitsky and Murillo, 2009). Highly developed nations typically feature high enforcement and high stability, but crises can chip away at both. Weak enforcement of rules can result from ‘window dressing,’ i.e. law or regulation enacted primarily to appeal to others without intention of enforcing it (Levitsky and Murillo, 2009). In a crisis, policymakers could engage in window dressing as a way of signaling to the public that the government is doing what is morally right, e.g. by capping executive pay, while at the same time putting business interests at ease by implementing weak monitoring and enforcement mechanisms. Weak enforcement may also be a result of governments lacking the power to enforce even if they wanted to. The reach of the state might be lower in some sectors than in others—highly internationalized and ‘footloose’ sectors such as finance, or highly complex sectors such as investment banking, for example. Finally, when actors perceive rules as unfair, they are more inclined to not comply with them, making effective monitoring and enforcement more costly and in turn rule violations more likely. Lawmakers, who may well be
inclined to crack down on the perceived causes of an economic crisis, thus risk higher violation rates if firms do not perceive the new rules as fair.

Institutional instability may also result from a number of sources. Time is one of those factors and highly relevant to situations of crisis. Levitsky and Murillo (2009, p. 123) argue that “the pace of institutional design may affect stability,” as quickly-designed ‘emergency legislation’ does not give actors enough time to calculate its potential impact and how it affects their interest, increasing resistance to the new rules. Institutions imported from abroad may also be weakened, either on the policy level or the corporate practice level, due to poor fit with the domestic institutional context. Just as corporations seek to reduce uncertainty through imitating best practice of their peers, policymakers may also adopt what they perceive as the best way of handling the crisis. Adopting perceived ‘best practice’ solutions from other countries could boost confidence among businesses, investors and consumers, regardless of how fitting the rules may be to the domestic context. These imported policies may have the desired signaling effect, but are also liable to being exposed as ill suited to the domestic context. Whether institutions are weakened by poor enforcement or instability, Levitsky and Murillo (2009) argue that it makes them more vulnerable to change. In advanced democracies, this cannot be expected to lead to institutional breakdown and replacement, but it may have a large enough effect to enhance the power of bottom-up methods of change by making formal institutions more malleable in times of crisis.

Proposition 5: Institutional softening may enhance the impact of bottom-up methods of change in times of crisis.

Conclusions and future research

This paper has presented and discussed a theoretical approach to understanding the role of bottom-up processes of institutional change in times of crisis. Unlike in processes of top-down change driven by policymakers, whereby corporate influence declines with rising political salience, bottom-up methods of change are a powerful avenue for corporations to influence formal institutions in times of crisis. In the first instance, a major shock event may lead to a splintering of practices as previous norms are discredited. As new role models emerge, however, corporations may converge on new perceived best practice through a process of mimetic isomorphism that reduces uncertainty induced by the crisis. Three types of mimetic isomorphism have been theorized and discussed: within-group mimetism, outside-of-group mimetism, and cross-border mimetism. The last type bears the largest potential for shifting aggregate firm behavior in a significant way through the import of institutional forms from abroad.
Mechanisms of bottom-up change are affected by crises in a number of ways that may enhance their potency. Mimetic isomorphism accelerates the formation of critical mass—a crucial first step in any process of bottom-up change. A severe crisis may also be the catalyst for reinterpretation, displacement of, or defection from formal institutions due to regulatory ambiguity, return to previous norms, or destabilization of related fields. The impact of bottom-up change could be enhanced by institutional softening in crisis situations, resulting from enforcement issues and reduced institutional stability. While political salience may work against corporate interests in high-stake issues, it could work for them in cases where policymakers or regulators see changes in corporate practice as evidence of self-regulation and deem it sufficient, eschewing regulatory action.

While empirical research will need to evaluate the arguments advanced here, this paper contributes towards addressing a major shortcoming of the literature on institutional change. There is still an overwhelming emphasis on institutional change as a politically driven process. The power of firms is either seen as reactionary or based on the deference of policymakers. If we want to take firms and their role in institutional change seriously, however, we need to subject them to the same scrutiny as the policymaking level. That means moving beyond conceiving reform processes as either purely political battles or as struggles between policymakers and firms, to also consider the processes of change on the firm level. Shedding more light on corporate behavior could help us understand better how firm practices change and spread, which is the first step towards a better understanding of bottom-up processes of change.

This paper is neither able to nor intends to answer the question why policymakers failed to pursue a more radical overhaul of financial market regulation or the economic system as a whole after the GFC. As a fundamentally political question, other authors have given this issue considerable attention (cf. Crouch, 2011; Schmidt and Thatcher, 2013). Such political accounts are limited not only by their specificity and ex post nature, but also by ignoring almost entirely the role of corporations and processes of change outside the political arena. Hence, this paper contributes to providing a corrective to this shortcoming by preparing the ground for empirical research on the role of corporate practices and bottom-up methods of change in times of crisis, which may well hold the key to understanding why and when shock events do not lead to radical institutional change.

A path for future research

Empirically testing the theoretical framework presented in this paper should begin by examining changes in corporate practice over the past decade. The propositions developed in this paper can guide the analysis towards testing a number of important questions—how firm practices were initially affected by the GFC and whether they became more heterogeneous, to what extent mimetic isomorphism lead
to convergence on new practices, and who the role models are that others imitate. As a next step, firm-level analysis could be supplemented with policy-level data. Comparing change in corporate practices with change or absence of change in corresponding policies may be a fruitful approach to illuminate processes of bottom-up change. It may show instances where firm practices fall quickly in line with a regulatory change, indicating a classic case of top-down institutional change. More interestingly, however, it may also reveal cases where firm behavior converges on a new norm and prompts regulatory change that merely formalizes said change. If a public discourse dimension is brought into play as well, we will also be able to identify cases where policymakers or regulators accept firm-level change as sufficient despite public demands for action—either by adapting regulation in line with changes in corporate behavior, or by eschewing regulatory action entirely. Such instances of policymakers accepting firm-level change as sufficient could be good evidence for the power of corporate interests and bottom-up methods of change in times of crisis.
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