Trust within and between organizations

CONCEPTUAL ISSUES AND EMPIRICAL APLICATIONS

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Contract Law and the Economics of Interorganizational Trust

I. Introduction

Following the seminal study of Macauly (1963), writers in the socio-legal tradition have generally assumed the system of contract law is marginal to the process of business contracting. The juridification of commercial relations through contract and regulatory law is seen as inimical to the emergence and preservation of trust. Organization theorists also view legalistic procedures and sanctions both as a threat to trust and as ineffective in restoring trust when contractual relations break down (Sitkin and Roth 1993).

In economic theory, by contrast, it is trust, rather than law, witch is regarded as peripheral to contracting. Legal sanctions, operating as a set of implicit prices or incentives, help to ensure an efficient level of performance of contractual obligations (Posner 1993). Trust, o the other hand, is simply an outcome or expression of agents calculations concerning future contingencies (including the possibility of legal liability). As such, it is a largely redundant or misleading notion (Williamson 1993, 1996: Ch. 10).

This chapter seeks to reassess the relationship between organizational trust and the legal-institutional framework governing economic relations. It will be suggested that the assumed apposition between trust and law springs from an unnecessarily rigid and narrow view of legal norms as predominantly coercive in nature. This view assumes that legal norms, along with other formal rules, impose external constraints to which agents respond in a rational, calculative manner. If, however, the assumption of omniscient calculation by agents is replaced by one of decision-making under condition of pervasive uncertainly, the normative rules no longer simply constrain agents behaviour; rather, they may play an enablingrole which opens up certain strategic possibilities for co-operation. Under these circumstances, normative rules, including the rules of the legal system, may provide an important mechanism for the reproduction of trust.

Our empirical research, referred to below, confirm this suggestion by... intensity of demand, market structure, and degree of stability) tend to adopt different strategic approaches to supplier elations according to the nature of the different institutional frameworks within which their exchange relations are conducted. There is no evidence that either co-operation or trust is necessarily reduced in national systems where the levels of institutional regulation and contract formality are high. On the contrary, there are indications that relations based on conflict and distrust are more likely in systems with minimal normative regulation.

Our discussion proceeds as follows. In section 2 we look at economic approaches to the definition of trust, including those of the economic analysis of law, game theory, and transaction cost economics. We will argue that rational choice analyses provide us with only an thin and partial account of trust and that, conversely, more institutionally orientated approaches within economics need to incorporate a viable theory of system trust if they are to progress. Section 3 illustrates this argument by reference to our empirical work. Section 4 concludes by considering the implications of our analysis for the question of whether the legal system, or other policy mechanisms, can be used actively to foster trust.

II. Contract Law, Trust, and Economic Theory

In common with other recent contributions, we take trust to refer to a belief or understanding on the part of the agent in the reliability or capability of another. Although from one point of view trust is "an element of all social exchange relations...and collective action" (Sitkin and Roth 1993: 367), it is also plausible to suggest that the degree of importance attached to trust varies according to the nature of the relationship in question. In this sense, trust becomes particularly important where relationships contain one of a number of elements, including uncertainly arising from unforeseeable future contingencies, a degree of interdependence between agents, and the threat of opportunism (ef. Lane, Introduction). There is also general agreement that trust can be an important means of enhancing the effectiveness of relationships which depend upon extensive co-operation at either an inter- or intra-organizational level. Here, trust may contribute to operational efficiency by reducing transaction cost which are associated with relational contracting. By providing a basis for the sharing of information and risk, it may also promote dynamic efficiency based on innovation and adaptation (Deakin and Wilkinson 1996; Sako, Chapter 3, This volume). At this level, the question of trust is bound up with that of economic development and competitiveness (Humphrey and Schimitz 1996); Deakin, Good-win, and Hughes (forthcoming).

But is trust, as just described, a phenomenon which is ultimately reducible to interactions between self-interested, utility – maximizing individuals?

A form of calculative or self-interested trust could be based on the belief of parties to an economic relationship that it is in their individual self-interest to continue trading (Dasgupta 1988; Lyons and Mehta (fothcoming). Where the relationship rests upon an agreement to co-operate, this can be maintained by the possibility that any defection will be sanctioned by retaliation of some kind. Expectations may be formed over time on the basis of a Bayeisan updating of beliefs, as each agent recalculates the probability of future defection by others in the light of their past behaviour (Axelrod 1984). The same process can be understood as operating at a broader societal level: social practices which are regarded as underpinning contractual relations –such as reputational effects, norms of ethical behaviour, and conventions of standard business practice (ef. Macauly 1963; Beale and Dudgate 1975)– may be established through the repeated, recursive interactions of individual agents (Coleman 1990; Kreps 1990; Casson 1993 a, b).

Here, the basic insight of game theory is that the success of strategies for future co-operation between contracting parties depends on how far each agent calculates that it is in his or her self-interest to continue observing the norm of co-operation, given the likely behaviour and response of the other. A situation in which each party adopts and maintains a strategy which will maximize its own interest, given the choice or strategy of the other(s), is know as a "Nash equilibrium". A Nash Equilibrium does not necessarily respresetant a state in which the allocative efficiency of society´s resources is maximized. Thus in many of the situations analyzed by the prisoners dilemma game, self-interested behaviour by both of the parties results in a sub-optimal solution.

It can be shown, nevertheless, that under circumstances of repeated exchange, there is a greater likelihood that strategies of co-operation will prevail, as each party now calculates that the costs of defection include the prospect of relatiation by the other party in future rounds of bargaining (Axelrod 1984). In other words, co-operation may be enforced as long as there is a credible threat of retaliatory behaviour, and this, in turn, depends upon the extent of future trading opportunities and of the parties, knowledge or perception of them. Where both parties anticipate the continuation of trading relations between them, their agreement to co-operate may be self-enforcing. However, for complete self-enforcement, it is necessary that the parties are not equally will informed about the terminal date of the relationship, since once that is known, the parties enter a bargaining endgame in which, through backward induction, it becomes relational for each party to defect in response to the impending defection

of the other. This insight can be thought of as explaining the apparently stable nature of many contracts for an indeterminate duration, such as permanent employment contracts, but, in general, few contracts conform to this model.

Possible "external" solutions to the problem of non-co-operation in long-term relationship include legal enforcement, on the one hand, and the presence of a shared commercial morality or set of ethical values, on the other. However, it has also been suggested that agents can devise their own governance structure through *private ordering* in such a way as to obviate the need to external intervention. Incentive structures may play a role in supporting long-term exchange relations in contracts of varying degrees of complexity and duration. A substantial body of work in the modern economic theory of contract has been devoted to understanding the operation of exchange relations under conditions of risk, opportunism and asymmetric information, in other words, the very same conditions which are also the focus of study in the debate over trust. From an economic point of view, the effects of relaxing the assumption that all agents are equally well informed aboyt the quality or characteristics of goods, or of the prices of alternative commodities, area far-reaching. If, for example, buyers cannot observe the quality of goods purchased at the time of contracting –the problem of adverse selection or hidden information– individual sellers may have an incentive to lower the quality of the goods offered to the *average* level of quality which buyers expect to receive; higher-quality sellers may then withdraw from the market. The result is a sun-optimal allocation of resources (Akerlof 1970). Similarly, economic relationships involving a divergence of interests between "principal" and "agent" may be vitiated by "moral hazard" or hidden action, that is, by the likelihood that the agent will act to further his or her own interests at the expense of the principal, under circumstances where the latter cannot effectively monitor the former's performance.

One response to adverse selection is "signaling", whereby a seller takes steps to indicate to potential buyers that the goods which he or she offers for sale are of above average quality. The seller can do this by taking steps which are less costly for him or her that they would be for sellers of lower-quality goods (Spense 1973). Buyers may then draw the necessary inference. In the case of moral hazard, it is argued that the principal can devise a payment schedule which induces the agent to behave in such a way as to maximize the principal's utility. Certain common contractual arrangements, such a piece-work employment contracts, and share-cropping tenancy agreements, have been analyzed in this way (ef. Stiglitz 1990)

More generally, where there area transaction-specific rents, contract terms can be used to set up an incentive structure aimed at giving credibility to the parties commitments. The essential idea is that one or both of the parties undertakes to cede something of value in the event of committing a breach of contract. Bonds, collateral, penalties, and other forms of contractual hostages, which might appear to be the result of inequality of bargaining power, may be designed instead to stabilize the exchange in the interests of both parties (ef. Williamson 1983; Kronman 1985). Contracts may also contain incentive structures which embody a positive reward system of some kind in order to elicit co-operation over the long term, such as the informal job security guarantees and more formal pension entitlements which are found in contracts of employment.

Even though these approaches predict considerable scope for self-enforcing agreements, or agreements which do not depend for their effectiveness upon the threat to external legal enforcement, limits to self-enforcement must also be recognized (ef. You and Wilkinson 1994). Even in the case of incentive structures which represent an *ex ante* efficient allocation of risk, there remains the problem that renegotiation of the contract terms may become necessary at some point in the life of the relationship, or that one party may acquire a temporary market

advantage which it can use to indicate new terms of trade. The formal conditions under which long-term contracts can be written so as to be "renegotiation-proof" are so extreme as to have only a tenuous connection with agreements of the kind which are observed in practice. If, indeed, they can be stated formally at all (ef. Harsanyi and Selten 1988). As a result, most analysts see a significant role being maintained for mechanisms of institutional enforcement of various kinds, even if they work in conjunction with, rather than against, those based on private ordering. Hence, "government policies which enhance complete contracts and improve their enforcement can be welfare enhancing. Examples are contract law, liability rules, and trade regulations" (kotowitz 1990:212).

In the law and economics literature, contract law is generally seen as providing a set of –default rules which serve to reduce transaction costs and overcome informational and related barriers to optimal exchange. Legal enforcement of promises is not absolute, but is set by a comparison of the marginal costs and benefits of court-led intervention (Posner 1993). The costs include the time and expense involved in administering and en-forcing the remedies concerned. Information and measurement problems make it difficult for the courts effectively to gauge the value of the parties *ex ante* contractual expectations; nor can they enforce or supervise specific performance of a contract without encoun-tering serious problems of moral hazard (Kronman 1978, 1985). Strict legal enforcement may, indeed, be actively harmful in the context of long-term, relational contracts which rest upon shared assumptions and understandings and on the possibility of extra-legal sanctions which may not be expressed in formal terms. Such arrangements may easily be misinterpreted by the courts, which do not have access to the specialized knowledge or assumptions shared by the parties (Charny 1990; Bernstein 1992).

As a consequence, "the legal right to enforce a promise can reduce but not eliminate the insecurity associated with all temporally asymmetrical exchanges (Kronman 1985;25). *Specific Performance,* or the literal enforcement of a promise of contractual performance, is normally only available where the victim of breach could not have been adequately compensated by other means (such as finding a substitute contract). Moreover, the extent of damages awarded will be reduced by (amongst other things) the requirement that the innocent party take steps to minimize his or her losses through *mitigation*. Damages seek to protect the expectation interest or opportunity cost of the plaintiff, but the courts will no award punitive or restitutionary damages in excess of this amount. As a result, the common law of contract permits an "efficient" breach of contract which, by redirecting the resources in question to a more efficient use than originally envisaged, would leave all the parties better off (on the assumptions that the victim of breach can be fully compensated out of the resulting surplus). There area other ways in which the law of contract is seen as providing incentive structures which promote allocative efficiency. For example, common law rules concerning mistake and misrepresentation cab be seen as providing the parties with incentives to minimize joint search costs in situations of limited information (Kronman 1978). These common law liability rules can be seen as supplementing private ordering based on specialized incentive structures and "signaling".

The phenomenon of trust in contractual relations may be explained, therefore, in terms of the rational responses of agents to incentive structures supplied by mechanisms of private ordering, on the one hand, and by the legal system and other instruments of state inter-vention, on the other. But another interpretation would be that these analyses deny any role at all for trust as a explanatory factor. Williamson, for example, has argued that:

> Transaction cost economic refers to contractual safeguards, or their absence, rather than trust, or its absence. I argue that it is redundant at best and can be misleading to use the term "trust" to describe commercial exchange for which cost-effective safeguards have been devised in support of more efficient exchange.

> Calculative trust is a contradiction in terms. (Williamson 1996: 256).

In other words: from an economic perspective, there may be value in studying the incentive structures and other processes by which barriers to efficient contracting are overcome; but the notion of trust does not help us to understand *these* processes.

Williamson then goes on to suggest that other possible formulations of trust –personal or process trust, on the one hand, and institutional or systems trust, on the other– are of limited value as explanations of economic form. The use of the term "personal trust" is, he suggests, "warranted only for very special personal relations that would be seriously degraded if a calculative orientation were "permitted". Commercial relations do not quality (1996; 275). Institutional trust, which refers to the social and organizational context within which contracts are embedded, also has the appearance of being non-calculative: but this is deceptive because transactions are governed with reference to the institutional context (environment) of which they are a part. Calculative ness thus always reappears (*ibid*). In other words, the institutional framework is simply a part, for this purpose, of the incentive structure from which the pattern of transactions emerges. Institutions are important, but to describe their effect in terms of "trust" is misleading except to the extent that some kind of partial or "hyphenated" trust can be derived from institutional sources. This "hyphenated" trust may be worthy of study, but it cannot be properly compared to the kind of trust which is generated at the level of interpersonal relations.

At one level, a calculative, or "economic-rational" dimension to business contracting cannot be denied. Still less would it be appropriate to talk o cooperative relations involving the denial or submergence of the parties *separate* interests. If there is no separation of interest, then there is no problem of trust worth discussing. In the world of perfect unity of interests, the issue of trust would be a trivial as in the zero transaction cost world of perfect rationality, foresight, and candor on the part of contracting agents. How ever, if we wish to retain a role for "calculative" behaviour, this need not be regarded as synonymous with the peculiar hyper rationality which much of economic theory imputes to agents. As Williamson (among others) has noted, this makes patently unrealistic assumptions about the cognitive ability of human actors to receive, store, retrieve, and process information (Williamson 1996: 8). His version of transaction cost economics concedes that comprehensive contracting is not a feasible option (by reason of bounded rationality), yet it maintains that many economics agents have the capacities both to learn and to look ahead, perceive hazards, and factor these back into the contractual relation (*ibid*., 9).

But if "hyper rationally" is rejected, the implications for analysis are much more far-reaching that adherents of transaction cost economics seem prepared to accept. Why should it be assumed that choices about the forms of contractual governance –such as the choice between integrating production in a single firm and pursuing extended forms of co-operative relations between firms– represent an efficient, economizing response by agents to their environment? We might expect one result of bounded rationality to be bounded efficiency (Zucker 1986: 67). If that were so, there would be limits to the capacity of agents to contract for the safe-guards needed to sustain complex exchange relations. Institutions might then have a role to play in the production and reproduction of trust, on the basis of which long term exchange relations could be sustained notwithstanding the incompleteness of the contracts on which they were based.

This suggestion is admittedly difficult to reconcile with a transaction cost analysis which sees the institutional framework as a coercive and constraining force, to which agents respond by modifying their behaviour taking the institutional environment as given, economic agents purportedly align transactions with governance structures to effect economizing outcomes (Williamson 1996; 5, cf. also North 1993, 1994). It

naturally enough follows from this point of view that the legal system, as an external *given* constraint on agents behaviour, can have little or no part to play in generating interpersonal trust.

This is a theme which is echoed in parts of the organization theory literature, where it has been analyzed in detail by Sitkin and Roth (1993). They suggest that while legalistic sanctions and procedures can promote trust in the (arguably limited) sense of enhanced reliability, they can, at the same time, engender *distrust* in the sense of disrupting a sense of shared values. This occurs for three reason: first, legalistic remedies can erode the interpersonal foundations of a relationship they are intended to bolster because they replace reliance on a person's "good will" with objective, formal requirements. Secondly, legal intervention, by placing distance between the parties, is hostile to the tacit or implicit elements which underlie close interpersonal relations. Thirdly, legal procedures can only address a particular aspect of a dispute or conflict, and so fail to address the wider effects of "value incongruence" (Sitkin and Roth 1993: 376). In some what similar vein, Sako (Chapter 3, this volume) advances the hypothesis that formal legal contracts can enhance "competence" trust, or the expectation of reliability in performance, but are likely to undermine "goodwill trust".

What is lacking from these analyses is an appreciation that the social impact of legal and other norms may be more that just coercive. There is no recognition, for example, of the "normative" and "cognitive" di-mensions of institutional forms which area recognized by writers in the neo-institutional strand within sociology. We may refer briefly here to Scott´s formulation, in which the regulative or "constraining" aspects of insti-tutional rules area offset by normative rules which "introduce a prescriptive, evaluative, and obligatory dimension into social life" (Scott 1995: 32) and by cognitive aspects which "constitute the nature of reality and the frames through which meaning is made" (*ibid*. 40). The effect is to posit a richer theory of individual agency than the rigidly deterministic one offered by rational choice theory within economics. From a *normative* viewpoint, choice is no longer predetermined by instrumental considerations, but is influenced by conceptions of appropriate behaviour in particular settings; from a *cognitive* viewpoint, choices are not simply constrained but are also informed by rule-based systems.

If this view is taken, then the relationship between the institutional framework and economic agency must be seen as a mltilayered and complex one. It cannot be reduced to the (more or less straightforward) adaptation of individual behaviour to the signals sent out by "incentive structures" which are derived, in turn, form some "given" set of institutional forms. Legal and social norms operate on individual agency at a number of levels, so that agency itself can be said to presuppose the prior existence of a system of institutionalized norms and rules. Hence, "rational" economic agency presupposes the existence of norms concerning acceptable, legitimate, or conventional behaviour by business parties. The operation of business organizations presupposes the existence of constitutive norms relating to the status of the organizational form (as a public limited or joint stock company, or as a public-sector body) and of its members (employees, managers, and so on). These norms may take a tacit or implicit form, but their relationship to more formal norms at the level, for example, of the legal system, must also be taken into account.

Here, the idea of institutional-based trust, as developed by Zucker (1986), or system trust, as developed by Luhmann (1979), Giddens (1990), and Lane and Bachmann (1996), offers important insights. This point of view holds that trust, by its very nature, cannot be *merely* calculative. This is because he complexity of the environment is such that complete contracting over future contingencies is impossible. But, Equally, it is inappropriate to think of institutional rules or social norms as simply filling in the gaps in "incomplete" contracts, or as providing the necessary "missing" incentive structures, as in the mainstream "law and economics" literature. Much of the importance

of the legal and regulatory system lies in the "taken for granted" quality of the norms which it produces. As Lane and Bachmann (1997) put it, if trust is "a mechanism by which actors reduce the internal complexity of their in-teraction system and which enables the actors to mutually establish specific expectations about their future behaviour, then the principal function of the legal system is not to "be activated and imposed on actors who have cheated. Rather it serves as a background structure which provides for the possibility of sanctions and thus deters from cheating. In other words: norms operate as a set of framework conditions, setting standards which, to a greater or lesser degree, are internalized by agents, and which may serve to reinforce expectations of future behaviour. But it is not being suggested that agents respond in a mechanically instru-mental fashion to the presence of norms. Their choice of action is not predetermined. Rather, legal and other normative influences have a potentially "facilitative" or "channeling" role. Agents faced with the need to co-operate whit one another in a contractual setting have a number of "strategic" options at their disposal as a consequence of the institutional framework within which they operate, and given the resources or capabilities which they have at their disposal.

To sum up our argument to this point, the notion of "calculative trust" is, as Williamson suggests, a contradiction in terms. However, it does not follow, as Williamson implies, that the concept of trust more generally is of no interest to economics. On the contrary, economic analysis should be informed by an understanding of how institutional mechanisms can operate to generate trust. In this respect, the role of the institutional framework cannot be confined to that of "constraining" agents behaviour, as implied not just by transaction cost economics but also by many accounts in the socio-legal and organizational literature. Instead, attention should also be focused on the role of the institutional framework in "channeling" economic activity, in particular by creating an environment in which firms view cooperative behaviour as feasible.

It is essential, therefore, to maintain a distinction between, on the one hand, the process by which individual firms form trusting relationship with each other (which we may refer to as personal or *processual trust) and,* on the other, the *system trust* which derives from the operation of collective institutions (Dei Ottati 1994). The more effective this wider framework is in promoting information flows and spreading the cost of conflict, monitoring, and uncertainty, the greater will be the potential for trust-building through individual relationships and interoganizational links cannot be seen in isolation from the institutional framework within which contracts are made and performed.

System trust and co-operative strategies

In this part, we illustrate the arguments set out above by reference to our empirical work on interfirm realations. As has been suggested elsewhere (ef. Sako, and kern, both this volume), the idea that high-trust relations might improve economic performance has been widely theorized, but relatively little empirical evidence has been produced in its favor. Problems arise in conceptualizing trust, in measuring it, and in obtaining reliable comparative evidence of the performance of different productive systems. The Cambridge study of vertical interfirm contracting (ef. Arrighetti, Bachmann, and Deakin 1997; Lane and Bachmann 1997; Burchell and Wilkinson 1997), on which we will draw here, involved a cross-sectoral and cross-country comparison which throws into relief the impact of the legal regulatory system on contractual practice. It also provides evidence of perceptions of trust on the part of business managers operating under different sectoral and institutional conditions. The study is therefore of particular relevance to our hypothesis that the institutional framework may be an important factor in the generation of trust.

The Cambridge study was based on a randomly selected sample of around sixty firms in two engineering sectors (mining machinery and Kitchen furniture) in three countries (Germany, Britain, and Italy).

Lengthy interviews, using a semi-structured questionnaire, were carried out through visits to the firms which took place during 1993 and 1994. Information was also collected on the sectoral and institutional contidions under which the firms were operating.

The two industries had strongly contrasting features in terms of market structure, entry and exit cost, the extent of capital investments, and the nature and intensity of competitive pressures. Mining machinery is a highly developed and technically advanced industry, which a relatively small and stable population of firms. Until recently, most manufactures had close relationships with coal production companies which were all or part-owned by the state (in particular, British Coal and Ruhrkohle in Britain and Germany respectively). Relationships in the supply chain had been subject to a high degree of regulation, much of it either encouraged or simply imposed by the large coal producers in each country. The collapse of demand for coal in the early 1990s, together with the related effects of privatization in they energy sectors, placed manufactures under severe com-petitive pressures, and, at the time our interviews were carried out, had led them to diversify into rapidly growing export markets including those in China, the former Soviet Union, and Iran, Kitchen furniture, by contrast, is a developing industry which has enjoyed steady growth for several decades as part of the rise in demand for fitted kitchens. On the whole, star-up costs are low (at least for certain segments of the trade), alternative suppliers are readily available, and neither state bodies nor large private-sector firms play much of a role in the organization of the supply chain.

Significant differences in the institutional frameworks of the countries studied were also identified. These included the prominent role of notions of good faith in German contract law; the strength of trade associations and quality standards in Germany; the prevalence of softer, cultural assumptions about quality in Italy; the perceived expense and rigidity of the Italian legal system; and a strong tendency towards "voluntarism" in commercial law and relations in Britain. The single most important difference *at the level of legal doctrine* between the three systems concerns the absence from English law of a generalized principle of good faith in contractual dealings.

The English courts have had difficulty in formulating an acceptable version of the good faith doctrine, and have insisted instead on the need to preserve the notion that commercial parties deal, for the most part, at arm´s length. As a consequence, certain doctrines which are well known in civilian systems, such as requi-rements of pre-contractual duties of disclosure and the possibility of relief for commercial impracticability, have remained under developed; this is also the case, although to a lesser extent, by way of comparison to the commercial laws of the United States (ef. Generally McKendrick 1995; Brownsworld 1997).

In Germany, the principle of good faith in Article 242 of the Civil Code has come to have an extensive influence throughout the body of commercial contract law. The immediate aim of Article 242 is to spell out what performance entails, for example, to show that one need not accept delivery at an inconvenient time... (Leser 1982; 135) but through the interpretations of the courts its function has become one of giving legal force to broad ethical values (*ibid.*, 138). One of the most important areas in which Article 242 has been applied is to require parties to renegotiate long-term contracts which have been subject to an unanticipated event, such as an unexpected rise in prices of fall in demand, in such a way as to go far beyond what would normally be permitted by the common law doctrine of frustration, which relieves the parties from future performance but only in a much more restricted range of circumstances (Dawson 1983); 1984). In Italian contract law, similarly, it has been said that the application of the notion of good faith means that performance of contractual obligations must take place with the loyal and honest co-operation of the parties to achieve the reciprocal benefits agreed in the contract. Only in that way can the contract play its part as a useful private mechanism in the

context of the "social solidarity" which is the inescapable duty of all citizens under Article 2 of the (1949) Constitututions (Criscuoli and Pussley 1991; 142).

The role of good faith in the civilian systems is not confined to this high level of legal abstractions. In Germany, it operates at the micro-level of interfirm relations by virtue of the close relationship between the civil Code, legislation governing terms in standard-form contracts, and the contents of the standard-form contracts themselves which are agreed at industry level. The general effect is to confer a very high level of stability upon the normative framework within which interfirm relations are conducted. Firms rarely seek to vary either the standard term agreements which derive from the trade association or those implied terms which operate as a matter of law, indeed, there is considerable doubt as to whether they may, legally, contract out of those norms which the courts would read into the contract (Casper 1997). Under English law, on the other hand, the parties to commercial agreements enjoy, from this point of view, almost compete freedom of contract: judicially implied terms and the clauses of standard-term agreements operate only at the level of default rules which can varied or omitted as the parties wish. The principal difference between the systems, then resides not so much in the "Quantity or weight of legal intervention (assuming that this can be measured in any relevant way), but in the way in which the different elements of the institutional framework –legal doctrine, industry-level standards, individual contractual agreements– relate to one another. In Germany the relationship between the levels is one of a high degree of functional interdependence, with normative influences flowing in both directions so that the legal system is affected by the content of agreements as well as vice versa. In Britain, neither legal doctrine nor the terms of industry-level associations are particularly important by comparison to the scope given to individual parties to "make their own agreements".
Italy represents a further variation on the nature of the relationship between contract law and norms set outside the formal parameters of the legal system. Here, legal notions of good faith have limited relevance in commercial life, by virtue of the perceived rigidity and inefficiency of the court system. However, the principle of ethical dealing is reflected in trading standards which operate in particular regions or industries and which area linked to the roles played by local government and by trade associations. On the whole Italian associations play a less im-portant role in setting and enforcing standards that their German counterparts (ef. Lane and Bachmann 1997), but they are not negligible force which many associations in Britain have become. The artisanal associations, in par-ticular, operate as a "blend of trade association and government agency (Best 1990; 210) in providing a framework for interfirm co-operation. Economics of scale and risk-sharing are achieved through such means as co-llectively owned industrial parks, financial and marketing consortia of firms, and service centers which collect business information and provide technical training (Best 1990; Brusco 1992). Local associations of firms and artisans also operate to set "benchmark prices" which serve to reduce negotiation costs, limit the opportunistic renegotiation of contracts and, by outlawing cutthroat competition, encourage firms to raise and maintain product quality (Dei Ottati 1994; 473).

How would we expect these sectoral and institutional differences to be reflected in attitudes towards contracting and trust? The voluntaristic framework in Britain would seem to favour adaptation through processual trust, since it provides organizations with a high degree of contractual autonomy: formally, at least, firms have the capacity to shape their own agreements to meet changing circumstances. By contrast, firms in Germany and, to a lesser extend, Italy, operate within a framework of legal and extralegal norms which are largely taken for granted, cannot be contracted out of except at high cost, and which can be changed only through collective action at level of trade associations or through the intervention of the courts. A central question is how firms respond to economic fluctuations, even shocks, in environments which are orientated towards

the generations of institutionalized trust: do such systems allow sufficient flexibility for firms to develop strategies to cope with competitive pressures?

The evidence we have relates to the form and duration of contracts entered into by buyer and supplier firms; respondents perceptions of trust the use of legal sanctions and procedures; and company performance in terms of profitability and employment growth.

The form and durations of contracts:

Sectoral factors had a certain influence on the types of contract agreed firms operated were found to be far more important. Across the two sectors, a greater degree of contractual formality was observed in the mining machinery industry that in kitchen furniture. Mining machinery firms almost all made use of exclusion or limitation clauses to cover themselves against the risk of extensive liability for the cost of lost production if one of their machines broke down. Few furniture firms were faced with potential costs of this kind, and use of exclusion clauses and other complex risk allocation devices was rare. But apart from this, there were no statistically significant differences by sector in the use by firms of written documentation, in their use of legally binding agreements, in the use of particular contractual clauses, in their understanding of the likely cost of legal action, and in the likelihood of legal action against another firm for breach of contract.

However, statistically significant differences in all of the above factors were found at the level of the cross-country comparisons. In relation to the level of contractual formality, German firms in both sectors were much more likely to make use of clauses indicating a high level of interdependence and of formal planning for contingencies. Contracts in Germany tended to be longer term, in the sense of spanning a number of discrete exchanges. In both Britain and Italy, most agreements tended to be order specific or, at best, were loose "framework" or "requirement" contracts under which the buyer could place orders as required. British firms were the least likely to have formal performance standards based on audits and rating systems incorporated into contracts.

German and British agreements were found to be significantly more likely that Italian ones to contain clauses providing for a degree of exclusively dealing, protection of intellectual property rights, and retention of little over property after sale. In relation to planning, German firms were most likely to have hardship clauses requiring the parties to renegotiate the contract in the event of an unforeseen contingency (see Table 5.1). By contrast, British firms reported finding such terms "confusing". German firms were also more likely to have clauses governing the duration of the contract and allowing for termination for breach of condition or by way or notice; as all these are terms which are only necessary in contracts of a certain duration and covering more that one exchange, their presence is an indicator of the greater length and complexity of German contractual arrangements. Numerous German companies also reported making use of gentlemen's agreements; but their function was one of supplementing the more formal agreements. No German respondents used non-binding agreements or understanding to the exclusion of a formal agreement. Italian firms reported the lowest level of formality of contract terms, with little provision for contingencies and very little use of terms indicating a high degree of interdependence. The UK firms occupied a middle position, this is largely accounted for by an important difference between the two sectors.

With the kitchen furniture firms relying on contract formality far less than firms in mining machinery.

TABLE 5.1.
TYPES OF CLAUSES IN CONTRACTS

	Germany		Britain		Italy	
	№ Of firms	% of firms	№ of firms	% of firms	№ of firms	% of firms
Firms with clauses in contracts for: Retention of little[1]	19	86	15	93	1	5
Protection of intellectual property rights	17	77	10	63	2	11
Exclusive dealing	12	57	5	31	3	16
Hardship	15	68	0	0	0	0
Exclusion or limitation of liability[2]	13	59	12	75	4	21

TABLE 5.2.
PERFORMANCE STANDARDS AND INTERFIRM LINKAGES

	Germany	Britain	Italy
Percentage of firms with: Just in time	65	58	42
Quantity guarantees[3]	61	25	53
Formal Quality audits[4]	76	37	74
Rating systems	87	35	72
Computerized links	45	42	5
№ of Firms	21	19	19

Other mechanisms cited by firms as means to promote long-term relationships included use of just-in-time delivery, guarantees of quantities to be supplied, formal quantity audits, rating systems and computerized links. The British firms in the sample had a significantly lower incidence of formal performance standards based on audits and rating systems than in the two other countries, and they were also significantly less likely to make use of guarantees of future supply (Table 5.2). British firms valued personal contacts more highly than financial or technical assistance in building long-term relationships (Table 5.3), while in Germany, personal contacts were important but not to the exclusion of financial or technical ones.

TABLE 5.3.

	Germany	Britain	Italy
Percentage of firms: Financing arrangements[5]	47	25	5
Technical assistance[6]	56	65	32
Personal contacts	86	95	68
№ of firms	23	20	19

1. Intercountry distribution significant at the 1% level using the Chi-square test.
2. Intercountry distribution significant at the 5% level using the Chi-square test.
3. Intercountry distribution significant at the 5% level using the Chi-square test.
4. Intercountry distribution significant at the 1% level using the Chi-square test.
5. Intercountry distribution significant at the 10% level using the Chi-square test.
6. Intercountry distribution significant at the 5% level using the Chi-square test.

Taken together, these finding indicate that the most highly formalized linkages were to be found in Germany, while in both Germany and Italy there was a strong emphasis on formal mechanism for raising quality. British firms placed the greatest emphasis on personal contacts, but such contacts were also important in the other two countries and in particular in Germany. In Britain the tendency was to see personal relations as independent of more formal mechanisms for collaboration, whereas in Germany the perception of managers was that "gentlemen´s agreements" and other personal understanding only operated in the context of an otherwise stable institutional framework.

Perceptions of trust:

When asked what was their understanding of trust in business relations, respondents gave answers which describe trust largely in interpersonal or processual terms. Thus, trust was seen as the ability to depend on other firms being honest, reliable, open, fair and co-operative, and on being able to keep their word, whether given contractually or otherwise. Firms saw the process of building and maintaining trust in terms of both projecting themselves as trustworthy and deciding whether to trust others; in both cases they identified the importance of establishing or investigating a firm's reputation, experiencing its performance, and building personal contacts and long-term relationships.

Nevertheless, even at this general level, intercountry difference differences in responses were observed. A relatively high proportion of the Italian firms surveyed associated favourable past experience with trust and saw themselves as having no particular strategy for establishing themselves as trust worthy. They saw satisfaction with performance as a means of deciding whether other firms could be trusted and chose to terminate relationships when other firms proved untrustworthy. A relatively large proportion of British firms said that personal contacts were important in establishing themselves as trustworthy and in deciding whether other firms could be trusted, and a relatively large proportion said they tried to sort out the differences through persona contact when another firm proved untrustworthy rather that end the relationship. This suggests that in establishing and maintaining business relations, informal personal links are relatively important. In Germany, a higher proportion of firms emphasized the importance of reputation of competence, reliability, and straight dealing for establishing themselves as trustworthy; German firms were more likely formally to investigate the reputation of others before they decided whether they could be trusted, and to resort to contractual protection against untrustworthiness. This indicative of a system in which firms are careful about entering into business relationships, but where, when they do, the expect such relationships to endure.

Respondents were shown a list of actions and were asked to score on a scale 1 to 10 (where I was of no importance and 10 was most important) the degree to which they associated each action with trust in business relationships (ef. Burchell and Wilkinson 1997, for a more detailed account of these findings). The actions can be broadly divided into three groups. There was first a set of actions associated with the idea of *contract adherence* (these were: paying and delivering on time; maintaining high product quality at all time; preserving confidentiality; ensuring the relevant standars are complied with; and honouring strictly the terms of contracts). There was secondly a set of actions associated with flexibility. Certain of these can be thought of in terms of gap-filling and discretionary behaviour, of *flexibility beyond contract* (being ready to exchange business information; honouring informal understandings; and being ready to renegotiate the terms of contracts at any time). Other actions could be classified as more social in orientation, and as representing a form of *flexibility regardless of or outside contract (*being ready to help in an emergency, being prepared to give and take being willing to overlook occasional faults).

There were important intercountry differences in the ranking of the mean scores for responses under these headings. Statistically significant

differences in intercountry scores were found for the categories of preserving confidentially (German 9.1, British 8.0, Italian 7,7); strictly honouring the terms of contracts (Italian 8.3, German 8.0, British 6.0); being prepared to give and take (German 7.8, Britain 7.7, Italian 5.9); and being willing to overlook faults (British 7.3, German 5.6, Italian 4.8). In sum, the Italian respondents put relatively more weight on the association between *contract adherence* and trust that those in the other two countries, especially in Britain, while, on average, the British respondents associated trust more highly with *flexibility outside contract* than with contract adherence. This is indicated in particular by the relatively high mean score given by the British respondents to the category of being willing to overlook occasional.

Faults and relatively low mean scores to the headings of "strictly honouring the terms of contracts and ensuring that the relevant standards are complied with. The German and Italian firms gave high average scores to contract adherence, but the German respondents saw a greater association between flexibility and trust, and in particular *flexibility beyond contract*.

In short, despite the general association of trust with factors operating at an interpersonal or processual level, firms in different systems tended to adopt different strategies for achieving goodwill trust based on flexibility. The role of the contractual environment in fostering certain types of co-operative strategies can be seen more clearly in the context of our finding on the use by firms of legal remedies and sanctions for breach of contract.

Trust and the Legal System

The survey found evidence of important differences in respondents´ attitudes in general towards the legal system, trading standards and the role of trade associations in the sectors and countries studied. In Germany, respondents commented that their contracts were shaped by the general law as well as by the "general conditions of business" applying in their industry. Both the Civil Code and the general conditions were seen to apply "as a matter of course", as did quality standards laid down by the DIN and by trade associations. These findings, when taken together with the results of the questions on contract form and duration, indicate a high level of awareness on the part of the German firms of the legal and regulatory framework for exchange, as well as a high level of stability within the framework of norms operating at both sectoral and notional level. There is a strong contrast here with Italy, where firms were unable to estimate the cost and out comes of legal action and did not rely extensively on contractual form to shape their relationship. This appears to reflect a system in which the court system is seen as slow, expensive, and uncertain in terms of outcome. In addition, the impact of formal standard setting and regulation by the state and by sectoral bodies alike was seen as limited. In Britain, there was a sectoral divide. Most mining machinery contracts were detailed and sophisticated, but a large proportion of firms in the kitchen furniture sector reported that informal understandings were common, with some firms conducting business over long period without either legally binding or written agreements.

A clear intercountry difference also arose with regard to methods of dealing with untrust-worthy behaviour (Table 5.4). When asked how they dealt with untrustworthiness in business relationships, more that 50 per cent of all firms suerveyed said they ended relationships immediately, 21 per cent made contractual arrangements to cover the risk, and 14 Per cent made more informal efforts to sort things out. All but two (88 percent) of Italian respondents to this questions claimed that they would terminate relations immediately. Such immediate action would also be taken by 50 per cent of British respondents while 25 per cent tried to sort out differences, and 25 per cent made contractual provisions to cover risk. An even smaller proportion of German firms said that they would respond to untrustworthiness by ending relationships (32 per cent), and a much higher proportion (41 per cent) responded by making contractual provisions´ to cover risk.

TABLE 5.4.
HOW DO YOU DEAL WITH UNTRUSTWORTHY BEHAVIOUR?[7]

	Germany	Britain	Italy
Percentage of firm who: Terminate immediately	32	50	88
Terminate eventually	5	5	0
Limit exposure	9	0	6
Contractual protection	41	15	0
Personal contact	14	25	0
Other	0	5	6
Nº of Firms	22	20	16

We have described the predominant British strategy in terms of *flexibility outside contract,* because the informal contacts and understanding on which the parties relied to do business most often arose independently of, and sometimes even in contradiction of, the terms of a formal agreement. In Germany, on the other hand, *flexibility beyond contract* meant that flexibility tool account of the contract in the sense of filling in gaps or providing for additional elements of performance. In Italy, the absence of hard standards and the cost of using the legal systems to enforce contracts was made up for, in part, by the presence of widely accepted social norms governing quality and reliability and by collective provision of public goods, as well as by an implicit threat to cease trading with any firm which failed to match up to these expectations.

Did the voluntaristic approach of the British firms lead to reduced reliance on costly legal procedures for enforcing agreements? There was no evidence that this was the case, indeed, there was evidence to the contrary. German respondents made frequent references to the role of normative influences, in particular the standard form contracts of industry-level trade associations, in shaping contractual practice, but they expressed the greatest confidence in their ability to predict the level of legal cost and they were the most likely to carry insurance against legal liability (Table 5.5.). They were also the least likely to take legal action for breach of contract, even to recover debts (Table 5.6). By contrast, legal action for non-payment of the price was regarded as highly likely in Britain in both the sectors studied, but in particular in the kitchen furniture sector which exhibited the lowest level of contract formality of any of the industries studied, in the sense that several firms in this sample reported that they dispensed with contractual documentation altogether in favour of informal understanding. A number of British firms in both sectors complained about the practice of late payment of debts and many looked on legal action to claim the price as a matter of first, rather than last, resort.

TABLE 5.5.
DEGREE OF CLARITY CONCERNING THE OUTCOME OF LEGAL ACTION[8]

	Germany	Britain	Italy
Percentage of firms who are: Very clear	77	37	0
Clear	0	26	5
Unclear	23	37	95
Nº of firms	13	19	19

7. Intercountry distribution significant at the 1% level using the Chi-square test. The German column sums to more than 100 because some firms gave more that one response.

8. Intercountry distribution significant at the 1% level using the Chi-square test.

TABLE 5.6.
LIKELIHOOD OF LEGAL ACTION AGAINST A CUSTOMER OR SUPPLIER COMMINTTING A BREACH OF CONTRACT[9]

	Germany		Britain		Italy	
	№ of firms	% of firms	№ of firms	% of firms	№ of firms	% of firms
Very likely	0	0	9	45	1	5
Fairly likely	0	0	1	5	3	16
Likely	1	5	2	10	0	0
Unlikely	9	41	1	5	6	32
Very unlikely	12	54	7	35	9	47

On this basis, there is some evidence to suggest that the presence of a formal legal contract may be part of a strategy of building a "trusting" relationship in which the parties are able to avoid the use of the courts (Germany); alternatively, in the absence of effective court-based ordering, firms revs on intermediate institutions and on a widely shared commercial morality, as well as the availability of alternative sources of supply, to achieve co-operation (Italy). By contrast, a strategy of basing the exchange on loose understandings and "give and take", while it has certain advantages from the point of view of encouraging close personal dealings, may also lead both to distrust and to frequent recourse to the courts (Britain). In Britain, then, the relatively limited role for system trust did not necessarily entail a greater role for interpersonal or processual trust. Rather, the weakness for collective institutions resulted in an environment in which the formation of trustworthy relations was inhibited by the tendency of the more powerful firms to pursue their market advantage for all it was worth. Consider, for example, the following statement, made by British respondent in the mining machinery industry:

> There has been a fundamental change. In the old days of standard form conditions it was easy to place subcontracting work. Now that customers are varying their terms and conditions so quickly, there are enormous costs monitoring this and of customizing terms with our own subcontractors. The whole process is much more difficult and twice the cost of before.

9. Intercountry distribution significant at the 1% level using the Chi-square test.

British respondents reported that it was becoming common for larger customers to seek to customize the normal industry-level terms, often insisting on the insertion of terms which exposed their subcontractors and suppliers to a high level of risk. Suppliers reported that they were obliged to accept this practice as a condition of continuing to do business with these customers. Instability in this aspect of the institutional framework was put down to the effects of the sharp recession of the early 1990s and also to privatization in the electricity and mining industries, which had led to a reassessment of previously established standard form agreements.

Trust and Economic Performance

We turn finally to the question of how far different modes of contractual organization are reflected in economic outcomes. The data do not reveal a significant link between the adoption of practices which would indicate a high degree of close co-operation, and superior firm-level performance. No significant correlations were found between the adoption by *individual* firms of one of the features of close co-operation listed above (such as financial assistance, or quality audits), and their performance as measured by increases in turnover and/or employment in the five years before the date of the interview. Both within the sample as a whole and within individual countries, the incidence of "relational" contracting was randomly distri-buted among more successful and less successful firms.

Evidence was collected from firms concerning changes in turnover and employement between 1998 and 1994. As would be expected, mining machinery firms sustained a greater level of job loss and greater fall in turnover during this period than firms in the kitchen furniture sector. Differences by country are less marked, nevertheless, only 33 per cent of the British firms reported any growth of turnover in real terms in the period of questions as opposed to 61 per cent of German and 50 per cent of Italian firms. 39 per cent of the British firms reported rapid decline in turnover, compared to 14 per cent in Germany and 11 per cent in Italy. In relation to employment, only 27 per cent of British firms reported a rise, compared to 53 per cent to German firms and 67 per cent of Italian firms. At the other extreme, 39 per cent of British firms reported rapid decline in employment, compared to 19 per cent in Germany and 6 per cent in Italy. There is evidence to indicate, then, that the location of a firm may make a difference to its performance in terms of employment and turnover.

It was take performance of industries as a whole as opposed to that of individual firms, the British pattern stands out: a small group of successful firms at one extreme is set against a long tail of under performers at the other. This is also indicated by information on the export orientation of firms. A larger percentage of British firms that in either of the other two countries had no overseas customers al all (45per cent, as opposed to 14 per cent in Germany and 11 per cent in Italy), but at the opposite end of the scale, a sizeable group of British firms had more than half of its customers overseas (15 per cent, as apposed to 9 per cent in Germany and 5 per cent in Italy).

If it is only at the level of particular industries that German and Italian firms on average performed better than their British counterparts, this raises the possibility that the relational linkages which, in different forms, exist in Germany and Italy, have improved the *general* level of performance of firms in those systems, by requiring firms, as an effective precondition of entry, to come up to a certain threshold. Evidence for this view is supported by the findings of Jarvis and Prais (1995), to the effect that the level of quality embodied in German consumer goods in a range of industries was substantially higher than that for equivalent British products. This suggests, in turn, that the export performance of firms is linked both to the nature of consumer demand in their domestic markets, and also to the domestic institutional conditions under which our data reveal reflect the managerial and other capabilities of individual firms to meet the required standards; the institutional influences which serve to promote quality in a given system are necessary but not sufficient conditions for its achievement at the level of the firm. But even if individual firms vary in their capacity to compete, it may still be the case that such institutional support is a prerequisite for the enhanced competitiveness of the system as a whole.

III. Conclusion: ¿Legislating for Trust?

This chapter has aimed to reassert the importance of the law-trust relation for the understanding of contractual relations. The long-accepted view that the legal system is "marginal" to contractual processes needs to be reexamined. This view can only be maintained if law is regarded in a narrowly instrumentalist sense. Closer attention should be paid to the standard-setting functions of law and to he close interdependencies between highly formal, legal norms, and less formal social norms. In particular, intermediate institutions (in particular, trade associations and standard-setting organizations) should be seen as playing an important role in the process by which the meta-values of the legal system come to be translated into the more concrete terms of standard form agreements, and into looser notions of business ethics.

This suggested reassessment of the role of the institutional framework, and of legal-regulatory mechanism in particular, may help to cast

light on the contemporary debate over trust. Economic analysis is right to be skeptical of "the idea of a disembodied notion of trust floating around somewhere in the social ether" (Kay 1996: 256). On the other hand, little is gained if trust is seen as simply the end product of contractual strategies based on rational choice (Williamson 1993). We have sought to show here that a way forward may be found by adopting a conceptual division between system trust and interpersonal or processual trust. While it is often through experience, reputation and other processual mech anisms that trust is built up and maintained between trading partners, a crucial influence is also provided by the environment in which they operate. The issue at stake here is to explain the ways in which transactions are made possible or facilitated by the presence of systemic rules of a certain kind.

One way in which transactions of a certain kind may be encouraged is through legal sanctions against opportunistic or uncooperative behaviour. According to Williamson, the institutional framework (or environment) may be conceived of as a set of parameters, changes in which elicit shifts in the comparative cost of governance (1996; 112). It follows that the need for transactions-specific safeguards (governance) varies systematically with the institutional environment within which transactions are located... Accordingly, transactions that are viable in an institutional environment that provides strong safeguards may be nonviable in institutional environments that are weak (ibid 267). We may agree that the institutional framework is an important determinant, in this sense, of risk, and hence of the strategies which trading partners may pursue. The empirical research which we have drawn on in this paper provides some support for that view. However, it is necessary also to recognize that penalizing opportunism is just one of a number of techniques through which the institutional framework may influence economic outcomes. In particular , it may be that norms such as the norm of "good faith", which seek to promote cooperation in a more affirmative way and to set basic standards with regard to contractual behaviour, play a broader role in encouraging the sharing of risk and information between contracting parties.

We should not conclude that it is possible to change the institutional framework at will, or to legislate for trust in any straightforward fashion. The issue, rather, is how regulatory reform might contribute to the establishment of environments which are supportive of economic co-operation. Here, there may be a role for "reflexive law" which operates on the basis of an understanding of the operation of the economic and social relations which are being made the subject of regulation (Teubner 1993). Even then, as we have seen, the relationship between legal norms and economic outcomes is a highly complex one. A wide range of factors influence orga-nizational strategies. Hence, strategies cannot be expected to respond in a straightforward way to reforms initiated from the center. Moreover, insofar as there is a link between co-operative strategies and economic performance, then on the data presented here it is one which may be tenuously observed at the level of the relevant system as a whole, that is to say the relevant industry (or region), but not at the level of performance of individual firms. Nevertheless, this is quite different from accepting that the role of the state is confined to one of putting in place the bare minimum of conditions for the functioning of a market, in terms of guarantees of contract and property rights. Just as an excess of regulation may, conceivably, stifle innovation (Kern, Chapter 7 this volume), so its opposite, extreme voluntarism, may result in a form of *anomie*, in which contractual co-operation breaks down under the pressure of short-terms self-interest seeking. The precise nature of the relationship between institutional influences and economic outcomes is, as yet, far from being well understood. What is increasingly clear, though, is that the institutional framework plays an important role in determining the success or failure of productive systems.