The Role of Trust and Power in the Institutional Regulation of Territorial Business Systems[1]

by
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SOM-theme G: Cross-contextual Comparison of Institutions and Organizations

Abstract

This paper discusses the role of trust and power in organizational relationships. In its theoretical part it draws on conceptual ideas of Systems Theory, Structuration Theory and New Institutionalism. The empirical part investigates the English and the German speaking business regions within Europe as two distinct environments which in different ways shape the quality of organizational relationships. Depending the characteristics of these business systems, trust and power will be shown to inter-link with each other in quite specific patterns. The final part of the paper considers some conclusions relevant for European innovation policy.

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[1] The empirical part of this article (section 3) is not only based on the analysis of secondary data. It also draws on primary data the author collected (together with A. Arrighetti, S. Deakin, T. Goodwin, A. Hughes, C. Lane, F. Wilkinson) in a comparative research project carried out at the University of Cambridge between 1993 and 1995. For more detailed empirical data produced by this project see (among other publications of the research team): Arrighetti, Bachmann, Deakin 1997; Lane and Bachman 1996 and 1997. I am thankful to Gerry Redmond, Joerg Sydow and Arndt Sorge for their extremely helpful comments on one earlier version of this paper.

1 INTRODUCTION: TOWARDS AN APPROPRIATE APPROACH TO ANALYSING THE EMBEDDEDNESS OF BUSINESS RELATIONS

Academic observers and practitioners seem to agree that - at least under current conditions of global competition - long-term oriented forms of close co-operation between economic organizations can bring important advantages. In the organizational and management literature of the past 15 years or so 'strategic alliances' (Jarillo 1988; Child and Faulkner 1998), 'joint ventures' (Hennart 1991; Das and Teng 2001) and 'organizational networks' (Miles and Snow 1986; Sydow et al. 1995; Ebers 1997) have been described as very promising forms of organizing both horizontal and vertical exchanges across firms' boundaries. The various reasons given for this view are built on a two-fold argument. Compared to forms of complete organizational integration, close and long-term oriented relationships to horizontally collaborating partners, customers and suppliers can be conducive to reducing costs through specialisation and competition. At the same time, these forms of co-operation allow for more mutual flexibility than pure market-based relationships and can serve as a basis for the collective bearing of risks associated with new business strategies and technological innovation (Loasby 1994). The possible problems of *hybrid* relations (Williamson 1985) obviously rate low compared to the possible advantages. Thus, the disadvantages that might occur with very stable partnerships such as increased vulnerability of individual organizations or mutual blockages between them are far less in the focus of the current debate and only a few scholars consider these issues systematically in their conceptual frameworks (for exceptions see: Grabher 1993; Nooteboom 2000).

Much of the empirical work that investigates *hybrid* relationships does *not* simply take the individual firm as the basic unit of their analysis. Since culturally or politically defined business territories are often seen as an important parameter when the quality of inter-firm relationships and the performance of individual organizations are to be explained, the characteristics of these business territories themselves become a central focus of interest. Primarily drawing on the automobile and the electronics industry, the studies on the Japanese production model, for example, identified ‘obligational contracting’ (Sako 1992) as a typical Japanese way of co-ordinating interactions between organizations, and as the seed-bed of Japan’s economic success in the post-war decades of the 20th century. Building on these insights, management in Europe and in North America were keen to imitate Japanese business practices in one or the other way and many scholars went so far as to speak of a ‘Japanization’ process in developed Western countries’ manufacturing sectors (e.g. Ackroyd et al. 1988; Oliver and Wilkinson 1988; Morris and Imrie 1992). In similar vein, the literature on ‘industrial districts’ (e.g. Keeble and Weever 1986; Sengenberger, Loveman and Piore 1990) has explained the economic success of territories such as Baden-Württemberg and the Emilia Romagna by the long-term orientations and flexibility which prevail in the relations the regions’ firms have with each other. Often it was found that the firms were small and medium sized enterprises (SMEs), owned by families for generations, and deeply embedded in the territorial business system. On a smaller scale, these regions were equally viewed as examples from which other territories might learn if they could not copy them.

Trying to discover the secret of highly successful territories many scholars point to the fact that trust is an effective lubricant in business relationships and that some territories obviously provide good conditions for developing this resource while others are much less capable of creating these. Admittedly, it may not be easy to get a firm grip on phenomena such as ‘milieus’ (Lawson 1997), ‘tacit knowledge’, or ‘trust’, but these categories seem to be central when revealing what constitutes firms’ innovativeness and performance. Trust, in particular, seems to be a valuable ‘social capital’ of territorial business systems (Coleman 1990) and thus deserves special attention when regional innovation systems are under review.

In recent years a number of contributions to the debate on trust have appeared, many of them suggesting more or less handy classifications such as ‘contractual trust’ vs. ‘competence trust’ vs. ‘goodwill trust’ (Sako 1992) or ‘calculus-based trust’ vs. ‘knowledge-based trust’ vs. ‘identification-based trust’ (Lewicki and Bunker 1995) (for an overview of classifications that are on offer: see Möllering 1998 or Lane and Bachmann 1998). However, these classification schemes as such do not lead very far in coming to grips with the phenomenon. Fruitful conceptual approaches to developing a deeper theoretical understanding of the phenomenon of trust would seem much more useful. But these are still very rare (for exceptions see: Sydow 1998; Bachmann 2001) and much theoretical input is still needed to understand fully how trust works as a governance mechanism and what is the specific role in co-ordinating expectations and interactions in territorial innovation systems. This paper makes an attempt to contribute to a theoretically informed analysis of trust in business relationships and to show the importance of this co-ordination mechanism for economic policies to encourage the development of territorial business systems. In doing so, trust will not be viewed as the only social mechanism that should be deemed relevant for co-ordinating expectations and interaction in business relationships. Rather, it will be examined in the context of other social phenomena, risk and power in particular.

This approach to analysing business relationships does not build upon conventional economic theory which, as is recognised widely today, provides only limited insight into these issues. The central argument which, for instance, is offered by Transaction Cost Economics (Williamson 1985), namely that the quality a relationship solely depends on the 'specificity' of investments made in relation to it, seems too simplistic to explain economic developments and strategies. It does not only ignore the fact that economic relationships are a subtype of social relations and thus will always be 'contaminated' by the social logic of business behaviour. It is also blind to the territorial embeddedness (Granovetter 1985) and the dynamics of relationships, i.e. learning processes, which can transform the quality of these over time (Colombo 1998). Even less capable of comprehending the complexity of business relationships in terms of trust, knowledge and power are other approaches within current economic theory. Game Theory (Axelrod 1990), for example, often refers to the category of trust but as it is based on the counter-factual assumption that economic actors' behaviour is exclusively driven by calculation, it skips the most interesting aspects of actors' intrinsically social identity. This is not only an extremely simplified view of the socio-economic world but - no matter whether this is only meant to be a heuristic device or an empirically testable hypothesis - it places itself so far beyond empirical business practices that the results of these studies may only be deemed relevant with regard to very exceptional cases of business behaviour.

This article will try to avoid such simplifications and will develop a conceptual argument based on a realistic understanding of economic behaviour and a much wider analytical focus. In doing so, it will dig into basic *sociological theory* and also connect to central insights developed in the literature on territorial business systems (Whitley 1992 and 1999; Sorge 1996; Streeck 1997). Section 2 of this article will be concerned with a conceptual analysis of trust drawing on Systems Theory (Luhmann) as well as several other strands of sociological theorizing (Structuration Theory, New Institutionalism and - with critical reservation - Rational Choice). In this context, power as a mechanism quite similar to trust, will also be analysed thoroughly and it will be shown that both mechanisms can occur in different forms and - depending on these - engage in specific relationships to each other. With reference to the conditions of the institutional framework in which relationships between firms are embedded, Germany and Britain will then be discussed as two territorially bounded examples of European business systems. It will be shown that these systems represent distinct forms of producing co-operation and controlling the dynamics of interactions between economic organizations (section 3). The concluding part of this contribution (section 4) will examine whether the proposed combination of sociological theory, and comparative empirical studies on territorial business systems can be deemed a fruitful approach to understanding and formulating the conditions and chances of regional innovation policies in Europe.

2 THEORETICAL CONSIDERATIONS

2.1 **Trust, Uncertainty and Risk**

Any theoretically deep analysis of trust that aims to grasp its central function with regard to social actors' behaviour builds on the insight that trust is one of the basic mechanisms of co-ordinating social expectations and interaction. Trust can fulfil this role because it reduces uncertainty in that it allows for *specific* (rather than arbitrary) assumptions about other social actors' future behaviour. Someone who considers trusting another actor is prepared to offer a pre-commitment (Luhmann 1989: 23) notwithstanding the fact that he cannot harvest any immediate benefits resulting from this behaviour. In the initial phase of a trust-based relationship a trustor makes the assumption that the trustee will simply *not* behave opportunistically and take advantage of his not being willing and/or able to insist on any guarantees and/or enforceable promises in exchange. On the basis of this assumption, which as such may appear difficult to understand from a mainstream economics point of view, (two) social actors position themselves to *start* interacting with each other. From a sociological perspective, this is one of the most important aspects of an actor's decision to invest trust with regard to another social actor's future behaviour. If such a decision is made it is not only the trustor who makes specific assumptions about the trustee's behaviour; also the trustee can then reduce the number of (re-)actions he may expect realistically from the trustor's side. Thus, the reduction of uncertainty by means of investment of trust allows for establishing long chains of co-ordinated social exchanges. Preparedness to make one-sided commitments alone may not be sufficient to generate differentiated social systems but it is often a necessary starting point of communication between social actors. If nobody was prepared to take the first step and offer a pre-commitment, it is most likely that none of the social actors would find a way of engaging in any interaction. Depending on the psychological disposition of individuals and the cultural traditions of countries and regions in which social actors' behaviour is embedded, this situation will occur more or less frequently. Clearly, all individuals in all geographical areas of the world communicate with each other and manage to build up a certain degree of trust in their relationships. But at the same time it is obvious that their inclinations also considerably differ from each other in this respect (Hofstede 1991; Fukuyama 1995).

Although trust is such a fundamental mechanism in all social reality it involves a severe problem which cannot be ignored: Trust is an inherently risky behaviour (Luhmann 1979). On the one hand, it absorbs *uncertainty* but, on the other, it produces *risk* as a social actor who decides to trust another actor inevitably extrapolates on the limited information he has available about this actor's future behaviour (Luhmann 1979: 26). Trust, in other words, is always in danger of being misplaced. This is a risk that someone, who considers whether he should trust another actor or not, must be prepared to bear. If he could *exclude* it, trust would be unlikely to emerge as there would simply be no need for it. Notwithstanding this fact, a potential trustor is eager to find *good reasons* to believe that the risk he will have to run when he actually decides to invest trust in a relationship is relatively low. If he cannot find sufficient reasons for this assumption he might well refrain from trusting and either avoid social interaction with the potential trustee in the given situation or seek an alternative basis for social communication. If, however, he can find enough good reasons trust is likely to become an important control mechanism within the relationship.

Even if this may seem somewhat counter-intuitive, Luhmann suggests that the existence of *legal norms* is one of the most effective remedies to confine the risk of trust. Such legal norms, in other words, can provide exactly those *good reasons* which a potential trustor seeks before he actually decides to invest trust in a specific relationship. Legal sanctions can be seen as a means of reducing the risk of being betrayed and thus allow for trusting behaviour which would otherwise seem overly hazardous. It is however important to understand that legal norms do not fulfil this function by mobilising the sanctions connected with them. The basic social function of legal norms can rather be seen in their potential to channel the expectations of social actors to specific routes of behaviour. If it is effective, law does its job long before sanctions are seriously considered by any party. In this way - and only in this way! - legal regulation can play a major role in the constitution of trust. Sanctions are always possible where legal norms exist but should not become a matter of explicit consideration if trust is to be fostered in a social relationship (Luhmann 1979: 36). With reference to relationships between *economic* actors, it can thus be assumed that *commercial law* is of central importance for the development of trust-based forms of business behaviour. While in a *first step* an economic actor might be inclined to offer a pre-commitment to his customer, supplier or horizontally collaborating business partner, the existence of a strong legal framework that exerts its influence in a *latent* manner - in a *second step* - may lead him to actually decide to invest trust in the relationship.

Commercial law and practices of contracting can be understood as *one* important element within the wider institutional framework of a given country or region in which business relationships are embedded (Deakin, Lane and Wilkinson 1994; Lane and Bachmann 1996). On closer inspection, however, there are other institutional arrangements which can be equally conducive to building trust in organizational relationships. The role of trade associations, for example, which may or may not represent the collective interests of a whole industry, the structures of the specific system of education and vocational training, the more or less binding rules of technical standardisation of products and production processes, etc. also belong to the institutional environment which shapes the quality of business relationships. The central role of such institutional frameworks, which differ to a large extent between regions and nation-states, is to generate *shared* economic, technical, cultural and social knowledge on which generally accepted forms of business behaviour can be built. In this way rather than through mobilisation of legal and social sanctions institutions can often reduce the inherent risk of trust to such a level that economic actors find tolerable and choose trust as an important mechanism in governing their relationship with another actor. Thus it can be concluded that where powerful institutions exist in a specific business territory, these can orient the expectations and (re-)actions of social actors towards specific patterns of behaviour and make it less likely that a supplier, customer or horizontally inter-linked business partner will behave in an unpredictable manner or indeed see incentives to cheat. In contrast, in territorial business systems where this is not the case more opportunistic behaviour can be expected and the risk of trust will increase accordingly.

2.2 System Trust and Personal Trust

Trust in this sense may be called *system trust,* as opposed to trust which is likely to develop when individual actors frequently have face-to-face contact and become familiar with each others' personal preferences and interests, which may then be called *personal trust* (Luhmann 1979; Giddens 1990). With explicit reference to *business* relationships, Zucker (1986) closely links into this conceptual differentiation. She suggests that advanced socio-economic systems have to produce s*ystem trust* - or: *institutional-based trust* to use her terminology - since establishing personal forms of trust often requires too much time and effort on part of the individual actors who considers engaging in business relations with each other. The systemic form of trust production, drawing on the institutional framework of a given business system, is seen as a central means of producing sufficient trust in business relations to effectively reduce the social complexity of advanced business systems, i.e. to allow for a swift and reliable co-ordination of expectations and interactions between customers, suppliers and horizontally co-operating business partners (Zucker 1986). Thus, the concept of *system trust* or *institutional-based trust* - if this expression is preferred - refers to a depersonalised mode of trust production which is no less than a precondition of the existence of highly differentiated socio-economic systems, especially when these are geographically large so that frequent face-to-face contact is difficult to arrange and *personal trust* must be deemed a very scarce resource.

A classical example of *system trust* refers to the universal usability of money. The latter is a medium which symbolises the transfer of material resources and, to a very large extent, it does its job irrespective of who are the individuals involved in the exchange relationship and what is the purpose of the payment (Simmel 1978). In this example, the existence of a stable monetary *system* - which might include commonly accepted rules and practices of money lending and a central reserve bank acting as a 'third party guarantor' (Coleman 1990: 182) – can be seen as a means of *mass-producing* trust at low individual costs and, at the same time, in such a quantity that differentiated modern socio-economic systems can function efficiently. Similar to other elements and subsystems of the institutional framework in which business relations are embedded, the institutionalised patterns of monetary transfers provide a way of collectively controlling individual actors' expectations and interactions. In these circumstances, the risk of trust can be deemed relatively low and co-ordinated interaction can emerge without economic actors being brought into a position where they must bear unacceptably high individual costs of building trust in their relationships.

While *personal trust* may have fulfilled a pre-eminent role in business relationships in the past, Zucker (1986) argues, this form of trust - *process-based* or *characteristic-based trust* as she calls it - is simply not sufficient for today's large and complex socio-economic systems. With reference to the American economy of the 19th and early 20th century she explains the limits of the production of personal trust being dependent on inter-personal contacts and/or familiarity based on a shared ethnic background. Zucker (1986) does *not* suggest that face-to-face contacts have ceased to be important in many situations. She only points to the fact that these cannot serve any longer as the main - or even less so: the only - way of generating trust in large and highly differentiated business systems.

According to Giddens' (1990) theory of trust the functioning of abstract social systems such as the monetary system, the legal system or the air traffic control system, which Giddens himself suggests as an instructive example of how *system trust* is generated (1990: 85f), presupposes social actors playing a different role as compared to the actors involved in the process of establishing *personal trust* in their relationships. In his view, social actors' behaviour is anything but unimportant when trust is produced at a systemic level. In this case, they appear as tangible individuals at the 'access points' of the abstract systems which they represent at the level of individual behaviour offering 'face-work commitments' to potential users or clients of these systems and, thus, do play a vital role in the process of establishing *system trust*. As such, face-to-face contacts are not viewed as capable of producing a high level of trust in a very system(at)ic manner but - as Giddens suggests - de-personalised institutional structures, standards of expertise, anonymous rules and procedures would not be able to do their job if these individuals who appear at the 'access points' of abstract systems were not permanently translating general social rules into meaningful concrete social practice. In the world of business relations, Giddens' notion of 're-embedding' social structure into individual interaction contributes to the insight that the existence of *commonly acknowledged* patterns of legal regulation, the representation of collective interests by trade associations, vocational training systems, practices of financing corporate investments, etc. makes it much more likely that economic actors swiftly find enough *good reasons* to assume that the inherent risk of trust is bearable than would be the case if these institutional structures did not exist (or only existed in rudimentary form).

2.3 The Dialectics of Trust and Power

Undoubtedly, trust is an efficient means of co-ordinating expectations and interactions in business relationships. But it also has severe disadvantages. The risk of investing trust in a relationship may be seen as intolerably high in some situations and a potential trustor might simply not find (enough) *good reasons* to make the assumption that a potential trustee will behave trustworthily. This, however, is not the only problem which can occur when trust is considered the central governance mechanism in business relationships. Also, trust that has been established in a relationship over many years can - whatever the causes may be - suddenly break down and leave no chance of continuing the relationship on any basis, even if this might seem in the vital interest of both sides. It is simply an intrinsic feature of trust that it *can* turn out to be misplaced and render the social actors involved considerable damage. This possibility can never be excluded when a relationship is built on trust (no matter whether business or any other field of social exchange is concerned).

But trust is not the only means of reducing uncertainty and thus facilitating co-operation between economic actors. Power is another mechanism for co-ordinating expectations and controlling the dynamics of business relationships. Perhaps not in all - but certainly in many! - respects, power is equally effective in reducing social complexity and uncertainty. At the same time, it is more robust than trust and the risk of misplacement or unforeseen breakdowns usually do not entail damages as dramatic as when trust was the basis of the relationship. Seen from a mere analytical perspective, both mechanisms - trust and power - seem to operate with reference to very similar principles. Power does its job in that it ‘influence(s) the selection of actions in the face of other possibilities’ (Luhmann 1979: 112). In this regard there is no difference to how trust works. Both trust and power allow social actors to co-ordinate their mutual expectations and (re-)actions swiftly and effectively. One of the differences between trust and power, however, concerns the mode of selection of expectations. A trustor will choose to assume that the trustee will behave the way he prefers. A powerful actor, in contrast, will suggest to a subordinate actor that a particular course of action is undesirable in that - especially in the face of consequences that it might entail - it would not satisfy the interests of either side. Unlike a trustor, a powerful actor does not make the assumption that the other side will comply with what he suggests as a positive way of interacting with each other in the future. He rather constructs a hypothetical possibility as regards the subordinate actor's future behaviour and - more or less openly and concretely - links it with a threat of sanctions should the subordinate actor actually opt for it. Thus, one can say that trust works on the basis of *positive* assumptions about *alter ego's* willingness and ability to co-operate while power is based on the selection of a *negative* hypothetical possibility as regards *alter ego's future* (re-)actions. What is most important from an analytical viewpoint, however, is that in both cases processes of *selection* of possibilities of behaviour lie at the heart of the social relationship.

Thus, power is to be seen as a mechanism for co-ordinating social expectations and interactions as efficiently as trust does, and often suggests itself as the better option. Depending on whether the threat of sanctions which a powerful actor makes reference to is realistic and has a good chance of being acknowledged by the subordinate actor or not, power can in many cases be deemed the most efficient way of co-ordinating interactions. Of course, in circumstances where the subordinate actor has reasons to doubt that the threat of sanctions would ultimately be used against him, the position of the powerful actor is weak and someone who considers the use of power under these conditions might well come to the conclusion that this would simply be too risky and refrain from doing so. Although in many ways power is more robust than trust, it would be misleading to assume that power cannot fail if it is massively challenged. The damages that might occur in the case of a breakdown of power, however, are usually limited and a relationship may then perhaps be continued on another basis since power has not the same emotional weight that trust has. Thus, trust as well as power has its specific risks and safeguards. While a trustor, in most cases, has *good reasons* to assume that the risk he is prepared to run is relatively low, a social actor who considers using power as a central governance mechanism in a relationship usually has *good reasons* to believe that the ‘authoritative’ and ‘allocative’ resources (Giddens 1984) which he can make reference to will find recognition by the subordinate actor. If that is not the case it would seem naive to opt for power as the central mechanism to co-ordinate interactions just as it would be silly if a social actor offered *blind trust* to another social actor.

Examining issues more closely, most social relationships seem to be based on a combination of trust and power. As both of these mechanisms are limited in their capacity to structure social relationships and to control their dynamics, drawing on both mechanisms simultaneously is often the only way to ensure that the co-ordination of expectations and interactions is reliably achieved. Nonetheless it is, of course, important whether trust or power *dominates* (and thus characterises the overall quality of) the relationship. Only in this sense, social actors may come into a position where they can choose between two *alternative options*. As mentioned above, this, however, is not an arbitrary choice since social actors tend to have *good reasons* for their decisions even if they are by no means solely driven by rational motivation.

Although the interrelationship between trust and power can often be seen as an *alternative* choice in the sense described above, it also seems that - depending on the *forms* of trust and power occurring in social relationships - this is not the only way in which these two mechanisms can be inter-linked. On closer inspection, it becomes evident that the concept of combinable alternative options mainly applies where *personal* forms of trust and power are concerned. Where other forms trust and power are in question, specifically those that are constitutively produced by reference to a given business system’s institutional framework, in which social interactions between economic actors are embedded (i. e. *systemic* forms of trust and power), power often appears as a *precondition* rather than as an *alternative* to trust. Under conditions of a weak and patchy institutional regime, where trust is mostly *personal trust*, and where power predominantly depends on individually attributed resources (i.e. personal power), individual social actors might be confronted with a choice between trust or power to dominate their relationship. In this situation the risk of trust is likely to be intolerably high for a potential trustor who will then have *good reasons* to prefer power - always provided that he has the corresponding resources to draw upon - instead of trust as the central co-ordination mechanism in his relationship with another actor. If, under such conditions, he does not have these available it is likely that the other social actors with whom he starts a business relationship will exert power *on him.* It is not impossible - but unlikely! - that he will have the chance to offer or be offered trust in these circumstances.

Generally, it can be assumed that in business systems based on a relatively low level of institutional regulation, power more often appears as the dominant mechanism for co-ordinating expectations and controlling the dynamics of relationships. Where, in contrast, a strong and coherent institutional framework exists, trust is produced on an institutional basis, i.e. in the form of *system trust*. Here, individually attributed resources of power have a relatively low value and, thus, will often remain unused. However, power as such is not absent in this kind of business system. In strongly regulated systems power appears as *system power*, i.e. in the form of powerful trade associations, legal and technical standardisation, rigid structures of intra-organizational hierarchy and inflexible patterns of inter-organizational co-operation. It is precisely this systemic - or: structural, if this term is preferred - form of power which can *mass-produce* the systemic form of trust. In this sense, trust is a *precondition* of - rather than an *alternative* to - *system trust*.

3 EMPIRICAL OBSERVATIONS

3.1 **The Functioning of Trust and/or Power in Two European Business Systems**

The literature which analyses empirical features of national and regional business systems widely agrees that socio-economic systems which are characterised by a relative lack of trust, such as for example the Anglo-Saxon business system, are strongly oriented to individual strategies of solving the problem of co-ordinating social actors' expectations and interactions. In contrast, many continental European business systems, particularly the German speaking part of Europe, are often described as being based on inter-organizational control mechanisms which give special attention to the pursuit of collective goals and allow for developing long-term perspectives rather than providing incentives for short-term profit- maximising (Stewart et al. 1994; Lane 1995; Lane and Bachmann 1996; Bachmann and Lane 1997).

Of course, no business territory can be deemed in itself homogenous. Sector- and firm-specific differences, for example, can play an important role in determining the quality of organizational relations. Notwithstanding this fact, however, it seems that even in the face of Europeanization the English and the German speaking business systems still differ so strongly that it must be assumed that territorially bounded influences of the specific institutional framework often overrule other factors that might also affect the quality of intra- and inter-organizational behaviour. In the following section of this paper, the two named European business regions will be examined more closely in order to put the theoretical conceptualisations presented above (section 2) to test and to specify the empirical conditions and consequences of different forms of trust and power within the context of each framework of the institutional order. In doing so, it will be shown that the two mechanisms for co-ordinating expectations and interactions in business relationships - trust and power - (a) take on specific forms in Germany and Britain, and (b) appear in specific inter-relationships to each other depending on the institutional arrangements that can be found in each of these business territories.

In the German speaking part of Europe as well as in the English speaking part of it, trust is highly valued as an efficient means of coping with uncertainty and complexity in business relationships. In the Anglo-Saxon socio-economic system which - connecting to ancient liberal traditions - underwent radical de-regulation during the 'Thatcherite Revolution' (Lane 1995; Lane and Bachmann 1997) trust, however, is a scarce resource without much hold in the patchy institutional inventory of this system. The German speaking parts of Europe are, in contrast, one of the continental European regions which have largely resisted the trend towards radical de-regulation and individualisation of business behaviour. With certain *caveats*, it can still be described as based on tight regulation, i.e. a strong and reliable institutional framework which not only represents collective interests of business organizations but also ensures that individual interests are compatible with what is considered to be in the interest of the business system as a whole.

In both business territories inter-personal contacts between individual representatives of business organizations are very important with regard to the development of trust. In the German speaking context, however, these individual contacts *per se* are not to be overrated. While in the Anglo-Saxon case frequent personal contacts tend to result in *personal trust,* i.e. trust in the integrity of the interacting individuals that are involved in a business relationship, in the German speaking part of Europe the personal level of communication between firms tends to be symbolic 'face work' at the 'access points' of large and 'abstract systems' fostering the development of system trust as described with reference to Giddens (1990) in the theoretical part of this article (section 2). German or Austrian businessmen, in other words, trust reputable organizations which are embedded in highly regulated socio-economic systems. British or Irish businessmen, in contrast, place much more emphasis on how well they get on with individual persons, often quite irrespective of which organization stands behind them. The output of this mode of trust production is *personal trust.* This form of trust - if trust occurs at all - is dominant in the Anglo-Saxon system, while Giddens' concept of *system trust* and what he describes as processes of re-embedding abstract systems into social praxis by individual asocial actors' 'face-work' is particularly well illustrated by the German speaking business system.

Furthermore, empirical evidence strongly confirms that - as has also been argued at the theoretical level (cf. section 2) - advanced socio-economic systems such as the English and German speaking business regions in Europe, are far too complex to be able to predominantly rely on trust that emerges on the basis of individual experiences, i.e. *personal trust*. If, however, *system trust* is not produced in sufficient quantity, as this seems to be the case in the Anglo-Saxon system due to the absence of a strong and coherent framework of institutional arrangements, individual resources of power play a greater role with regard to the quality and dynamics of business relationships. This supports a central assumption developed in the conceptual part of this article (section 2), namely that trust becomes generally less important where it presupposes too much time and effort individuals would have to invest in cultivating inter-personal contacts while power (in its personal form!) receives more emphasis as a governance mechanism in organizational relationships under these conditions.

Thus, comparative analyses of the English and the German speaking business territories also widely confirm the theoretical assumption that the *genuine form of power* draws on *individual* resources rather than on a *collectively* (re-)produced institutional order. As has been argued in the theoretical section of this article, power does a job quite similar to trust and can thus, to some extent, be seen as a functional equivalent. Where institutional arrangements are not strong enough to serve as a basis for producing trust efficiently and reliably - which can be assumed for the Anglo-Saxon business system - there is always power as a back-up mechanism. Since power - in its personal form! - does not presuppose much of an institutional framework, it is used as a central mechanism to co-ordinate expectations and interactions between businessmen where these arrangements are missing or exist only in rudimentary form. Looking at the Anglo-Saxon business this assumptions can largely be confirmed.

Trust in its genuine form, in contrast, seems to be *system trust*. The production of trust - much more than the availability of power - relies on the existence of coherent and strong institutions. *Personal trust*, as has been argued in the theoretical section of this paper, can only play a minor role with regard to governing relationships in today’s complex socio-economic systems. Only where business systems are spatially confined to a local scale long-standing personal contacts between businessmen may still be a major source of trust. Due to cheap transportation and telecommunication, however, local business communities are rare today. Under conditions of the

European unification process, business regions often cover a traditional nation-state or - more likely - a territory as large as two or three of these.

At first sight, regions with a weak and patchy institutional framework might generally seem disadvantaged as compared to those which have strong and reliable institutions. However, the automated ‘mass-production’ of trust in the form of *system trust,* as can be found in Germany and Austria, also has its downsides. The absence of strong forms of *system trust* in Britain and Ireland at least results in a greater awareness of the development and cultivation of *personal contacts* which allows for specific and very valuable forms of flexibility which are less likely to flourish under conditions of a very tight framework of institutional regulation. While highly regulated business territories breed strong ties between businessmen who are active in the same system, the chances of developing trust-based organizational relationships across the boundaries of the domestic system are considerably lower. It is not by accident that German or Austrian firms have only a limited ability to develop trust-based relationships with foreign vertically or horizontally collaborating business partners. Many of these firms’ international relationships do not go beyond export/import activities while equity-based co-operations are still quite rare, particularly with small and medium-sized firms. This seems to be a most direct result of the dominance of the institutional-based mode of trust production. Because trust in this system relies so heavily on the existence of collectively binding rules generated and guaranteed by the institutional framework, it is of less use when a shared world of institutional arrangements simply does not exist. The latter must be assumed to be the case when inter-territorial relationships are concerned.

3.2 Differences of the Institutional Frameworks

Each of the two business systems is deeply rooted in autochthonous political, cultural and economic traditions. These concern the role of the state and, particularly, the relationship between state and civil society (Lane 1995). While, for instance, in continental European countries, as for example in the German speaking part of Europe, the authority and neutrality of commercial law is guaranteed by the state and thus withdrawn from individuals pursuing idiosyncratic interests, the Anglo-Saxon view sees law primarily as a means to protect individuals' interests against any kind of collective pressure. Under English law, it is much more left to the discretion of the individual as to what are the conditions under which he wants to engage in economic relationships. Thus, Anglo-Saxon lawyers hesitate to interfere in private business. Even when the disputing contractors of an ongoing relationship have failed to resolve differences on their own and seek legal advice, lawyers tend to refer to the letters of the individual contract rather than to any general principles of business behaviour. German or Austrian lawyers, in contrast, are likely to apply highly generalised legal rules and to prevent the stronger side of the relationship from taking advantage of his position. In the German speaking part of Europe, contractual arrangements are based on a detailed legal code which may sometimes imply *fuzzy* guidelines of business behaviour such as - for example - the notion of 'good faith'. However, they are always binding and very effective in channelling businessmen's expectations and interactions, long before disputes may arise (Arrighetti, Bachmann and Deakin 1997).

Thus, empirical evidence confirms that where the system of legal regulation - as part of the overall institutional framework - is strong, it can efficiently reduce the risk inherent in trust. Consistent with Luhmann's argument presented above (cf. section 2), reliable legal rules direct economic actors' expectations to certain patterns of commonly accepted behaviour. On Anglo-Saxon business territory, severe disputes on the terms of contracts are generally more likely than in Germany or Austria. At the same time, it is less likely that a commonly accepted solution for these can be found. Under these conditions, it is quite understandable that legal aspects brought into a business relationship will not foster the development of trust. Indeed, the contrary must be assumed (Beale and Dugdale 1975). Where, however, the system of legal regulation helps prevent opportunistic strategies of the stronger side and general legal rules exist which businessmen accept as guidelines of their behaviour - as can be observed in the German speaking part of Europe - *latent* references made to commercial law can indeed be highly conducive to building trust in business relationships.

How commercial law translates into everyday practice is well illustrated by the use of contracts in each of two business systems. In the Anglo-Saxon system, detailed and carefully worded contracts are often the result of a fierce ‘battle of contracts’ (Sako 1992). Here, each side is keen to force its conditions upon the other making use of its individual resources of power where this promises individual advantages. Of course, the existence of detailed contracts must under theses circumstances be interpreted as a sign of distrust. In Germany and Austria, detailed written contracts and trust are no contradiction at all. Quite the opposite holds true in this business environment. German speaking businessmen are seldom tempted to use contracts as a means of maximising their individual interests. Against the background of a business environment where standard legal rules in most cases overrule individual contract clauses, if discrepancies occur, this would indeed not seem to be a very promising strategy. Analysing the contents of contracts in the German speaking part of Europe more closely reveals that these often simply repeat standard legal norms. They function as a means of permanent *reassurance* of the common legal principles within a *shared world* of institutional order which strongly supports the theoretical argument presented earlier in this article (cf. section 2). Clearly, contracts used in this business system can be viewed as highly conducive to the development of trust in organizational relationships.

Different concepts of commercial law and legal practice may draw on ancient traditions. But it cannot be overlooked that in the past 15 years or so neo-liberal deregulation policy has further weakened the institutional basis of the English speaking part of Europe and thus brought the Anglo-Saxon system even closer to its own principles (Sorge 2000). The massively changed importance of trade associations, which in the post-war decades had at least some influence within the system, is a good example to illustrate this. The Thatcherite revolution in the 1980s decreased the power of these trade associations dramatically leaving behind many small privately run organisations competing with each other to attract clients within the same industry. Thus, it is not surprising that today’s Anglo-Saxon trade associations can hardly be seen as an important element of the institutional framework of this business system. They act more or less as consulting firms selling their services to *customers* which have little interest in sharing their technical know-how, market strategies etc. with each other.

On German speaking business territory powerful trade associations still exist. They can truly represent their industries as they are self-organised by their *members* who take an active interest in developing collective strategies, e.g. to enter international markets or to discuss economic policies with political administrative bodies at regional, country- or European level. In associations such as the very powerful association of the German machinery sector ('VDMA'), many study groups exist in which economic and technical know-how is freely exchanged between engineers of firms that compete with each other in the same product market. These trade associations, of course, play a major role in generating and monitoring rules and standards of business behaviour within their industry (and beyond) (Bachmann and Lane 1997).

The example of German trade associations illustrates particularly well how associational structures can play a central role as regards the constitution of *system trust*. Trade associations, which can represent the collective interests of an entire industry and can thus even claim considerable influence on the business system as a whole, are an efficient tool for producing and monitoring commonly accepted guidelines of business behaviour. Opportunistic strategies of individual managers or firms are not ruled out in these circumstances but they are far less likely when powerful trade associations exert a latent threat of social sanctions on any form of misbehaviour. This makes a strong contribution to *channelling* economic actors' expectations and interactions into stable and predictable routines and thus to producing trust in business relations. Through their *system power*, in other words, these trade associations produce *system trust* which indeed strongly confirms what has been argued in the theoretical part of this paper (section 2) as regards the interrelationship between trust and power in socio-economic systems that are built on a high level of institutional regulation. Trade associations on Anglo-Saxon territory, in contrast, lack the power to provide general guidelines of business behaviour. Thus, their contribution to reducing risk and producing *system trust* within their business system is quite limited.

The central assumption discussed in theoretical terms in this paper (cf. section 2), namely that the mode of trust production is strongly dependent on the quality of the institutional order of the given business system, is confirmed by empirical studies. In particular, comparative analyses of business systems as divergent as the English and the German speaking parts of Europe support the notion that an institutionalist perspective on the constitution of trust and power is a fruitful approach to understanding the constitution of the quality of inter-organizational relationships. Such empirical analyses show that the embeddedness of individual interaction into a collectively accepted institutional order is the *differentia specifica* which can to large extent explain why - despite all efforts to harmonise business conditions in Europe - territorially bounded factors still matter and what it is that makes them an influential determinant with regard to how successful business strategies can be in a world of globalized competition. Clearly, economic policy has to connect to the inherited cultural traditions and the logic of the given institutional framework, the latter being probably the most important access point for the introduction of change in a business system.

4 CONCLUSION: CONSEQUENCES FOR EUROPEAN INNOVATION POLICY

A theoretically and empirically fruitful approach to analysing the quality and dynamics of organizational relations within a given business system needs to adopt a view that focuses on social mechanisms such as trust and power. Following a traditional economics perspective drawing on the idea of a universalistic concept of a purely calculation-based process of strategic decision-making seems too narrow to describe economic actors' mutual expectations and patterns of interaction. A thorough examination of how social co-ordination mechanisms are linked into each other reveals that the socio-economic order in which organizational relations are embedded plays a crucial role in determining the chances as well as the limits of firms' innovativeness and competitive advantage in globalized markets. As the socio-economic environment to a large extent is territory-bounded, it seems fruitful to utilise conceptual categories developed against the background of empirical studies in geographically confined business systems, on the one hand, and profound sociological theory, on the other. With reference to these categories a wider focus of analysis can be established and a greater theoretical comprehensiveness can be achieved than with counter-factual modelling of economic behaviour.

Against the background of these insights it also becomes apparent that no simplistic conclusions can be drawn with regard to innovation policy. Each of the two European business regions analysed in this article have their specific advantages and disadvantages. While the system of strong institutional regulation in the German speaking part of Europe was and still is quite successful where capital-intensive manufacturing industries, e. g. the automobile and chemical sectors, are concerned it has become doubtful in the past 10 years or so that it provides optimal conditions for the growing sector of services and the high-tech industries such as software engineering and biotechnology (e.g. Kern 1998). The strong orientation towards stability and collective controls of technological developments and new business strategies may be conducive to incremental innovation at a high level of quality standards but has relatively little potential for fostering radical innovation. As opportunistic business behaviour driven by individual interests is systematically discouraged under these conditions, *system trust* can flourish and breed a co-operative climate which in many ways can save on transaction costs, prevent unproductive rivalry and produce important synergies with regard to incremental innovation. In contrast, the Anglo-Saxon system encourages individual actors to be creative and promises higher rewards for those individual managers and organizations who outperform their competitors. This system puts a premium on individual risk-taking and thus appears to be quite conducive to radical innovation. Instead of generating a high level of *system trust* it places emphasis on the utilisation of individual resources of power (‘*personal power’*) where *personal trust* seems too circumstantial to establish. Thus each of the two systems supports a specific form of flexibility. Anglo-Saxon flexibility builds upon the absence of rigid institutional arrangements to control individual actors’ behaviour while flexibility between individual economic actors in Germany or Austria constitutively draws on strong collective guarantees and institutional control.

Each of the two business systems also has specific downsides. Notwithstanding the fact that close forms of co-operation are so much embraced at the rhetoric level in low trust systems such as the Anglo-Saxon one, this business model lacks the institutional preconditions of producing a high level of trust and in fact encourages the use of individually accessable resources of power instead of trust. In contrast, on German speaking business territory the ‘over-embeddedness’ (Uzzi 1997: 58) of organizational relationships reduces risks so effectively that tendencies towards *blind trust* can occur which is, of course, dangerous particularly when the pace of innovation is fast, as is currently the case in many strategically important industries.

Given this situation it seems necessary to draw on a *hybrid* form of regulation and to carefully avoid inflexibility and ‘lock-in’ effects (Grabher 1993; Isaksen 2001) which can arise at both ends of the scale: where there is either too much trust (e.g. Germany) or too little trust (e.g. Britain). The specific problem of high trust systems is that they encourage too strong ties (Grabher 1993) creating a world of business where *internal* organizational relationships are central for understanding the overall logic of the business system. Under these circumstances, processes of self-reference tend to replace communication with the *external* environment and thus systematically invalidate an important source of radical innovation. In contrast, on English speaking business territory organizational relationships are often based on too weak ties between economic actors. Thus, the general level of co-operation is often not high enough for effectively pooling risks and resources between two legally independent organizations so as to provide suitable conditions for putting promising innovation ideas into practice.

To conclude, European innovation policy would not be well-advised to follow current mainstream debates on the assumption that it all depends on the abstract question of whether deregulation or re-regulation can be balanced in such a way that none of the underlying principles of each system are dominant. This approach clearly gives no guarantee that it will always be the strengths rather than the downsides of each system which are combined. To avoid the latter possibility it seems necessary to understand how the specific socio-economic system under review works and how the relevant mechanisms of co-ordinating of interactions between firms are constituted. Only where the logic of the specific business system can be revealed can it be possible to reconstruct the patterns in which these mechanisms decide upon fruitful and unfruitful pathways of economic modernization (Whitley 1994). Policies to strengthen the innovativeness of European regions, in other words, should stay away from both extremes: i.e. to believe that basically nothing can be done as territories will eventually have to find their niches on their own anyway, or that one ideal model fits all regions in a part of the world as culturally diverse as Europe.

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