

Competitive ‘Trust Contracting’ And Transaction Cost Economy

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ABSTRACT

Evolutionary and spiral acquisition are currently trends in use for acquisitions where the outcomes are uncertain. This paper looks beyond these processes to a concept emphasising trust and transparency within a transaction cost paradigm – ‘trust contracting’. The evidence suggests that in this experimental ‘trust contracting’ case study, there was a transaction cost advantage to the buyer of 55% over that of existing high tech acquisition processes. Where the end product (good or service) is largely unknown at the time of contract signature, ‘trust contracting’ provides transparency and contractual safeguards for both contracting parties, and offers an alternative form of corporate governance which makes use of trust to improve buyer-seller relationships and outcomes for both, allocates risk according to the party best placed to carry the risk, speeds completion of contractual arrangements, and reduces transaction costs for both parties.

INTRODUCTION

Trust Is The Income Not Spent On Specifying And Verifying Contract Compliance

Knack and Zak (2002) demonstrated that interpersonal trust has a considerable effect on economic growth, as trust affects the transaction costs associated with investment. Policies examined by Knack and Zak (2002) argue that trust is measured by the proportion of income not expended to enforce contracts. This is dependent upon the institutional, social and economic environments in which transactions are embedded. Zak and Knack (2001) define trust as the income not spent on specifying and verifying contract compliance.

With Greater Transparency Will Come A Rebalancing Of The Relationship Between Clients And Contractors

Williamson (2002a,b,c) argues that with greater transparency will come a rebalancing of the relationship between the economy and society, and between corporations and their stakeholders. His view is that transparency is already well on its way to establishing itself as a powerful norm in global policies and a transformative force within the firm and its stakeholder relationships. Electronic procurement is a demonstrable part of this transformation. Witherill (2003) adds that information about policies towards stakeholders and corporate social objectives is a desirable element of transparency, and that transparency relates to the critical issue of trust. Greenspan’s (2003) view on this aspect relates to the importance of reputation in a market economy, where rules simply cannot be a substitute for integrity. Witherill (2003) thinks that when markets, such as electronic product markets, lose confidence in the integrity of information provided by an organization, that is, when market participants can no longer trust an organization, the negative effects are likely to be dramatic. Aziz (1999) suggests that transparency and accountability work hand in hand to help improve economic performance, but there may be a trade-off between the high cost of collecting, collating and interpreting procurement information and the benefits achieved.

Trust Between The Transacting Parties Is Often Vital

Electronic procurement is about virtually instant transactions between a community of buyers and sellers, in the process of which trust between the transacting parties is often vital. Distrust could significantly reduce market efficiency (Braynov and Sandholm 2002). Transactions involve contracts, often implicit, some simple and instant for

‘off the shelf’ products (goods and services), some complex and longer term for the more complex, more expensive, often longer duration ‘development’ procurements. Hutton (1997, p31) suggests that the ethic of trust is particularly vital as the crucial element in solving the problem of constructing contracts with an unknowable future and which can set in motion dynamics that nobody wants. The more solid a trust relationship he argues, the more solid the implicit contract. Whatever shocks the relationship may receive, neither party is going to desert the other. Both sides are committed. But Fukuyama (1995) is of the view that trust cannot be reduced to an equation, nor is it easy to build. Lenz, Oberweis and Schneider (2001) suggest that the main difficulty lies in finding the right balance between time consuming but safe ways based on traditional contracts, and less reliable but faster ways based solely on traditional forms of trust. Lenz et al (2001) propose an inter-organizational work flow based on a minimal set of contractual documents supplemented by trust based features.

AN EXPERIMENTAL CASE STUDY

Purpose

The purpose of this experimental case study was to examine the corporate governance and transaction cost effects of trust between a buyer and a seller in the development and delivery of a product.

Researcher’s Role

The researcher’s role in this longitudinal action research was that of the concept and methodology developer and acquisition manager of the case study from inception to completion.

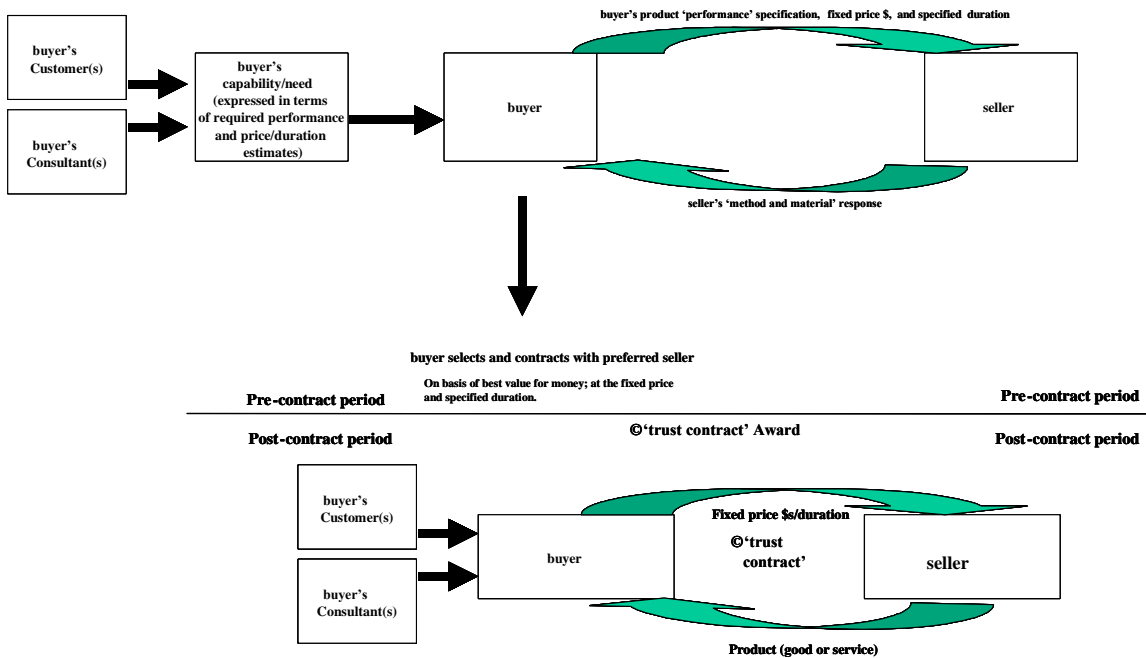
The Competitive Trust Contracting Process

A fundamental concept of the competitive trust contracting process is to make as much information between the parties as available and transparent as possible. Because of greater transparency, this reduces the scope and opportunity for rent seeking with guile activities (Williamson 2002a,b,c; Handy, 2002) and in doing so minimises areas for trust between the parties. The open process commences with the buyer’s (client’s; Principal’s) development of the product’s performance specification as far as it can be ascertained and estimated cost/time parameters based on the buyer’s needs. If the buyer requires assistance in this precontract award activity, assistance in the form of a consultant (or ‘street wise kid’) should be obtained competitively from the marketplace. This Performance Specification (including intellectual property ownership arrangements, estimated time and cost parameters) and a standard General Conditions of Contract are then made available to the select list of sellers (bidders, tenderers, contractors) after a ‘fundamental transformation’ (Williamson 2000b) has taken place ie the large numbers bidding competition (57 sellers in this case study) is transformed into a (two to five) small numbers competitive supply relationship prior to contract execution. Where there remains unknown asset specificity, such as often occurs in case of hardware or software ‘development’ acquisitions, the ‘trust contract’ may be split into several phases, each phase concurrently or consecutively conditional upon the outcome of previous phases. This phased process continues until asset specificity is fully known. Phase interval durations may be regular or irregular. In some cases, it may also be appropriate to competitively continue asset specificity ‘development’ through ‘fundamental transformation’ to only two or three sellers. These sellers may then develop prototypes or models, and be equitably (and equally) funded by the buyer for this further ‘development’, particularly if intellectual property is involved. The main contract may then be awarded to the best of these developments, such as may occur in advanced technology demonstrators (ATDs) ¹. The buyer’s intellectual property ownership arrangements, product funding, performance requirements and duration are preset and transparent to all sellers. Thus the buyer’s evaluation of tenders reduces to a value for money assessment of the product (good or service) proposed by the few remaining sellers. This not only reduces the transaction costs of tender assessment for both buyer and seller, but also minimises the requirement for trust between the two parties (Figure 1). For this AU\$0.965m case study, the receipt of bids, individual presentations by each of the five sellers, assessment of the bids and the award of the longer term contract by the buyer took one day. Two of the

¹ <http://www.dtic.mil/ttcp/techdemo.htm> accessed July 2004;

sellers were global/national corporations, two were national/regional, and one was regional/local. The contract was completed to price, under time, with improved performance and with no contract variations.

Figure 1: The Competitive Trust Contracting Process



Competitive ‘Trust Contracting’: The Contractor Is Not Submitting A Proposal For The Client’s ‘Approval’ But For The Client’s ‘Acceptance’

The terms and conditions of competitive ‘trust contracting’ are designed to minimize and to define the trust arrangements between two contracting parties. In ‘trust contracting’ the seller is held to its own proposal, not the buyer’s – that is, the seller is not submitting a proposal for the buyer’s ‘approval’ thereby committing the buyer to being legally bound to that ‘approval’, but rather for the client’s ‘acceptance’. Instead, the seller is held to its offer, but with incentives to change as circumstances change. For example, if a contract is let with then technology specified and there is a subsequent change in technology over the period of the contract which will improve the performance of the product, the seller is incentivised to incorporate those changes during contract delivery at no cost to the buyer. The following key contract clauses approved by the Australian Government’s Attorney General were used in this experimental approach:

- **acknowledgement:** *nothing in this contract nor any act of the Principal (buyer) constitutes an acknowledgement by the Principal or condition of contract expressed or implied that such information estimate or representation is accurate or sufficient for the completion of the work under the contract and any inaccuracy or mistake however arising shall neither affect the contractor’s (seller’s) obligation to complete the work under the contract nor entitle the contractor to payment of any extra moneys whatsoever.*
- **‘acceptance’ of (incomplete) drawings and specifications:** *after acceptance of the contractor’s tender, the contractor shall expeditiously prepare and complete all other documentation including contractor’s drawings and additional drawings, additional specifications, and other written information and material as*

is necessary or required by good practice to define the nature and extent of the work and to enable the execution of the work in accordance with the contract.

- *‘approval’ - liability remains with the contractor until completion of the contract: any approval of a design or specification given by the Principal shall be construed as an acknowledgement that such design or specification is in general accord with the Principal’s requirements under the Contract, but shall not constitute an acknowledgement or admission that such design or specification is correct in detail as to measurement, dimensions, materials or in any other particular the responsibility for which shall remain with the contractor. No approval, direction or assistance given to the contractor in respect of specification or designs or other data produced shall relieve the contractor of responsibility under the contract for the correctness of all such designs, drawings, specifications and other data created or supplied for the purposes of the contract;*
- *‘warranty’ of sufficiency and fitness for purpose: the contractor warrants the sufficiency and fitness for its purpose of all designs, drawings, and specifications prepared pursuant to the Contract for use in the execution of the work.*
- *‘variations’ cause or delay: ... the contractor shall not, irrespective of the cause or the delay, be entitled to claim from the Principal any damages, loss, loss or expense or extra costs incurred by the contractor in respect of cause or delay.*

The Transaction Cost Reduction Indicates The ‘Trust Contracting’ Dividend

Table 1 provides a summary of the buyer’s actual delivery transaction costs using ‘Trust Contracting’; the estimated delivery transaction cost from the buyer’s previous ‘best practice’; and demonstrates a difference of \$121,915 or a 55% transaction cost advantage in using competitive trust contracting.

Table 1: Comparison Of Estimated And Actual Transaction Costs For ‘Pilot’ Trust Contract Project

Period	Buyer’s best practice delivery transaction cost benchmark (based on Thomson 2000)	Actual delivery transaction costs using ‘Trust Contracting’
Pre contract award (concept to contract award)	\$133,650	\$49,874
Ex post contract award (contract award to contract completion)	\$89,100	\$50,961
Total	\$222,750	\$100,835

CONCLUSION

The evidence suggests that in this experimental ‘Trust Contracting’ case study, there was a transaction cost advantage to the buyer of 55% in using ‘Trust Contracting’ over the buyer’s other best practice acquisition delivery processes which ignore the trust factor. ‘Trust Contracting’ provides transparency and contractual safeguards for all contracting parties, and offers an alternative form of corporate governance which makes use of trust to improve buyer seller relationships and outcomes for both, allocates risk to the party best placed to carry that risk, speeds completion of contractual arrangements, and reduces transaction costs. It is a more subtle, sensitive approach to acquisitions for those who empathise with trust and transparency issues. Trust contracting provides a framework for building honest, open, long term but competitive relationships to achieve quality outcomes for both contracting parties.

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