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Implementation Of Legitimacy Theory On SME To Achieve Sustainability

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Abstract

Small and Medium Enterprise (SME) have and important role to contribute to the national economy and also can contribute to achieve sustainable development goals (SDG). To achieve sustainability, SME should have a positive effect on the surrounding community. There is a theory that can be applied to support the existence of SMEs, namely the legitimacy theory. Legitimacy theory is widely used in the literature to explain Corporate Sustainability. Some of the things that SMEs do to achieve legitimacy are as follows, SME implement corporate social responsibility, communicating CSR to stakeholder, attract foreign investor by enhance social, environment, and governance performance. In addition, the legitimacy of SME can be viewed from the owner-manager of SME's perspective. Based on owner manager's perspective, to establish legitimacy can be from customer's satisfaction through the value of the product/service, and also by give a responsibility to employees. SMEs that can achieve legitimacy, can achieve sustainability.

Keywords: sustainability, small medium enterprise, legitimacy theory, SDGS

INTRODUCTION

SMEs have played and continue to play an increasingly important role in the global economy and contribute significantly to output, employment and incomes. For example, at the start of 2019, SMEs accounted for 99.9% of all private sector businesses in the

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United Kingdom in 2018 (Department for Business, Energy and Industrial Strategy [DBEIS], 2019). They also accounted for 60% and 52% of all private sector employment and turnover, respectively (DBEIS, 2019). In Indonesia, there are 8,71 million unit SME on 2022. Therefore, there are tagline for “UMKM Upgrading and Modernizing Cooperatives” was echoed by President Joko Widodo in the framework of building a people's economy. This is due to the large number of SMEs in Indonesia that can contribute to the Indonesian economy which reaches 60.5% contribution to Gross Domestic Product and absorbs as much as 96.9% of the workforce (Press Release of the Coordinating Ministry for Economic Affairs).

Recent studies show that small and medium enterprises (SMEs) account for an overwhelming majority of private sector business and economic activity in both developed and developing countries. SME have a role in the global economy and potential contribution to the Sustainable Development Goals (SDGs) (Lessidrenska, 2019). SME development has the potential for wide reaching impacts on the SDGs globally, including SDG 1 (end poverty), SDG 2 (zero hunger), SDG 3 (good health and well-being), SDG 5 (gender equality), SDG 8 (promote inclusive and sustainable economic growth, employment and decent work), and SDG 9 (improve sustainable industrialization and fostering innovation)’. In many cases, the message and narrative of the Sustainable Development Goals has not penetrated SMEs, and often SMEs are not aware of brave Sustainability decisions they already have been implementing. Research has pointed out that SMEs struggle to identify how they could use Sustainability as a force for growth and adapt to megatrends such as increased globalisation, digitalisation, the new industrial revolution, the changing nature of work and demographic changes (sustainabilityknowledgegroup.com). One of the primary reasons why SMEs should consider sustainability is its importance in enhancing efficiency. By adopting sustainable practises, SMEs can reduce their consumption of energy, water, and materials, resulting in substantial cost savings. Moreover, sustainable practises can lead to more effective and streamlined operations, which can increase productivity and profitability. According to recent studies, SMEs that prioritise sustainability can also gain access to new markets in green industries and supply chains. For instance, small and medium-sized enterprises that produce environmentally (Low, 2023).

To help SME to achieve sustainability to contribute for SDGs, SME should have a positive effect on the surrounding community. There is a theory that can be applied to support the existence of SMEs, namely the legitimacy theory. Legitimacy theory states that organization can gain legitimate status, which is the approval and support of the

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society and elimination of threat to survival, such an organization should maintain integration of its value system with that of the social system within which it operates (Dowling & Pfeffer, 1975; Guthrie, J; Cuganesan, S; Ward, 2006; Noah, 2017).

According to Crossley et al., (2021) findings, SMEs not only demonstrate a commitment to symbolic legitimation but also a wide range of substantive assertions that reduce the legitimacy gap by enhancing their intention and ongoing activity in proving their validity. Their results are in line with the expectations of the legitimacy theory, which holds that organizations may participate as symbolic behaviors to enhance their reputation and image in the market. This paper try to describe the implementation of legitimacy theory on SME to achieve sustainability, so that can contribute to achieve SDGs.

LITERATURE REVIEW

Small Medium Enterprise (SME)

In literature, the definitions of small and medium enterprises have been differently defined by the countries and international organizations based on the capital assets, production capacity, number of employees, annual turnover, input usage, level of technology adoption, management practices, and concerning the characteristics specific to the sector, region, and the country (Prasanna et al., 2019). The World Bank defines the SMEs and large firms in their recent Enterprise Survey using the employment size of the firm, 5–19 employees as small business, 20–99 employee as medium business, and 100+ employees as a large business.

Based on UU 20/2008 UMKM, defines MSMEs based on their net worth and annual revenue. The legal requirements for MSMEs are as follows:The term microenterprise refers to productive enterprises or business entities owned by individuals that meet the following criteria:a)a) Have a maximum net worth of IDR 50,000,000 (fifty million rupiahs), excluding land and commercial structures. b)b) An annual sales volume of no more than IDR 300,000,000 (three hundred million rupiahs).)A small business is an independent economic venture run by people or businesses that are not subsidiaries or divisions of companies directly or indirectly owned, owned by, or become part of medium or large businesses. Here are the criteria for small companies (KUK):a)The eligibility criteria for this particular requirement is to possess a net worth ranging from IDR 50,000,000 (fifty million rupiahs) to a maximum of IDR 500,000,000 (five hundred million rupiahs), which excludes land and business buildings.b)Possess yearly revenue exceeding Rp. The maximum amount that can be

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granted is IDR 300,000,000 (three hundred million rupiahs) until IDR 2,500,000,000.-(two billion five hundred million rupiahs).

Medium Enterprises refer to productive economic entities operated by individuals or business entities not affiliated with small or large businesses, either directly or indirectly. These entities must satisfy the following conditions:a)To be eligible, individuals must meet one of the following criteria: a) possess a net worthranging from IDR 500,000,000 to a maximum of IDR 10,000,000,000, exclusive of land and buildings designated for business purposes, or b)generate annual sales proceeds exceeding IDR 2,500,000,000.-up to a maximum of IDR 50,000,000,000.-(fifty billion rupiahs).

Sustainability

The concept of sustainability was initially launched as an environmental idea, which focused on the conservation of resources. Now, it has become a milestone for the entire business community. Sustainability represents a paradigm change in business and places organizations that wish to thrive and perform well in this new, difficult environment in a new position where it is essential to combine shareholder value with stakeholder value. Businesses that just focus on providing a product or service to clients in an effort to increase short-term profits without also considering the social and environmental implications will not have a competitive advantage (Radoiu & Batusaru, 2022).

Company have to realize that not only focus on the economics of their business, but also care about social and environtmental to stay relevant in changing market. How well a firm positions itself in terms of sustainable development that balances financial, environmental, and human development is becoming increasingly important for designing a solid business plan (Alshehhi et al., 2018). Corporate sustainability is about expanding the financial bottom line into a triple bottom line, which includes environmental and social aspects of corporate performance (Alshehhi et al., 2018).

Today corporate sustainability is a well-practiced area in big companies where sustainability considerations are increasingly becoming a viable strategy for business and investment (Swarnapali, 2017). SME businesses can address sustainable development-related concerns in communities and boost transformations on the road to sustainability (Westman et al., 2019). Sustainability is crucial for SMEs seeking to increase their long-term profitability and competitiveness. Focus on sustainability in their business operations can make SMEs to reduce operational expenses, enhance their brand's reputation, and enter new markets.

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SMEs typically view sustainability as a way to preserve a balance between social, economic, and environmental concerns. They can meet the demands of their stakeholders to lessen the social or environmental impact of their business operations and develop the skills necessary to have a good impact on both society and the environment by using sustainable strategies (Das et al., 2020). SMEs can incorporate sustainability principles into their long-term planning, including setting sustainability goals, developing strategies to achieve these goals, and regularly monitoring and reporting on their progress

Legitimacy Theory

Legitimacy theory originated from organizational and social system theory that view organization as complex component that must interact with the environments in order to survive (Guthrie et al., 2006). Gaining organizational legitimacy is essential for organizations because it influences social and economic exchange and consequently market access (Deephouse et al., 2016).

Legitimacy theory explains the social contract between organization and communities where companies operate and use economic resources. Legitimacy can be seen as something that companies want and seek from society. The survival of the organization will be threatened if the communities feels that the organization has violated its social contract. When communities are dissatisfied by the organization's operations legally (legitimately) then communities can revoke the social contract in organizational operations (Deegan, 2002).

According to legitimacy theory, businesses must consider internal and external stakeholder expectations, which may not always be profit-maximizing but instead involve developing self-regulation and legitimacy (Worokinasih & Zaini, 2020), (Fallan, 2015)). Legitimacy theory suggests that organizations strive to maintain a positive image in the eyes of stakeholders in order to be seen as legitimate. In the context of SMEs (Small and Medium Enterprises), legitimacy can be achieved by incorporating sustainable practices into their operations. By demonstrating a commitment to environmental and social responsibility, SMEs can build trust and credibility with stakeholders, which can lead to improved relationships, increased customer loyalty, and better financial performance. This can help to ensure the long-term viability and success of the business.

Based on (Suchman, 1995), there are three types of legitimacy namely pragmatic legitimacy, moral legitimacy, and cognitive legitimacy. Pragmatic legitimacy is gained when an organization serves the interests, needs, and aspirations of its closest

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stakeholders (Díez-Martín et al., 2021). Moral legitimacy based on the assumption that it is successfully advancing societal welfare, which is determined by the value system of the community (Cruz-Suarez et al., 2014), (Suchman, 1995). Cognitive legitimacy is the process by which stakeholders evaluate an organization's acceptability and understandability in a passive manner (Suchman, 1995), (Alexiou & Wiggins, 2018).

From a performance perspective, corporate legitimacy is anticipated to arise from a company's ability to establish and maintain nice relationships with stakeholders through a variety of stakeholder engagement practices. Hence, the concepts of empowerment, collaboration, engagement, and participation are positioned as drivers of legitimacy. From this angle, the two main types primary legitimation strategies may be characterized as pragmatic and moral (Ellerup Nielsen & Thomsen, 2018).

Legitimacy theory is widely used in the literature to explain Corporate Sustainability reporting practices (Lu et al., 2015). As per the legitimacy theory, a firm needs to have legitimacy in the sense of a social license to operate (Deegan, 2002). The theory suggests that firms engage in sustainability reporting to seek legitimacy and it is of strategic importance to firms.

DISCUSSION

Implementation Of Legitimacy On Sme

This part will be explain the effort to establish the legitimacy on SME to achieve sustainability. There are some effort to gain legitimacy, such as:

Corporate Social Responsibilities

CSR (Corporate Social Responsibility) refers to the voluntary actions that companies take to improve society and the environment beyond what is required by law. CSR can be defines as integration of social, environmental, ethical, and philathropic responsibilities towards society into company's operations, process, and core business strategy (Hatten, 2012). CSR can be a good means for organizations to gain the legitimate status (Guthrie et al., 2006), shuili (2012). Ashrafi et al. (2020) argue that organizations are forced to use CSR to legitimate their business actions. Noah (2017) notes that organizations can meet public needs and expectations through CSR. Based on the argument above, we argue that CSRs performance can infer a legitimate status on an organization. Olateju et al., (2021) recommend organizations to operationalize CSR since doing so will give them legitimacy, which in turn will lower organizational risks and boost

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profitability over time. By implementing CSR practices, companies can interact with stakeholders and communicate to the public that they are adhering to social norms.

Other research also shown that CSR practice can gain the legitimacy, like a (Zhang & de Vries, 2022) research, examined the relationship between Chinese manufacturing MNCs' engagement in terms of CSR and gaining moral legitimacy in host countries, and whether the institutional distance between countries is an important moderating factor in this relationship. Gaining moral legitimacy can be done by means of engagement in customer and government related CSR when the institutional distance from host country is greater.

There is a misperception that CSR activities are only engage by large business ((Jansson et al., 2017); Lucky (2018)). But, in the fact, Small and Medium Enterprises (SMEs) also play a significant role in the global CSR activites ((Janson et al., 2017); Lucky (2018)). Businesses, including SMEs, can support societal objectives through CSR. The benefit of CSR implementation is to mitigate the negative effects of business operation on environment (Melissen et al., 2018). CSR can be implemented by create value to stakeholder and make a good communication (van Woerkom & van Zeijl-Rozema, 2017). corporate social responsibility (CSR) plays a vital role in enhancing corporate sustainability and improving reputation (Lee et al., 2017). Ashrafi, Magnan, Adams& Walker (2020) argue that integration of CSR into business strategic decisions and operation processes will help to improve the organizational performance.

For SMEs, incorporating CSR principles into their operations can enhance their reputation, attract customers, and improve employee morale, which can lead to long-term business success. Implementing CSR initiatives such as reducing waste, conserving energy, and supporting local communities, can help SMEs become more sustainable and create a positive impact on the environment and society. Additionally, by addressing social and environmental issues, SMEs can build strong relationships with stakeholders, increase brand recognition, and differentiate themselves from their competitors.

CSR Communication

Beside CSR practice, CSR communication is also crucial for achieving legitimacy in addition to CSR (Ellerup Nielsen & Thomsen 2018). CSR communication as a communication approach used by businesses to work closely with their stakeholders to incorporate social, environmental, ethical, human rights, and consumer concerns into their core business operations.

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Corporate legitimacy is attained through supporting and adhering to stakeholder demands, necessitating thorough knowledge of these expectations on the part of enterprises. From a reputation and image perspective, corporate legitimacy is mostly related to how well businesses are able to establish and maintain relationships with stakeholders. In more detail, it is presumable that scanning and monitoring the environment—more especially, paying close attention to and tracking public responses to businesses' and rivals' CSR practices—is a first requirement for attaining corporate legitimacy. This view on CSR communication preempts pragmatic legitimacy.

Study by Ellerup Nielsen & Thomsen (2018) approached from the legitimacy perspective about CSR communication discovered that the most significant types of legitimizing communicative practices articulated in the four types of studies were related to: gathering information about stakeholders through perception, impact, and promotion activities; observing and managing the environment through image and reputation activities; creating stakeholder value through collaboration and engagement; and persuading and convincing stakeholders. Also, it was shown that practices and activities relating to understanding stakeholders' expectations, demands, and requirements are thought to be the most suitable for businesses looking to establish or maintain legitimacy. This literature support that CSR communicative practices and activities which are more effective than others at influencing stakeholders' perceptions of business' social and environmental actions (CSR action).

Olateju et al, (2021) recommend organisations should operationalise CSR policy as that will grant them legitimate status which in return will reduce organisational risks and increase profitability in the long run.

Legitimacy Judgement of SME's Owner Manager

The legitimacy of SME can be viewed from the owner-manager of SME's perspective. The legitimacy judgment of the owner-managers is fundamental to determine the behavior of enterprise (Ivanova Ruffo et al., 2020), because the small business/ SME usually as is their primary source of income. Based on Ivanova Ruffo et al., (2020) research, the owner-manager of SME divide two groups of stakeholder, namely primary stakeholders consisting of customers and employees, and secondary stakeholders consisting of banks/investors, government, sector, and family. Mostly manager state that the legitimacy of their company can be seen from customer satisfaction through the value of the product/service, this is sufficient to establish legitimacy. The employees also give the high rating of legitimacy because they are the repositories of technical expertise and

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receiving proper training and care is of utmost importance to small business managers. Their statement support by three types of evaluations/ judgement, such as instrumental evaluation/judgement (positive financial results) which is relating to the purpose of company, moral evaluation/judgement (respect of clients) and moral evaluation/judgement (responsibility to clients by always going the extra step, or responsibility towards employees).

In comparison to investors and suppliers, they place a lot more weight on the validity cues provided by clients and workers. In fact, evidence of validity from various parties involved, including the government, investors, industry, and family, are not crucial in the formation individual legitimacy judgement. This research shows that cues from client/ customers and employees as the most important sources of legitimacy for small business/SME owner-manager.

From the research above, we can conclude that the legitimacy not only view by company's perspective but also can view from individual perspective especially the perpetrator of SME (owner-manager). SME can achieve the legitimacy from society and stakeholder by provide the high value of product/ service and give a responsibility to employees.

Attract a Foreign Investment by Environmental, Social, and Governance Performance

There is the major interest of any firm to attract foreign investment as the key indicator to enhanced legitimacy and competitive advantages to achieve sustainability (Alregab, 2022). Foreign investors difficult when deciding to invest in a host country due to information asymmetry and uncertainty that could be exacerbated by foreign investment. Hence, businesses that focus more on boosting Environmental, Social, and Governance (ESG) performance could lower the level of uncertainty and boost credibility. Legitimacy theory provides a theoretical framework that could explain the relationship between host firm with foreign investors. Foreign investors can build trustworthy relationships with corporations that engage in social actions within societal boundaries and norms.

Alregab (2022) research conclude that ESG score can predict foreign investment, On the one hand, foreign investors who require reliable signals to guide their investment decisions take note of excellent ESG performance. On the other hand, businesses must focus more on their ESG performance in order to please their existing or potential investors. Stakeholder theory and legitimacy theory both support this. Furthermore, the

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governance score exhibits the strongest positive correlation in terms of its level of significance, suggesting that corporate governance procedures are more significant to foreign investors. These findings imply that companies with high governance rankings might draw more foreign equity. by obtaining more foreign investor funds can also show that the company has gained legitimacy.

CONCLUSION

Sustainaibility of SME is very important in order to enhance national economy. To achieve sustainability on SME, they have to gain a legitimacy. Gaining organizational legitimacy is essential for organizations especially SME because it influences social and economic exchange and consequently market access. Based on some literature, gaining legitimacy can be by implement corporate social responsibility, communicating CSR to stakeholder, attract foreign investor by enhance social, environment, and governance performance. In addition, the legitimacy of SME can be viewed from the owner-manager of SME's perspective. Based on owner manager's perspective, to establish legitimacy can be from customer's satisfaction through the value of the product/service, and also by give a responsibility to employees. SMEs that can achieve legitimacy, can achieve sustainability.

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