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Trust and Transactions: toward Transaction Cost Analysis with a Differential Behavioral Assumption

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I. INTRODUCTION

The assumption of opportunistic behaviour has an important place in transaction cost economics (TCE) as developed by Oliver Williamson ((1975), (1985), (1991)). Without opportunism, the problem of economic organization would be substantially mitigated. For every situation a simple contract could be drawn, covering the most likely contingencies, and containing a 'general clause' to deal with unforeseeable circumstances that may develop (Williamson (1985), 65). But if actors are opportunistic, they will obfuscate and manipulate information in order to take advantage of gaps in the contract.

In this paper the consequences of the adoption of a slightly different opportunism assumption, differential opportunism, are explored. The purpose of this exercise is to enable TCE to more fully incorporate the concept of 'trust'. 'Trust' in this paper indicates the willingness of an agent to engage in a transaction in the absence of adequate safeguards. In doing so, the truster typically runs the risk of incurring costs that outweigh the immediate benefits sought, and becomes dependent on the course of action chosen by the trusted[1].

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The relationship between trust and opportunism is obvious. If all agents are opportunistic, the scope for trust is very limited. It is only rational to trust an opportunistic party if it acts in its own interest by not betraying our trust. Thus a monopsonist may expect its suppliers to honour their commitments for fear of going out of business. This kind of trust is grounded in characteristics of the transaction situation, and not in the characteristics of the other party (for all agents are identical in their opportunism). Thus we may speak of 'situational trust'.

But trust can also be based on the degree of opportunism (or its opposite: trustworthiness) that is seen to form an inherent characteristic of the behaviour of the agent in question. This kind of trust, which is relatively independent of the situation (although one will trust few agents in *all* situations), may be dubbed 'character trust'[2]. Character trust can conceivably be based on inherently opportunistic agents, who for their own benefit have chosen to follow a rule of trustworthy behaviour (Rowe (1989)). But, as will be argued below, this explanation is rather contrived, and there are grounds for adopting an assumption of differential opportunism, with regard to individuals as well as with regard to firms as economic agents.

A concept of trust encompassing both situational trust and character trust has intuitive appeal, and is in line with the use of the word 'trust' in everyday language. Trust is described as the 'firm belief in reliability, honesty, veracity, justice, strength, etc., of person or thing; (....); confident expectation'[3]. The first meaning is clearly connected to what is called 'character trust' in this paper, the last meaning could also be a description of 'situational trust'. If the concept is reduced to only situational trust, or to only the kind of character trust which is consistent with uniform opportunism, it is all but emasculated.

II. UNIFORM OPPORTUNISM AND DIFFERENTIAL OPPORTUNISM

Williamson does not explicitly propose a uniform opportunism assumption in his formulation of TCE. Instead, he assumes that 'some individuals are opportunistic some of the time and that differential trustworthiness is rarely transparent *ex ante*. As a consequence, *ex ante* screening efforts are made and *ex post* safeguards are created' (Williamson (1985), 64). However, the main thrust of TCE is to explain *ex post* safeguards, the possibility to screen successfully for opportunism and consequently of being able to renounce from safeguards is hardly elaborated. In fact the only two allusions to screening in Williamson's *Economic Institutions of Capitalism* suggest that this remedy is impotent (Williamson (1985), 58 and 64-65).

Thus the importance of differences in opportunism is de-emphasized in TCE. The line of reasoning is that as it is very difficult, if not impossible, to recognize an opportunistic agent *ex ante*, those who design a governance structure must reckon with opportunism all the time. The representative agent is an opportunistic agent. For all practical purposes, then, TCE can be seen as employing a uniform opportunism assumption.

This means that only trust of the situational kind, and the rather restricted kind of character trust that can be put in opportunistic agents that have chosen to behave in a trustworthy way, make sense in the context of this theory. Therefore it is not surprising that Williamson sees very little use for the concept of trust in TCE: 'trust is irrelevant to commercial exchange and [...] reference to trust in this connection promotes confusion' (Williamson (1993), 469). This position appears to be based on an assessment of what is here called 'situational trust' only.

III. RISK AND TRUST IN INTER-FIRM RELATIONS

Although the distinction between situational trust and character trust is relevant for all situations studied by TCE, this paper concentrates on the issue of buyer-seller relationships in industry[4]. Empirical studies of vertical inter-firm relations suggest that these relationships are often of an informal, non-contractual nature (Beale and Dugdale (1975), Galanter (1981), Macaulay (1963)). Instead of formal contractual arrangements, trust is said to be often the glue that keeps business partners together (Barber (1983), Lorenz (1988), Palay (1984)). Relationships based on trust, as opposed to formal contractual relations, are believed to become more and more prevalent as practices like just-in-time production and supply and early-supplier-involvement in development projects gain popularity (Håkansson and Johanson (1993), Johnston and Lawrence (1988), Larsson (1993), Ring (1993), Ring and Van de Ven (1992), (1994)).

In TCE, risk in a transaction relation like an industrial buyer-seller relation is closely connected with the level of asset specificity. If for instance the supplier invests in a machine specific to the production of components to be delivered to the client firm, he or she exposes himself to the danger of opportunistic behaviour from the side of the buyer. The supplier will want to set a price that enables him or her to recoup the specific investments. But the buyer, who knows that the machine is worthless if the transaction relation is discontinued, will try to negotiate a lower price as soon as the specific investments are incurred. As both parties will foresee this, the transaction will only be realized if a mechanism for making binding commitments is available, e.g., in the form of a legally enforceable contract.

Asset specificity is a multifaced phenomenon, and different kinds of asset specificity have different effects (Nooteboom (1993)). However, we will concentrate on the relatively straightforward case of a supplier investing in client-specific physical assets, like in the example above. At the face of it, it is the supplier who bears all the risk, and who will demand safeguards in the form of, e.g., a formal contract.

But on the other hand there is also reason to suggest that the relationship is more in balance. Given that the supplier has invested in special machinery, and can therefore presumably deliver at better terms than other suppliers, the buyer also has something to loose if the relationship is broken off. The relationships is akin to that between a monopsonist and a monopolist, and the outcome is indeterminate. In the absence of binding commitments the problem is not really a lack of balance in the relationship, but the fact that the situation may invoke the parties to engage in 'costly haggling' (Williamson (1985)). The costs of haggling, however, may very well be lower than those of writing a reasonably complete contract. Consequently the supplier may choose to renounce safeguards, and to act on the basis of situational trust.

In the analysis above it was implicitly assumed that the parties have accurate *ex ante* knowledge of the situation that will exist after the investment in specific assets has been incurred. This is not entirely realistic. In many cases, a supplier facing the decision to invest in assets specific to one particular client can with reasonable certainty predict what the relationship will look like in, say, six months. But he or she will not be able to tell with any assurance whether the situation will not change drastically in the more remote future. For instance, technological change may enable competitors to supply the client without incurring specific investments. Or because of market conditions part of the workforce of the client firm may become redundant, altering the terms of the 'make-or-buy' decision.

The upshot is that the risk associated with asset specificity has much to do with the dynamics of the transaction situation. In a static situation, situational trust is often possible and sufficient. But situational trust, by definition, is not robust over changes in the situation. Consequently in many practical situations parties cannot rely on situational trust. And therefore an explanation on the basis of the concept of situational trust alone appears to be insufficient to explain the observed renouncement of formal safeguards in inter-firm relations.

Character trust on the other hand *is* robust over situational changes, and therefore is a much more solid basis for transaction relations. Put differently, situational trust by its very nature is fragile, whereas character trust can be (but -as expounded below- not always is) much more resilient (cf. Ring (1993)). But how can the differences of opportunism in behaviour which form the basis for character trust be explained?

IV. SOURCES OF DIFFERENCES IN OPPORTUNISM

Character trust can be based on genuine differences in opportunism, or on differences in opportunistic behaviour originating in rules that unabatedly opportunistic agents impose on themselves. In the second case, the argumentation hinges on the concept of reputation. In the first case, trust may be placed in specific individuals representing an organization, in regular patterns of behaviour within the organization, or in the character of the organization as expressed in its culture. All four possibilities will be discussed.

A. *Reputation and Trustworthiness*

Reputation effects occur if a firm refrains from opportunism because it does not want to endanger future transactions, with the partner in question or with third parties (Dasgupta (1988), Klein (1985), Weigelt and Camerer (1988), Wilson (1985)). Although reputation effects are no panacea for all transaction problems caused by opportunism (Ring and Van de Ven (1992), Williamson (1985)), they should certainly be taken into account in an analysis of transaction relations.

It is clear that incorporation of reputation effects calls for a differential opportunism assumption. If reputation plays an important role in a certain market, reputed firms are selected because they are expected to be less prone to opportunistic behaviour. Or, put differently, in dealing with a reputed firm less tight safeguards will be demanded.

In principle, reputation can lead to differential opportunism without there being any intrinsic difference between firms. A firm may ostensively follow a rule of honouring commitments, in order to build a reputation that allows other firms to trust it. In this way its options for profitable exchange will be enlarged. This is the line of thought developed by Rowe (1989). A reputation is like an investment which only pays a profit if the agent is persistently trustworthy. Consequently, differences in reputation can cause otherwise identical rational agents to respond in divergent ways to the same situation. The reputed agent will be less easily tempted to defect, not because of the opportunities for defection foregone in the past (these are sunk costs), but because of more profitable future transactions that are jeopardized.

Note that the concept of reputation used in this way is circular: agents guard their reputation because it influences future trading opportunities, and it has this influence because agents guard it (Kreps (1988), 107). This circularity is caused by the fact that no inherent differences are assumed to lie at the basis of reputations. Through the agency of reputation the existence of differences in the degree of opportunism displayed in behaviour can be reconciled with the principle of rational maximization of self-interest (cf. Hardin (1991), Rowe (1989)).

But this explanation appears to be rather contrived. For one thing, it is impossible to explain why some agents at a certain point in time choose for a strategy of trustworthiness, and other, intrinsically identical agents not[5]. Reputation also forms only a relatively fragile basis for trust. In the first place there is always the possibility of a 'golden opportunity': an opportunity for defection that pays too much to resist. Secondly, there are ways to defect without seriously damaging one's reputation, for instance if a reasonable case can be made for *force majeur*, or if the description of one's duties is ambiguous (Bhide and Stevenson (1992)). The upshot is that if an agent is perceived to follow only a rule of trustworthy behaviour without being genuinely trustworthy, the trust put in such an agent will be very limited. Trustworthy behaviour that is perceived as non-instrumental is much more convincing, for there is a qualitative difference between being trustworthy as a strategy, and being trustworthy because that happens to be one's character (King (1988)).

Therefore it seems much more plausible that the propensity to invest in reputation is not present in all agents to the same degree, and that this propensity correlates with genuine differences in behavioral characteristics. The next subsection deals with possible grounds for such inherent differences. The existence of behavioral differences leading to differences in opportunism at the level of the individual will be taken for granted. Not only are behavioral differences the subject of an important branch of psychology, personality theory, surveys and laboratory experimens also strongly suggest that opportunism and trustworthiness are not characteristics of all people to the same degree (Boone et al. (1994), Cox et al. (1991), Deutsch (1973), Etzioni (1988), Frank (1988), Kahneman et al. (1986), Kuhlmann and Marshello (1975), Petermann (1985), Rotter (1980)). The issue here is whether differences in the intrinsic trustworthiness of firms -or more generally: organizations- can be made plausible.

B. *Individual Personality and Organizational Trustworthiness*

In small firms a direct link between differences in opportunism at the level of individuals and differences at the organizational level can be assumed. These organizations to a considerable degree are reflections of their top managers (Hambrick and Mason (1984), Hitt and Tyler (1991), Mintzberg (1979)). Miller and Dröge (1986), for instance, have found that the CEO's need for achievement is strongly correlated with the formalization, centralization and integration of their organizations. Likewise, personal differences in trustworthiness may result in differences in (perceived) organizational trustworthiness. Especially in inter-firm relations in which top executives deal directly with each other, their personalities may be assumed to be important variables.

In transactions between larger organizations, and if these organizations are represented by functionaries below top-level, the personality of the representatives may be assumed to be less important. The behaviour of these functionaries is constrained by organizational rules and procedures, and they may be overruled by their superiors, even if they would personally be inclined to honour commitments. Nevertheless, even in this case trust in the representative of the other organization as a person is important (Husted (1989)).

Lorenz (1988) found that personal relations were instrumental in subcontracting relationships in French industry. As one of the managers interviewed stated: 'It is important to visit and to talk, to know each other. This is partnership. If we know each other it is easier to resolve problems and to adjust' (quoted in Lorenz (1988), 207-208). This is also consonant with the findings of Macaulay (1963) and Dore (1983).

C. *Institutionalization and Organizational Trustworthiness*

However, trust in larger organizations goes beyond trust in their representatives or even top managers. In these organizations the behaviour of participants is institutionalized: patterns of interaction are passed on from one role incumbent to the next, and the organization is perceived as something over and above the individuals that happen to embody it at a given moment (Berger and Luckmann (1966)).

Decision-making in an institutionalized context is to a large extent governed by rules, procedures and routines (Cyert and March (1963), March and Simon (1958)). The process of institutionalization in which these rules, etc. are formed is path-dependent, and involves irreversible events and choices (Selznick (1957), 38-40). Therefore every organization forms a unique configuration of institutionalized behaviour, the idiosyncrasies of which form its own individual 'character'. The degree of trustworthiness or opportunism displayed by an organization in its interaction with other organizations is a reflection of this 'character'.

In the context of inter-organizational relations the concepts of 'trust' and 'trustworthiness' do not have exactly the same meaning as in the case of relations between individuals. What do we mean if we say that we 'trust' an organization? What do we mean if we say that an organization displays 'trust'?

Trust *in* an organization occurs if that organization is seen as a system functioning in a consistent, reliable way (Luhmann (1979)). This kind of trust may be quite independent of the personal motivation inferred to the individual representatives of the organization one happens to deal with. When an organization *displays* trust, it is by the definition employed in this paper prepared to engage in a transaction in the absence of adequate safeguards. This willingness may stem from a favourable perception of the other party maintained by a dominant agent in the trusting firm (the top-management-reflection view), or from a set of rules, etc., that make the organization under certain circumstances routinely transact in this way.

It is unthinkable that a firm would trust every agent indiscriminately, though. Such a set of rules would be suicidal, both in the world of uniform and in that of differential opportunism. Therefore it is to be expected that routine trust is placed only in certain types of relationships, e.g., those of long standing, in which favourable experiences have accumulated (Klijn and Noorderhaven (1992)).

The implications of adopting an institutional view of organizations depend on the branch of institutionalism with which alliance is sought. Above the argumentation of the school of thought concentrating on internal processes of institutionalization was reproduced. These processes will arguably result in differences displayed by firms in the behaviour vis-à-vis their business partners. According to other scholars, however, processes of institutionalization in the environment of organizations cause these organizations to become more and more isomorphic (DiMaggio and Powell (1983), for an overview of both schools of thought see Zucker (1987)). According to the latter view, intrinsic differences in trustworthiness between organizations within one institutional context are unlikely to be significant. However, even in this case a differential opportunism assumption could be fruitful, if the focus is shifted to the comparison of transaction relations in different institutional contexts.

D. *Organizational Culture and Trustworthiness*

Parallel to the argumentation on the basis of institutionalization, an argument on the basis of the related concept of organizational culture can be developed. Hofstede ((1991), 180) defines organizational culture as "the collective programming of the mind which distinguishes the members of one organization from another". Whereas institutionalized behaviour is predominantly rooted in rules and procedures that at the moment of their conception reflected rational decision making, organizational culture is largely the product of unplanned and unconscious processes of socialization. Another difference is that the concept of institutionalization refers to patterns of observable behaviour, and the concept of organizational culture to the shared perception of these patterns of behaviour (Hofstede (1991), 182).

The important correspondence between both concepts is that organizational culture, too, can form the basis of genuine differences of 'character' between organizations. This is expressed in the definition employed by Hofstede, and in Kreps' ((1988), 126) assertion that "corporate culture (...) gives identity to the organization". Presumably transaction partners interacting with an organization can recognize its specific cultural characteristics, and assess the likelihood of opportunistic behaviour. For instance, one dimension of organizational cultures identified in empirical studies is that of *stability* (O'Reilly et al. (1991)). Organizations with a culture emphasizing stability have a relatively strong rule orientation, and value predictability. Opportunistic behaviour towards exchange partners is less likely.

V. IMPLICATIONS OF DIFFERENTIAL OPPORTUNISM

If differences in the degree of opportunism of economic actors -based on reputation, individual personality, institutionalization, or organizational culture- are assumed to be relevant, the important question from the perspective of TCE pertains to the relationship between the degree of opportunism of transaction partners and characteristics of the governance structure. The general proposition that can be formulated is that lower levels of opportunism of parties lead to higher levels of character trust, and therefore are associated with less tight safeguards, other things being equal. From this general proposition more specific refutable hypotheses can be derived. Testing such hypotheses calls for a careful conceptualization and measurement of opportunism, character trust and trustworthiness.

As far as the conceptualization of these concepts is concerned, this paper can be seen as a first step. The explanation of the phenomenon of trust, as defined in this paper, can be caused by different factors. The distinction between situational trust and character trust sorts these into two main categories: those that primarily have to do with the characteristics of the situation, and those that primarily have to do with the characteristics of the parties. If the phenomenon of trust is to be explained, both categories of factors have to be taken into account.

In measuring opportunism, two possibilities exist: one can measure the level of self-reported opportunism, or the opportunism of a party as perceived by its counterpart. John (1984) is an example of the first option. After a process of testing for face validity of items and scale purification, John (1984) constructed a scale of behavioral opportunism consisting of six items, such as: 'Sometimes, I have to alter the facts slightly in order to get what I need'; and: 'I have sometimes promised to do things without actually doing them later'. Adapted versions of John's opportunism scale were later used by Anderson (1988) and Provan and Skinner (1989). The statistics reported by John, Anderson, and Provan and Skinner suggest that the scales used reliably reflect a single underlying construct. They also indicate that opportunism does indeed vary between subjects. For instance, the opportunism scale showed a higher variance than any of the other scales constructed by John (1984). Unfortunately, in neither of the three studies opportunism was associated with independent measurements of safeguards as would be of particular interest in the context of TCE.

As an example of the second possibility, measuring the perceived trustworthiness (being the opposite of perceived opportunism) of the other party, Berger et al. (1995) asked for the attitude towards opportunism of a large industrial buyer, as perceived by its suppliers. Berger et al. (1994) used a scale derived in largely the same manner as John's to measure the perceived attitudinal opportunism of the other party. Examples of items are: 'This buyer always drives a hard bargain', and: 'This buyer does not always keep its promises'. Berger et al. (1994) linked perceived trustworthiness to the safeguards used in the relationship, but, probably because of inadequate variation in governance structures (all contracts were with one and the same buyer), no association could be found.

In future conceptualization and measurement of opportunism/trustworthiness the extensive psychological literature on trust can be used (cf. Noorderhaven (1995), and the references therein). Psychometric instruments for measuring trust in a specific other have been developed, and these can with some adaptations be used in the context of economic transaction relations (Butler (1991), Johnson, George and Swap (1982)).

VI. CONCLUSION

Adoption of a differential opportunism assumption admittedly makes TCE more complex. However, incorporation of a concept of character trust is not necessarily at odds with the core of the theory. It could contribute to the power of TCE, enabling the explanation of significantly more of the variance in governance forms (cf. Bromiley and Cummings (1992)). The few studies available (Anderson (1988), Berger et al. (1994), John (1984), Provan and Skinner (1989)) indicate that the degrees of opportunism, trustworthiness and trust expressed in the context of transaction relations show considerable variation. Unfortunately, these studies have not adequately linked this variance to variations in safeguards or governance structure. In order to ascertain the impact of differential opportunism, future studies should set out to measure independently asset specificity, safeguards, and character trust. If in such studies no significant relationship between character trust and governance can be found, trust is probably after all only a relatively unimportant 'smoothing device' (Semlinger (1991)). In that case it would be more profitable to discard the concept.

NOTES

1. This definition of trust corresponds largely to those used by Baier (1986), Deutsch (1973) and Luhmann (1979). For a more elaborate discussion of the concept of trust see Noorderhaven (1994).
2. The distinction between character trust and situational trust parallels the distinction between "adverse selection" and "moral hazard" in the insurance literature (Arrow (1970), Spence and Zeckhauser (1971)). The adverse selection problem does not arise if reliable information concerning the agent's inherent characteristics is available. And moral hazards arise in some situations, but by definition not in those in which situational trust is warranted.
3. The Concise Oxford Dictionary of Current English, 6th edition, (1976).
4. Bromiley and Cummings (1992) discuss the implications of differential trustworthiness for the application of TCE to internal organizational structures.
5. More in general, it is not very productive to try to reduce every kind of behavior to self-interest, (cf. Elster (1984), 141-146).

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