

The Effect of Social Norms on Sin Stock Performance

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RESEARCH SUMMARY

Institutional theory has provided remarkable insights to advance our understanding of organizational legitimacy and its relationship with firm performance. Studies have shown how normative and regulative institutional pressures shape organizational legitimacy (Ruef and Scott, 1998; Scott, 1987, 1995). Much of the extant literature has implicitly assumed that the criteria of legitimacy are established, and the definitions of desirable, proper, or appropriate behaviors are clear, with a few exceptions (i.e. Ashforth and Gibbs, 1990; Henisz and Zelner, 2005). When viewed through a historical lens, however, it appears that the criteria of legitimacy might be evolving over time. Consequently, we need a more fine-grained theoretical understanding and empirical verification of the way in which shifts in social values and regulations may affect organizational legitimacy and firm performance.

Legitimacy is bestowed on firms by society, and scholars have argued that firms may gain, maintain, and repair legitimacy in order to affect societal opinion (Suchman, 1995; Webb *et al.*, 2009). The majority of the literature focuses on how firms may face challenges in gaining and maintaining legitimacy, such as how entrepreneurial ventures must deal with liability of newness issues (Aldrich and Fiol, 1994; Autio, Sapienza and Almeida, 2000), and how internationalizing firms may deal with liability of foreignness issues (Kostova and Zaheer, 1999; Zaheer, 2009). Firms gain legitimacy through conforming to the environment, building reputations, and other symbolic displays, while firms maintaining legitimacy typically do so through small adjustments that protect their accomplishments and stockpile trust (Suchman, 1995). Literature that addresses repairing legitimacy typically deals with short-term shocks to a firm's reputation, such as product recalls or scandals. The assumption is that once firms have

legitimacy, it's theirs.

However, what if there were big changes in legitimacy? What about external changes, that can affect a firm through no act of its own? For example, what happens if societal opinion of an industry shifts? How do the firms within that industry deal with a sweeping change in social norms? This is not a case of gain, maintain or repair (Suchman, 1995), such as is typically heretofore seen in literature. This begs the question: In this situation, are there tactics a firm can engage in to mitigate the effect of a permanent change in organizational legitimacy?

In order to address these questions, we use the so-called “Triumvirate of Sin” industries (tobacco, alcohol, and gambling) (Hong and Kacperczyk, 2009) as a natural experiment. “Sinful” industries offer products or services that “for reasons of delicacy, decency, morality, or even fear tend to elicit reactions of distaste, disgust, offense or outrage when mentioned or when openly presented” (Wilson and West, 1981:92). The label of “sin stocks” did not always exist, however—it evolved gradually over time into a label of organizational illegitimacy. All three industries were once viewed as socially legitimate, but in recent decades have been affected by negative sweeping changes in societal opinion. Because industries themselves possess legitimacy, which can then be bestowed upon the firms operating within them (Aldrich & Fiol, 1994; Suchman, 1995), using the sin industries context allows us to examine whether historical shifts in public opinion affect how institutional and organizational forces shape organizational legitimacy and enhance firm performance.

Employing an institutional theory framework, we first argue that firms’ legitimacy is affected by evolving normative (informal) and regulative (formal) pressures, designated by social norms and restrictive regulation. Social norms are “unwritten rules of conduct for a group” (Meek, Pacheco, and York, 2010: 493), that reflect collective understanding about what actions

are required, tolerated or prohibited in a society (Cialdini and Trost, 1998; Ostrom, 2014). The stronger a social norm against a particular behavior, the less likely people will accept a firm that reflects that norm. Research has shown that institutional investors attraction to and analyst coverage of controversial industry firms decrease with the degree of negative social norms (Liston, 2016; Liu et al., 2014). Similarly, the more tightly regulated an industry, the more caution people have regarding purchasing the industry's products, and restrictive regulation limiting the sale and use of these products may discourage investors from owning stock in such firms. We therefore expect that social norms against objectionable behavior and restrictive regulation is negatively associated with the performance of sin stocks.

We then hypothesize that firms can strategically mitigate and manage societal perceptions of their legitimacy by employing distraction and decoupling tactics (Ashforth and Gibbs, 1990). Specifically, we hypothesize that firms can distract societal stakeholders through engaging in corporate social responsibility (CSR) activities such as corporate philanthropy. CSR is often used to address customers' social concerns, develop a positive corporate image, and support a positive relationship with stakeholders (Yoon, Gürhan-Canli, and Schwarz, 2006). In particular, voluntary corporate philanthropy is found to be effective for marketing "doing good" (Varadarajan and Menon, 1988), especially for firms highly sensitive to public perception (Lev, Petrovits, and Radhakrishnan, 2010: 185). We further hypothesize that firms can also employ decoupling as a tactic, to distance firm activities from negatively perceived primary industries, such as through unrelated diversification. Firms can engage in unrelated diversification as form of decoupling from the primary controversial industry for which they are known (Meyer and Rowan, 1977; Zimmerman and Zeitz, 2002) in order to reduce stock price risk from capricious customers and investors. We therefore expect CSR and unrelated diversification to be positively

associated with the performance of sin stocks.

Informal institutions such as social norms take decades to change (Scott, 1995). In order to observe the effect of such sweeping changes, researchers must examine a phenomenon over a long period of time. We therefore test our hypotheses using a database of 148 firms over 36 years in the tobacco, alcohol, and gambling industries during the years 1978 through 2014. We used several established sources of data for our variables, including but not limited to Factiva, CRSP, KLD, the World Health Organization, the Las Vegas Convention & Visitors Authority, and Compustat. Using fixed-effect panel data regression as well as two-stage instrumental variable (IV) regression, we find that sin stock performance is negatively associated with social norms against objectionable behavior regarding the use and sale of “sinful” products, but positively associated with distraction and decoupling tactics such as corporate philanthropy and unrelated diversification. By doing so, our paper is among the first to explore the effects of legitimacy on sin stocks performance from a strategic management perspective.

Although prior research that suggests both institutional pressure and organizational efforts are important to shape organizational legitimacy (Suchman, 1995), few studies have examined whether these effects are persistent or may decay in a long historical context. We provide a more nuanced understanding of how firms’ legitimacy evolves historically, by challenging the assumption that once gained, legitimacy standards are static. We also challenged the “gain, maintain, repair” paradigm (Suchman, 1995), by extending theory with new contexts. Finally, we showed that firms *can* employ tactics to mitigate damage to legitimacy caused by long term changes to societal values and norms.

Our paper also answers recent calls for the inclusion of a historical perspective on organizational studies (Godfrey *et al.*, 2016; Mills *et al.*, 2016; Rowlinson *et al.*, 2014) in order

to offer a finer-grained understanding of the way in which the past influences how firms and institutions interact. In this paper, we use an evaluating approach to history, where we confront theory “with detailed historical evidence to test its explanatory power and identify limitations” (MacLean, Harvey, and Clegg, 2016: 613). By examining how informal and formal institutions affect firms in controversial industries, in the guise of social norms against objectionable behavior and restrictive regulations, we develop and test historically informed theory and add more nuance to institutional theory.