Integrating Ethical Leadership into Performance Appraisal Systems: A Review of ESG Sustainability Practices

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Abstract. Past research has extensively documented the negative impacts of political appointments on organizational leadership and the significance of ethical leadership in enhancing organizational performance. However, there remains a gap in studies focusing on ethical leadership within the contexts of Environmental, Social, and Governance (ESG) criteria and performance appraisal systems for organizational leaders, particularly in state-owned agencies (SOAs). This paper aims to address this gap by reviewing recent literature on the relationship between ethical leadership, performance appraisal, and ESG factors, and relating their implications for organizational performance in Sabah SOAs. The review examines existing theories on performance appraisal and ethical leadership, identifies deficiencies in current appraisal systems, and assesses how ethical leadership influences ESG sustainability in large organizations. Findings indicate a lack of effective performance appraisal systems for leaders in Malaysia and limited generalizability of previous research due to variations in participant demographics, geographic locations, and cultural contexts. The study also highlights how factors such as human rights, good governance, labor relations, and corporate policies contribute to investment impacts through environmental effects. The review emphasizes the importance of transparency and integrity in organizations to ensure that politically appointed leaders are appropriately appraised and developed. This is crucial for sustaining ESG initiatives in Sabah state agencies. The paper advocates for further research to enhance performance appraisal systems and better understand the role of ethical leadership in promoting ESG sustainability in SOAs

Keywords: Ethical Leadership, Environmental, Sustainability and Governance, Performance Appraisal, State Agencies.

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1 Introduction

State-owned agencies (SOAs) are often intertwined with political appointments, particularly in Southeast Asian democracies. In Sabah, Malaysia, these appointments are typically made by newly elected politicians following general or state elections. Such decisions are frequently driven by political agendas and are often made without adherence to established guidelines, such as the Malaysian Code on Corporate Governance (MCCG, 2012). Several studies (Eryanto et al., 2022; Yap et al., 2020; Jones, 2022; Jaffar & Abdul-Shukor, 2016) highlighted that political appointments of organizational leaders are a common issue in democratic nations, particularly in Southeast Asia. The lack of meritocracy and proper selection criteria often leads to the appointment of unsuitable and underperforming leaders. In term of statistics, Malaysia's 2022 corruption index ranked it 61 out of 180 countries (Transparency.org, 2022), underscoring the prevalent issue of political interference in developing countries (Eryanto et al., 2022). Given the present and substantial body of literature on the impact of political appointments, this paper will not delve into these factors but will instead focus on mitigating their negative effects on the sustainability of Environmental, Social, and Governance (ESG) practices within Sabah state agencies.

Another critical issue related to organizational leaders is the performance appraisal system, which has been widely debated in recent years. According to Knoll and Sternad (2021, as cited in Laser, 2022), biased data are frequently used in the selection of top executives. An effective appraisal system should incorporate relevant attributes that allow assessors to evaluate leadership capabilities accurately. Morris (2021) and Na-Nan et al. (2022) highlight that numerous performance appraisal errors contribute to leadership failures in organizations. Laser (2022) supports this, noting the absence of a reliable appraisal system specifically designed for organizational leaders.

The effectiveness of performance appraisal systems for leaders in Sabah state agencies remains unclear. To the best of our knowledge, there is insufficient evidence to suggest that these leaders are appraised systematically with respect to ethical leadership. Given the frequent association of political appointments with ethical and moral issues (Jha & Singh, 2023; Alkhadra et al., 2022; Yazdanshenas & Mirzaei, 2022), it is essential to focus on developing a systematic and transparent appraisal system for organizational leaders. This is crucial for ensuring that ethical leadership prevails despite ongoing political influences. This paper aims to address the gaps identified by Laser (2022) and Morris (2021) and to propose improvements in measuring leadership performance and ethical traits. By doing so, subsequently, it seeks to mitigate the negative impacts of political appointments on organizational performance and ESG sustainability.

2 Literature Review

2.1 Current State of Performance Appraisal System

Performance appraisal systems are integral to managing and improving organizational effectiveness. However, numerous studies reveal significant issues with these systems, particularly in the context of leadership evaluation. A considerable body of research highlights problems in leadership selection and appraisal processes. Sorcher and Brant (2002, as cited in Knoll & Sternad, 2021) emphasize that reliance on gut feelings and biased data often leads to suboptimal leader selection. This is corroborated by Burke (2006, as cited in Laser, 2022), who found that 50% to 75% of leaders fail to meet the performance criteria set for them. This underperformance is often attributed to inadequate nomination processes and the appointment of unqualified individuals (Day, 2009, as cited in Laser, 2022), again, can be related to political appointments.

Furthermore, Anderson and Kleiner (2003, as cited in Laser, 2022) argue that evaluations of CEOs are infrequent and often skewed by biased data. Na-Nan et al. (2022) discovered that standardized appraisal templates, used indiscriminately across different roles, contribute to unreliable evaluations. They also found that the lack of clear objectives in appraisals exacerbates the problem, leading to inconsistent and ineffective performance assessments. Wood and Vilkinas (2007, as cited in Laser, 2022) identify seven key attributes of successful CEOs: a humanistic approach, achievement orientation, a positive outlook, integrity, inclusiveness, learning, and self-awareness. These attributes are critical for effective leadership, yet their measurement and integration into appraisal systems remain underdeveloped.

2.2 Improvements Required for Appraisal Systems

Recent advancements suggest the need for tailored appraisal systems that better align with organizational needs. Anderson and Kleiner (2003) propose that the board should oversee CEO appraisals and that these systems should be collaboratively developed with the CEO. Na-Nan et al. (2022) further developed and validated an instrument to analyze deficiencies in performance appraisals, highlighting issues with both the appraisal process and the appraising personnel.

Turning to ethical leadership, it is defined by leaders' moral character and the perception of their ethical behaviors (Brown and Trevino, 2006, as cited in Kalshoven et al., 2011). Ethical leaders foster environments of trust and integrity, promoting ethical behavior through reinforcement, two-way communication, and support for employee autonomy (Javed et al., 2017, as cited in Muniandi et al., 2022). Kalshoven et al. (2011) developed the Ethical Leadership at Work (ELW) questionnaire, a multidimensional tool measuring fairness, role clarification, ethical guidance, people orientation, power sharing, integrity, and concern for sustainability. While this model offers a comprehensive framework for evaluating ethical leadership, its application in performance appraisals remains limited. Research indicates that ethical leadership positively impacts

organizational culture and employee behavior, leading to improved performance and sustainability (Eisenbeiss, 2012; Brown & Trevino, 2006). Ethical leadership is linked to greater employee satisfaction, lower turnover, and enhanced organizational reputation (Kalshoven et al., 2011).

Jha & Singh (2023) and Alkhadra et al. (2022) underscore the practical implications of ethical leadership, particularly in politically influenced environments. Ethical leaders in such contexts must navigate complex political dynamics while maintaining integrity and promoting ESG initiatives. Yazdanshenas & Mirzaei (2022) further argue that ethical leadership is essential for the successful implementation and sustainability of ESG practices within organizations. The literature reveals significant gaps in integrating ethical leadership into performance appraisal systems. Existing appraisal processes often fail to account for ethical behavior and leadership attributes, resulting in incomplete evaluations of leaders' effectiveness (Na-Nan et al., 2022). To address these gaps, there is a need for appraisal systems that incorporate ethical leadership dimensions and are tailored to the specific needs of the organization. Enhancing performance appraisal systems requires developing more comprehensive and objective evaluation criteria that include ethical leadership attributes. Designing appraisal systems that are transparent, unbiased, and aligned with organizational goals is crucial. Collaboration between boards and leaders, as suggested by Anderson and Kleiner (2003), is essential for the effectiveness of these systems.

3 Materials and Methods

To conduct a comprehensive literature review, inclusion and exclusion criteria were established. A total of 28 publications were selected for qualitative analysis. The search focused on keywords such as "ethical leadership," "performance appraisal," "ESG," and "state agencies" to explore the impacts of ethical leadership on ESG sustainability within Sabah state-owned agencies (SOAs). Firstly, review is focused on political appointments and governance. The review included literature addressing the effects of political appointments, corruption, and poor corporate governance on organizational performance. This provided context for understanding the challenges faced by state agencies in Sabah.

Secondly, the current state of performance appraisal systems. Existing literature on performance appraisal systems for organizational leaders was analyzed to identify gaps and challenges relevant to Sabah SOAs. This analysis highlighted the need for improved appraisal systems. Early Development of Ethical Leadership Theory: Theoretical frameworks on ethical leadership were reviewed to establish a foundational understanding. This included analyzing how ethical leadership has evolved and identifying gaps in its application to performance appraisals.

Next, review is done on the impact of ethical leadership on ESG. The review examined how ethical leadership influences the sustainability of ESG practices within organizations. This included assessing how ethical behavior contributes to achieving ESG goals. The last is reviewing a case study analysis. The case study by Tolstoy et al. (2023) was analyzed to gain insights into an international firm's approach to implementing sustainable goals through ethical leadership. This case study provided practical examples and comparative insights.

4 Results and Discussion

The result is contextualized within the existing literature on ethical leadership, performance appraisals, and ESG sustainability, with a particular focus on Sabah state-owned agencies (SOAs). First to discuss are the gaps in ethical leadership due to political interference. The qualitative analysis reveals a significant gap regarding the impact of political interference on ethical leadership. Eryanto et al. (2022) argue that political interference often leads to poor ethical leadership by undermining integrity at the leadership level. This finding aligns with Knoll & Sternad's (2021) observation that much of the existing research on leadership focuses broadly on general traits rather than specifically addressing ethical leadership. Moreover, previous studies have been predominantly centered on MNCs from Europe and North America, as highlighted by Kalshoven et al. (2011) and Islam et al. (2023), who call for research in different cultural and political contexts to understand these dynamics better hence issues in Sabah SOAs is an opportunity for further research.

In terms of regional and cultural research gaps, the literature suggests a need for studies in diverse regions and cultural settings to fill existing gaps. Laser (2022), Na-Nan et al. (2022), and Burhan et al. (2023) recommend conducting research in countries with different cultural and political landscapes, such as Malaysia. This is supported by Zahari et al. (2024) and Tolstoy et al. (2023), who noted that previous research on ethical leadership and ESG has been limited by geographic and cultural constraints. The findings from our study confirm that the Sabah region's context provides a unique opportunity to address these gaps and offer insights into the application of ethical leadership within state agencies. As for the impact of ethical leadership on ESG sustainability, the results are consistent with the organizational-based theory discussed by Zahari et al. (2024) and Tolstoy et al. (2023), which emphasizes the role of leaders in demonstrating ethical conduct and motivating compliance with ESG principles. The analysis indicates that ethical leaders are crucial for fostering an environment that supports ESG sustainability. This finding aligns with Kalshoven et al. (2011), who highlighted that ethical leadership positively impacts organizational culture and employee behavior, contributing to improved ESG outcomes.

It is to mention here that improvement is needed for performance appraisal systems. The study identifies a critical gap in the current performance appraisal systems for leaders within Sabah SOAs. This finding reflects concerns raised by Laser (2022), Na-Nan

et al. (2022), and Burhan et al. (2023), who pointed out the inadequacies of existing appraisal systems and the need for systems that better account for ethical leadership attributes. The research suggests that implementing a performance appraisal system based on ethical leadership principles could address these weaknesses and enhance the effectiveness of leadership within Sabah SOAs. The overall result highlighted the necessity of developing a performance appraisal system tailored to ethical leadership, which can improve ESG sustainability and organizational effectiveness. This is in congruent with the recommendations of previous studies (e.g., Laser, 2022; Zahari et al., 2024) that advocate for comprehensive appraisal systems that include ethical leadership dimensions. By addressing the identified gaps and aligning appraisal practices with ethical leadership principles, Sabah SOAs can better facilitate ESG goals and foster a more ethical organizational culture.

5 Conclusion

This study has provided a comprehensive analysis of how ethical leadership influences the sustainability of ESG (Environmental, Social, and Governance) practices, focusing on the development of performance appraisal systems for organizational leaders. The contributions of this paper to performance appraisal and ethical leadership in Sabah SOAs are significant. The research extends existing theories in leadership, human resource management, and organizational behavior by proposing a performance appraisal system centered on ethical leadership. This framework offers new insights into integrating ethical attributes into leadership evaluations, thus enriching the theoretical discourse on effective leadership (Brown & Trevino, 2006; Kalshoven et al., 2011). For practitioners, the study offers practical recommendations for HR management within state agencies. HR consultants, training providers, recruitment agencies, and government officials can apply these findings to design and implement appraisal systems that emphasize ethical leadership. This aligns with the recommendations of Zahari et al. (2024) and Na-Nan et al. (2022) for more nuanced appraisal frameworks.

The research addresses several gaps identified in the literature, including the impact of political appointments on ethical leadership and ESG outcomes (Eryanto et al., 2022; Laser, 2022). By forecasting these impacts, the study provides a basis for monitoring political appointments and ensuring they support ethical leadership, thus aligning with organizational goals and sustainability efforts (Tolstoy et al., 2023). Finally, the findings contribute to improving leadership effectiveness within Sabah state agencies by advocating for a performance appraisal system that focuses on ethical leadership. This approach aims to enhance leadership skills and support organizational sustainability, in line with the insights provided by recent studies (Jha & Singh, 2023; Yazdanshenas & Mirzaei, 2022). In summary, this research advances theoretical knowledge and provides practical guidance for enhancing performance management systems and ethical leadership in state agencies. It is essential for supporting effective leadership practices and achieving ESG sustainability in complex political and organizational contexts.

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