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Trust and institutions

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Veröffentlichungsversion / Published Version
Arbeitspapier / working paper

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Empfohlene Zitierung / Suggested Citation:
Bachmann, R., & Inkpen, A. C. (2007). *Trust and institutions.* (Reihe Soziologie / Institut für Höhere Studien, Abt. Soziologie, 84). Wien: Institut für Höhere Studien (IHS), Wien. https://nbn-resolving.org/urn:nbn:de:0168-ssoar-196877

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Reihe Soziologie

Sociological Series

Trust and Institutions

Reinhard Bachmann, Andrew C. Inkpen

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Trust and Institutions

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December 2007

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Founded in 1963 by two prominent Austrians living in exile – the sociologist Paul F. Lazarsfeld and the economist Oskar Morgenstern – with the financial support from the Ford Foundation, the Austrian Federal Ministry of Education, and the City of Vienna, the Institute for Advanced Studies (IHS) is the first institution for postgraduate education and research in economics and the social sciences in Austria. The **Sociological Series** presents research done at the Department of Sociology and aims to share "work in progress" in a timely way before formal publication. As usual, authors bear full responsibility for the content of their contributions.

Das Institut für Höhere Studien (IHS) wurde im Jahr 1963 von zwei prominenten Exilösterreichern – dem Soziologen Paul F. Lazarsfeld und dem Ökonomen Oskar Morgenstern – mit Hilfe der Ford-Stiftung, des Österreichischen Bundesministeriums für Unterricht und der Stadt Wien gegründet und ist somit die erste nachuniversitäre Lehr- und Forschungsstätte für die Sozial- und Wirtschafts-wissenschaften in Österreich. Die **Reihe Soziologie** bietet Einblick in die Forschungsarbeit der Abteilung für Soziologie und verfolgt das Ziel, abteilungsinterne Diskussionsbeiträge einer breiteren fachinternen Öffentlichkeit zugänglich zu machen. Die inhaltliche Verantwortung für die veröffentlichten Beiträge liegt bei den Autoren und Autorinnen.

Abstract

This paper deals with the role of institutions in the development of trust among individual actors (managers), among collective actors (firms), and between individual and collective actors. We review various strands of literature on organizational trust and examine the assumptions made about how trust building processes are influenced by institutional arrangements. Building on this discussion, we develop a perspective on the interrelationship between trust and institutions. We examine four situations where the influence of institutions can be conducive to building trust in business relationships: in the early stages of the development of a trust-based relationship; when institutions are relatively strong; when trust needs to be established swiftly; and when the transaction is idiosyncratic rather than based on routine behavior.

Zusammenfassung

Dieses Papier beschäftigt sich mit den Funktionen von Institutionen im Prozess der Vertrauensgenese in Beziehungen zwischen individuellen Akteuren (Managern) und kollektiven Akteuren (Firmen). Es werden mehrere Ansätze zur Konzeptualisierung von Vertrauen in organisationalen Kontexten und deren Annahmen darüber diskutiert, wie institutionelle Arrangements Prozesse der Vertrauensbildung beeinflussen. Vor dem Hintergrund dieser Diskussion wird eine tragfähige Perspektive zur Analyse des Verhältnisses zwischen Vertrauen und institutionellen Strukturen entwickelt. Vier Szenarien, in welchen der Einfluss von Institutionen für die Genese von Vertrauen besonders wichtig sein kann, werden genauer betrachtet: das frühe Entwicklungsstadium von Geschäftsbeziehungen; Fälle, in denen Institutionen relativ stark und verlässlich sind; Fälle, in denen Vertrauen schnell aufgebaut werden muss; und Fälle, in denen idiosynkratische Transaktionen stattfinden.

Keywords

Institutions, trust, interorganizational relations, business systems, neo-institutionalist approach.

Schlagwörter

Institutionen, Vertrauen, interorganisationale Beziehungen, Wirtschaftssysteme, neo-instutionalistischer Ansatz.

Contents

Introduction 1

Institution-based Trust 2

Legal Norms, Contracts and Institutions 4

Non-Legal Institutions, Reputation and Social Structure 5

The Neo-Institutionalist Approach vs. the Analysis of National Business Systems 7

When do Institutions Specifically Matter? 9

Trust in the Initial Stages of a Relationship 9

The Strength of Institutions and the Type of National Business System 11

Swift Trust 11

Idiosyncratic Transactions 12

Conclusion 13

Introduction

Both the intuitive suggestions of the practitioner community and much of the academic literature assume that the development of trust is predominantly a micro-level phenomenon based on frequent contacts between individual actors (i.e. trustors and trustees). Thus, trust is seen as something that is dependent on the idiosyncratic behaviors of people who, for various reasons, get on well with each other rather than ending up in disagreement and conflict. People either develop trust in their interpersonal relationships or fail in doing so when sympathy and goodwill are absent. Studies building on this perspective often conclude that there should be some easy-to-grasp advice on how to behave in relationships in order to foster the development of trust. Other studies with more analytical intentions describe the typical trajectory of a trust-based relationship: from its initial steps to more robust stages and perhaps even to its breakdown and the subsequent repairing efforts. In these studies trust is conceptualized as a psychological phenomenon. Macro-level factors such as institutions are usually not recognized as essential to the quality of the relationships between two (or more) actors (see e.g. the large majority of contributions in Kramer & Tyler, 1996 or in the trust-oriented special issues of several highly ranked US-journals in recent years, including *Academy of Management Review* in 1998 and *Organization Science* in 2003). In the predominantly micro-level contributions on trust, institutions are often seen as external factors that perhaps have the capacity to disturb individuals' intimate relations but not to meaningfully influence them or even be conducive to increasing trust in social or business relationships.

Although institutions play a minor role in the organizational trust literature, there are several important research contributions on the macro aspects of trust, typically oriented around sociological theory (see Child & Möllering, 2003; Hagen & Choe, 1998; a number of contributions in Lane & Bachmann, 1998 and in the 2001 special issue of *Organization Studies* on trust). Concepts such as system trust (Giddens, 1990; Luhmann, 1979) or institutional-based trust (Zucker, 1986) are common in this context and a number of scholars (more so but by no means exclusively from Europe) suggest that institutions have a very crucial influence on the trust building process in inter- and intra-organizational relationships. At least two different and broadly defined branches of organizational literature have an increased interest in forms of trust that are not primarily based on interaction processes between individuals: New Institutionalism (e.g., Meyer & Rowan, 1977; Powell & DiMaggio, 1991; Scott, 1995) and the more empirically oriented literature on National Business Systems (e.g., Haake, 2002; Hall & Soskice, 2001; Lane, 1995; Whitley, 1999). In addition, there are also voices from quite different traditions of thought, such as Rational Choice theory and Game Theory, which are interested in environmental factors that influence individuals' decisions. Coleman, a prominent scholar of the utilitaristic research perspective, finds it almost self-understood that 'it is in the trustor's interest to create social structures

(*sic*!) in which it is to the potential trustee's interest to be trustworthy rather than untrustworthy' (1990: 111).

It is not an easy task to conceptually spell out exactly the way institutions can and do structure the quality of organizational relationships. In-depth empirical or conceptual studies that shed light on this linkage are scarce. Apart from general theories developed in the neo-institutionalist tradition of organization theory, such as organizational isomorphism, not much is known about the precise role played by institutions in influencing the quality of social and organizational relationships in a business environment. The current paper conceptually investigates the relationship between institutions and trust creation. We examine when and how institutions shape the processes of trust development among individual actors (managers), among collective actors (firms), and between individual and collective actors.

This paper is organized as follows. After the introduction, a general understanding and definition of institution-based trust is developed. We then analyse institution-based trust by considering formal and informal institutions and their potential to influence trust building. As an example of formal institutions we examine legal systems. A brief review of the neo-institutionalist approach and the literature on business systems follows. We then discuss situations when institutions actually matter and consider how institutions influence trust development in these situations. The key research question is whether institutions function to merely reassure social actors in their decisions to trust or to act as determinants of a type of trust categorically different from interaction-based trust.

Institution-based Trust

We define trust as the decision (rather than an attitude) to rely on another party (i.e., person, group, or firm) under a condition of risk. Reliance results in actions through which one party permits its fate to be determined by another. Risk is the potential that the trusting party will experience negative outcomes, i.e. injury or loss, if the other party proves untrustworthy (March & Shapira, 1987; Sitkin & Pablo, 1992). Through a leap of faith (Möllering, 2006) trust reduces uncertainty and creates the opportunity for interaction which might otherwise not be possible. Thus, we see trust as a basic social coordination mechanism, similar to power or resource-based incentive systems (Bachmann, 2001; Luhmann, 1979).

A definition of trust drawing on decisions or actions is consistent with the idea that decisions to act in a certain way, rather more than attitudes, shape and modify trustee-trustor relationships in organizational settings. This assumption is particularly crucial when institutional trust, rather than interpersonal trust, is under review. While interpersonal trust may, to some extent, be explained by attitudes, institutional trust is based on decisions made by individual or collective actors in the face of the institutional framework of their socio-

economic environment. Thus, institutional-based trust is a form of trust based on environmental conditions and assumptions about other actors' potential future behavior vis-à-vis such conditions. In our view, institutional trust or institutional-based trust does not mean trust *in* institutions (where institutions are the object of trust) but trust that individual or collective actors develop with reference to specific institutions.

Viewing trust as based on decisions does not necessarily imply that these decisions are always rational. Rather, trusting someone will typically involve social judgments, such as an assessment of the other party's benevolence and competence (Currall, 1992; Sako, 1993), together with a rough assessment of the unrecoverable costs if the other party turns out to be untrustworthy (Bachmann, 2001). In the case of interpersonal trust, if the trustor and trustee are reluctant to interact because they do not know each other well, a third-party guarantor may play a significant role in trust development (Coleman, 1990; Shapiro, 1987a; Zucker, 1986). The third-party provides common knowledge and allows for judgements which would not be possible otherwise. In a similar vein, the concept of institution-based trust is connected to the notion of the third party guarantor that exists outside the trustor-trustee relationship (Bachmann & Zaheer, 2007). However, rather than a third party as a person, institution-based trust involves impersonal structures, i.e. institutions, that are in place to facilitate and encourage trustworthy behavior between actors in a given situation (Zucker, 1986). Such structures are similar to the trust context created by personal actors: they provide a world-in-common, shared knowledge, and familiarity for the actors. An actor in these circumstances trusts another actor because of strong institutional arrangements that are capable of channeling social actors' behavior into relatively foreseeable directions.

McKnight et al. defined institution-based trust as 'the security one feels about a situation because of guarantees, safety nets, or other structures' (1998: 475). Structures that could create a sense of security include regulations, laws, professional codes of conduct that are or are not legally binding, corporate reputations, both explicit and implicit employment contracts, and norms of behavior such as those that facilitate internet auctions and other business transactions. Institutions also include norms of behavior that are deeply rooted in national cultures and values. For example, in the continental European business environment, and especially in Germany, active and powerful industry associations and their role in defining the terms of business can be very conducive to developing high levels of trust in interorganizational relationships (Lane & Bachmann, 1996; Bachmann, 2001).

According to Giddens (1984), institutions are structural arrangements represented by rules of behavior through which individual and collective action is channeled. They create social order by providing patterns of behavior used by actors to lend meaning and legitimacy to their behavior. Institutions can occur in the form of subsystems of socio-economic environments. Examples of subsystems include the legal system, the system of education and vocational training, the system of financing smaller and larger investments, and the system of industry associations (Lane, 1995). These subsystems may be seen as formal

institutions if they are based on explicit rules of behavior. Institutions also include informal practices associated with: applying legal rules, teaching and learning, financing of investments, the use of industry associations' resources by their members, structured improvements in product quality (e.g. a kaizen process), the treatment of vulnerable suppliers, and lobbying for technical standards. Informal practices become important institutions when they acquire stability and common acknowledgement.

Legal Norms, Contracts and Institutions

An obvious question associated with institution-based trust is: How exactly do institutions allow trusting parties to deal with the inherent risk that accompanies trust? With reference to this question, Luhmann (1979) argued that, for example, contract law can be an effective risk reducing institution because it aligns actors' expectations and behaviors, making them more predictable.

Consider the case of two organizations that have entered into a contractual relationship. There are no guarantees that the organizations will comply with what the law requires from each party but there is a high probability that the actors will orient their behavior to the existing formal legal rules in societies with effective legal systems. Usually, in the interaction between trustor and trustee, the contractual relationship will function without the trustor having to directly and explicitly resort to contract law or to threaten to mobilize the sanctions attached to the law. If the trustor did this, these actions would surely get in the way of a productive business relationship. Instead, the law as a formal institution providing explicit rules does its job best when it remains latent and both parties only vaguely know that there are ultimately sanctions available if one side violates the agreement (Luhmann, 1979). If sanctions need to be triggered, the law has actually failed to do its job efficiently because the sanctioning process will be costly, time consuming, and may preclude the two parties from working together in the future. Long before any conflict arises, legal norms are effective in aligning both parties' expectations. Thus, the existence of powerful legal rules will, in most circumstances, prevent contracting parties from engaging in conflict and encourage predictable and agreeable behavior instead.

If contracts are generally not enforceable and if the contracting parties are well aware of this, the likelihood that trust will be fostered by means of legal rules will be low. That said, it is possible that the contract itself, as a commonly respected social pattern of behavior, may mitigate some risk and facilitate a viable relationship between both parties. In contrast, where contracts are reliable and enforceable, the strong institutional safeguards that exist will rarely be put to the test. In this context it is interesting to note that some scholars see legal recourse via contracts rather than law as the pivotal institution in contractual relationships (Poppo & Zenger, 2002). With regard to our understanding of institutions, we disagree with this view. Only when the existence of a contract leads to behaviors outside the specific

bonds of the contract or a contract is shaped by the existing legal norms, would these behaviors or documents be viewed as evidence of the existence of institution-based trust. In this case, the legal contract is a tool that can be used to refer to the legal code, which in turn provides structural assurance that the other party will not act opportunistically. A contract as such can be a mere formalization of an idiosyncratic relationship between two business partners. This is typically the case in business systems that are characterized by a low level of institutional controls and safeguards (Child & Möllering, 2003; Humphrey, 1998). Even though the enforcement of a contract may be questionable given the nature of the legal system, the contract solidifies the relationship between parties but will only be relevant in the process of building institutional-based trust if it is understood as emanating from collectively accepted legal rules.

In line with this assumption about contracts, empirical research has shown that a contract can serve as a reassuring device that confirms what the written legal code requires from the contractors in a business situation. Business systems that build on the tradition of civil law, rather than common law, typically have such powerful rule-based legal codes (Arrighetti et al., 1997). These business systems are characterized by standardized general legal rules and a high level of institutional control through these and other arrangements. Regulation by means of legal norms features strongly in this type of business environment. In contrast, common law, which is widespread in English speaking countries, is not based on general rules and is relatively weak as an institution. It leaves a lot more freedom – and burden! – to the individual contractors to specify the nature of their relationship in their contract than civil law, which has its home in Continental Europe and is widely used in Asia.

Non-Legal Institutions, Reputation and Social Structure

Various non-legal and less formal institutions also influence organizational and managerial behavior. Non-legal institutions range from quasi-legal institutions, such as the professional societies that control the entry and behavior of accountants and lawyers, to societal rules and norms of behavior that influence organizational actions. For example, in Japan or Germany, hostile takeovers historically have not been accepted as a means for gaining corporate control. Thus, in an acquisition situation, there is little risk that a potential acquirer will launch a hostile bid. The interactions between target and acquirer in Japan and Germany will thus be very different from those that might occur in the United States, where many hostile acquisitions start out as friendly discussions between potential suitors but then become fierce and hostile battles.

Corporate reputation can also be considered an important source of non-legal institution-based trust. In other words, the reputation of an organization functions like an institution. Similar to legal rules or formal rules of business behavior such as ethics guidelines issued by industry associations, an organization’s reputation channels behaviors of and towards this

organization in certain directions, which in turn makes the future behavior of the reputable organization and the observer more predictable. A firm's reputation will influence the degree of attraction one has to affiliating with such an organization and affect whether one seeks employment with that organization or not. At a macro level, firms that value their reputation as social capital (Coleman, 1988; Putnam, 2002) will be unlikely to engage in practices that have the potential to damage that reputation, thus becoming more predictable and trustworthy.

On closer inspection, corporate reputation acts in two ways in its influence on trust. First, when Firm A engages in a transaction with Firm B, a company with a strong reputation for honest and ethical behavior, Firm A will be more willing to put itself at risk (i.e. rely on Firm B) than it would if Firm B had a reputation for unethical behavior and shady deals. If Firm B was known for questionable practices, Firm A would require stronger controls before it did business with the company. A second way that reputation influences trust is when Firm B uses its strong reputation to influence other firms to behave less opportunistically. To do business with leading firms such as ExxonMobil and General Electric, potential suppliers and business partners must have a demonstrated record of trustworthy behavior. In this example the trustor's reputation is a an institutional reassurance that creates an incentive for the trustee to be trustworthy. If a firm chooses to act opportunistically with ExxonMobil or other leading firms and this action becomes public knowledge, the untrustworthy firm may find it is shunned by other firms in the future even though no written contracts have been violated.

The previous discussion shows how important communities and social structures as well as collective judgment and control are with regard to trust building. A willingness to trust can not only be strongly influenced by institutions and by reputation but also by membership in a community. In a community, members draw on common knowledge and orientations and exert collective control on the behavior of individual community members. In functional terms such communities have an impact on their members quite similar to socio-economic institutions at the macro-level. Being a member of a community lowers the risk that actors from the same community with whom one deals will behave unpredictably, as Coleman (1990) nicely illustrates with reference to the diamond dealers of Antwerp. A highly standardized code of business practices and a tight net of informal control makes it almost impossible for members of this community to behave opportunistically.

Continuing this argument, consider the internet and the variety of different business communities that could not function without the collective willingness of parties, who usually do not know each other, to trust each other. Within internet communities, users form opinions about whether and to what degree multiple buyers and sellers can be trusted and in doing so, form an opinion about the community itself (Pavlou & Gefen, 2004). Information about many individual sellers serves as a proxy for the overall reputation of the seller community. Unlike dyadic trust between two actors, community-based trust is impersonal and is based on generalized perceptions of the community and its ability to function in a manner that is

honest and consistent with members' expectations. Buyers and sellers in online auctions will rarely meet or know each other and yet be willing to engage in transactions, with both aware that the other could be trying to cheat. Nevertheless, online auctions have become an enormous business and the level of cheating is very low. The reason is that community structures provide a third-party guarantor function in the relationship between the trustor and the trustee. This allows for familiarity and collective, i.e. legitimized, control of actors' mutual expectations and behavior. The community structures act as formal institutions to lower the inherent risk of trust and make actors more inclined to invest trust in a relationship than if such structures were not in place.

The Neo-Institutionalist Approach vs. the Analysis of National Business Systems

Institutions and the rules they incorporate often appear detached from individual social actors' preferences and intentions. This makes them look like unalterable forces ('faits sociaux' in Durkheim's (1895/1982) terminology) or natural laws that are both difficult to ignore and neutral with regard to individuals' socio-political interests. However, institutional rules are never set in stone and made for eternity, as many critical social scientists have pointed out. Institutions represent the views of a large number of social actors that permanently confirm the validity and acceptability of these rules by their concrete patterns of interaction (Giddens, 1984). Thus, institutions can be changed by social actors and, although a rare phenomenon, may evolve rapidly through a revolutionary event. In almost all times and places in the world, marriage can be seen as an example of an important societal institution. Although it is possible that marriage could vanish as a form of long-term partnership between two individuals who establish a specific emotional bond and have children together, this could happen only if a large number of individuals radically question its legitimacy and usefulness.

Institutions are relatively stable bundles of commonly accepted rules of behavior to which many people orient their relationships and forms of behavior. Irrespective of what single actors may think about a specific institution, institutions create guidelines of behavior that cannot be ignored. Social order of any kind manifests itself in institutions (Parsons, 1951) and even where old institutions are overthrown, new ones will emerge. At the same time, the strength of institutions can vary greatly between socio-economic systems and the degree of embeddeness of interactions in the given institutional arrangements (Granovetter, 1985) is another variable that matters when empirical contexts are under review.

The neo-intuitionalist approach in the analysis of business relationships, which has flourished since the early 1990s, emphasizes institutional arrangements that both enable and restrict actors' behavior. After about two decades of focusing on the creative and micro

aspects of individuals' behavior in the 1970s and 1980s, social theory in general and organization theory in particular became more interested in social structures and institutional order. Since then, many social and organizational scholars have re-balanced their views and tend to place more weight on institutional analyses that are geared to understanding not only the restrictions of social action but also the formative elements in social practices (Reed, 2001). Powell and DiMaggio (1991), Scott (1995), and Meyer and Rowan (1977) are some of the scholars involved in the neo-institutionalist approach in socio-economic and management studies. In their view, institutions have little to do with what economists and political scientists mean when they use this term. Institutions, in their sociological perspective, are generalized rules and patterns of behavior that are engrained in all kinds of social interaction (Berger & Luckmann, 1996). Trust is seen as intrinsically developed through these patterns of behavior and can never exist outside them. Thus, trust is primarily seen as institutional-based, following from collectively accepted norms and is not grounded in socially dis-embedded individuals' rational (or indeed non-rational) decisions (Giddens, 1990).

By contrast, the literature on national business systems (Hall & Soskice, 2001; Lane, 1995; Sorge, 1996; Whitley, 1999) shows less interest in abstract theoretical conceptualizations when analyzing institutional arrangements. In this body of literature, institutions are rarely defined as general forms of behaviors. Instead, in this relatively under-theorized view, a number of elements of the institutional framework of business systems are empirically identified (e.g. Whitley, 1999) and different countries' business systems are characterized by attributing country-specific variables to these elements. The quality of industrial relations, the system of vocational training and education, the legal system, and corporate governance practices are, like legal arrangements, often seen as institutions that differ from country to country. The research on intellectual property rights regulations (Andersen, 2006) finds significant national differences and the literature on alternative firm ownership structures (e.g., La Porta, Lopez-De-Silanes, & Schleiffer, 1999) analyzes corporate and legal practices that explain differences in firm ownership patterns across countries.

Looking at trust, the national business systems literature discerns high trust business systems and low trust business systems. Fox (1974) examined British and German industrial relations and was one of the first scholars to suggest such a conceptualization. In contrast to studies that see the differences between socio-economic systems rooted in culture, such as Hofstede (1991) or Trompenaars & Hamden-Turner (1997), the national business systems literature analyzes the fit between institutional characteristics of business systems and institutional configurations. Different from many neo-institutionalist contributions to the debate, the business systems literature provides strong empirical data, especially from a comparative perspective (e.g. Casper & Whitley, 2004 on the biotech industry), and much is known today about the varieties of capitalism (Hall & Soskice, 2001) and forms of trust development that exist around the globe through this approach. However, without references

made to neo-institutionalist approaches, the theoretical strength of the business systems approaches remains weak.

When do Institutions Specifically Matter?

While we do not claim that institutional structures *always* and *exclusively* foster the development of trust between two actors, we see institutions as a vital source of trust in differentiated socio-economic systems. Depending on the specific circumstances, there are often ways to develop trust through interactions between actors and without reference to institutions. But so-called personal trust or micro-level trust can be costly and sometimes ineffective (Bachmann, 2001; Zucker, 1986). We believe there are specific situations where the influence of institutions can be conducive to building a sufficient level of trust in business relationships. In this section we identify four such situations: in the early stages of the development of a trust-based relationship; when institutions are relatively strong; when trust needs to be established swiftly; and when the transaction is idiosyncratic rather than based on routine behavior. The prior research examining when institutions might matter to trust (e.g. Lewicki & Bunker, 1996) is patchy, vague and sometimes misleading. The following discussion presents a systematic and theoretically grounded approach to institutions and trust.

Trust in the Initial Stages of a Relationship

Institutions can be an important factor in trust creation in business environments where an intensive trust-based relationship is envisaged but limited or no previous interaction between the two (or more) parties exists. Consider what happens when a new joint venture is formed. At the formation stage, information about the other partner and, in particular, information about the managers involved in joint venture management will be fuzzy and/or incomplete. Assume a manager is assigned to the joint venture from one of the partners. Although this manager may be aware of prior relationships between the partners and may view the manager from the other partner as friendly and reliable, the willingness of that manager to trust may be tentative. In this situation, various institutional controls, such as legal recourse and clear operating rules, may encourage the manager to accept that the individuals in the partner firm will act in a trustworthy fashion. These controls create structural assurance belief effects (McKnight, et al., 1998) and were described by Shapiro as institutional side bets (1987b: 204).

Beliefs about institutions will help shape beliefs about the managers involved in the joint venture (McKnight, et al., 1998). For example, the specific language of the joint venture shareholder agreement may provide for legal recourse in the event that the partner violates certain provisions. Especially in the early stages of interactions among managers, if an

individual manager believes that legal recourse for the firm provides some positive assurance about the partner's probable future behavior, the manager will be more likely to initiate trusting action of his (her) own. Thus, trust is not just a function of the relationships among managers; it is also a function of the nature of the institutional context in which these relationships are embedded (Nooteboom, 2002; Sheppard & Sherman, 1998). The support for this argument is that safeguards produce perceptions of safety, which may lead managers to place themselves at risk with other managers. Without these safeguards, managers might be more focused on self-protection than mutual task performance (Sitkin, 1995). Over time, when information about counterpart managers becomes more complete, the safeguards will have less influence on managerial trusting behavior. But initially, managers will be more likely to trust partner managers when they know that, at the firm level, structural safeguards exist.

In many transactions the development of interaction-based trust would be much too time consuming and involve high costs (Bachmann, 2001; Barney & Hansen, 1994). Lane and Bachmann (1996) argued that rather than evolving spontaneously at the interpersonal level, trust-based buyer-seller relationships are often highly dependent on the existence of stable institutions. Thus, in the early stages of a business relationship characterized by limited prior interaction between parties, the existence of safeguarding institutions that involve no individual managerial effort to create or nurture can support transactional efficiency.

Proposition 1: The role and effectiveness of institutions in trust creation will be negatively related to the amount of prior interaction between the two (or more) parties forming a relationship.

As discussed above, institutional safeguards play a role similar to the third party guarantor that Coleman (1990) conceptualized as an individual actor who enjoys the trust of both the trustor and trustee, allowing them to engage in a trust-based relationship without knowing each other directly. The difference between the individual safeguard and institutional safeguards is that the latter are a common good and freely available to anyone who acts within the business system. In the case of an individual third party guarantor, efforts and costs are not negligible on the part of the involved actors. Although establishing and maintaining institutional arrangements comes with costs that need to be paid for collectively and over time in a given national business system, institutional safeguards do not claim their costs against individuals and not immediately. Moreover, individual safeguards are sometimes a scarce resource or are not available while institutions mass-produce trust so that anyone may benefit from them (Bachmann, 2001). Therefore, we propose that in the early stages of relationships, institutions are an efficient means of creating trust between business partners.

Proposition 2: In the early stages of a relationship, institutional safeguards are more efficient as a determinant of trust than individual safeguards.

The Strength of Institutions and the Type of National Business System

Institutions can substitute for, and possibly supersede, interpersonal interactions early in a relationship's trust building phase. This view challenges some existing literature, including Lewicki and Bunker (1996) and Child (1998). These authors assume that at the beginning of a trust-based relationship, inter-personal calculation is important. They imply that if institutional forces come into the picture it will be at later stages of the relationship. According to Lewicki and Bunker (1996) a trust-based relationship starts with calculation-based trust, moves to knowledge-based trust and if everything goes well, leads into identification-based trust. From our perspective, this view is based on specific conditions that will not always exist. In business systems with weak institutional arrangements (legal and non-legal regulatory rules), interpersonal trust development may well be the only option. This view, however, has less plausibility when institutions are strong. In the latter case, transactions can be done on the basis of institution-based trust, often swiftly (see the next section), and risk is mitigated by collectively maintained safeguards. In such an environment, which may not exist in countries like China (Child, 1998) or India (Humphrey, 1998), but does exist in strongly regulated socio-economic systems such as Germany (Lane and Bachmann, 1996), trust-based relationships are frequently initiated on the basis of institution–based trust. Only when relationships are well advanced and much is at stake a more deliberate form of interaction-based trust-building will set in and perhaps even become dominant in the latter circumstances.

Proposition 3: The role and effectiveness of institutions in trust creation will be positively related to the strength of legal and non-legal regulatory rules.

Interestingly, the way trust develops in a specific business environment may provide clues as to how and why particular industries are created and sustained. For example, Continental European firms that inhabit a world of strong institutional regulation are not very successful when it comes to risk-intensive high technology industries (see Kern, 1998 for the German case). German or French firms' strengths lie where a high level of semi-strong forms of trust is required, typically in mature and capital-intensive industries. By contrast, in countries with a generally lower level of institutional regulation, such as the United Kingdom or the United States, deliberate and interaction-based patterns of building strong forms of trust are more important. High-tech industries profit from an environment that fosters more idiosyncratic forms of trust between individuals than a mass-produced form of trust between large organizations.

Swift Trust

Where decisions have to be made swiftly and where it would be inappropriate in terms of time and effort for the involved actors to establish trust at an interpersonal level, institution-

based trust is often indispensable. Not all economic transactions require a high-quality relationship between the exchange partners. Also, business partners do not always have the time and energy to build these types of relationships, especially where one-off transactions are concerned and/or simple low-tech products are traded (Barney & Hansen, 1994). That said, a minimum of trust is a precondition of any exchange taking place between two contractors. This basic form of trust can be called contract trust, which is the trust in the willingness of a contractor to fulfill the contract (Sako, 1992) or swift trust (Meyerson et al., 1996). If this type of trust is to be created with low transaction costs for the trustor and trustee, stable and commonly accepted institutional arrangements can often do a very efficient job. Without having to make explicit considerations about whether to invest in trust or not in a particular relationship, actors can fall back on institutional risk absorption, which in many situations is sufficient and economical.

Proposition 4: The role and effectiveness of institutions in trust creation will be positively related to the speed by which actors wish to complete their contractual arrangements.

Idiosyncratic Transactions

The development of some relationships do not follow familiar patterns because the products or the services traded are unique or because the actors involved have a unique social status. Idiosyncratic transactions may be found in the arts market or where the transaction is politically symbolic. For example, the negotiations that lead to designing and building high-profile memorials usually involve many different firms, individuals, politicians and other actors that have to work together in a unique pattern of transactions. Although trust among such actors will be important, it would often be unlikely that sufficient trust could be developed if interaction-based trust was the only form of trust that was available. In these types of situations where the value of products and services is difficult to determine and prices are politically motivated, institutional safeguards plays a special role. Similar to relationships that are in their initial phases, few existing routines at the micro level of interaction makes it all the more important to be able to fall back on and orient one's behavior to macro level rules and norms, i.e. institutions.

For example, consider the designing and construction of the Holocaust memorial in Berlin which took place a few years ago. To establish trust between the architects, the foreign and domestic politicians, the religious and political NGOs, and the construction firms solely at the interactional level, would have been a virtually impossible task. The reputation of the actors involved played a strong role in establishing trust as did politically legitimized decision procedures. This example shows that idiosyncratic transactions often require institutional-based trust, similar to situations where low-key mass products and services are exchanged on the basis of swift trust.

Proposition 5: The role and effectiveness of institutions in trust creation will be positively related to the idiosyncrasy of the transaction.

Conclusion

The fundamental argument in this paper is that institutions matter in trust development. That said, the role of institutions in trust development is neither well received nor well researched. Indeed, some scholars are dismissive of the notion that trust can be institution-based. Hosmer (1995) suggested that Shapiro (1987a) *rejected* the argument that trust could be institution-based. According to Hosmer, Shapiro was skeptical about the influence of institutions such as ethics codes, practice standards, and regulatory statutes on the behavior of managers. In her view, the temptations to lie, to steal, and to misrepresent the safety and security of institution-based guarantees continued to exist. She concluded that 'in complex societies in which agency relationships are indispensable, opportunities for agent abuse were sometimes irresistible and the ability to specify and enforce substantive norms governing the outcomes of agency action nearly impossible, a spiraling evolution of procedural norms, structural constraints, and insurance-like arrangements seems inevitable' (Shapiro, 1987a: 649). In other words, institutions alone are insufficient for the existence of trustworthy transactions and must be supplemented by a host of additional controls. Reichman (1989: 188) examined fiduciary relationships in capital markets and argued that role conflicts existed and have not been resolved. She quoted Stevens (1987) to show the difficulty of relying upon legal constraints and regulatory procedures: "In the pretzel logic of insider trading laws, gaining secret information from insiders such as lawyers, bankers or arbs is illegal uncovering it on your own is ingenious. The former makes you a criminal; the latter makes you rich."

Our view is that depending on the situation where trust is required, institutions do matter. We identified four specific situations where the influence of institutions can be conducive to building trust in business relationships. In examining these situations, we believe we have made a persuasive case as to why institutions should play a more prominent role in the study of organizational trust. However, we are also cognizant of the reality of human behavior and acknowledge the above concerns of Hosmer and others. Agency problems do occur and agents occasionally abuse their positions, with the result that principals pay the price. As Schleiffer and Vishny (1997) found, shareholders in developed countries are protected by an extensive system of legal rules, which is consistent with Shapiro's statement. The Sarbanes Oxley Act in the United States was in response to the furor over the SEC, the issue of transparency and validity of financial reporting, and the fraudulent actions taken by various managers. However, Schleiffer and Vishny also argued that legal protections are not sufficient to explain why investors in countries such as the United States, Germany, and Japan are willing to put their capital at risk. Institutions associated with corporate governance

underpin financial markets and include both legal and economic institutions that can be altered through the legal process.

The strength of institutional influences is key to understanding institution-based trust. Future research should seek to understand and differentiate situations where institutions are strong enough to directly influence actors to trust each other from those situations where institutions merely encourage or discourage actors who make their choices about trust. To address this question, researchers will need to determine whether actors make deliberate decisions based on well known routines or whether decisions are contingent upon the factors identified above, such as the need for speed or the presence of idiosyncratic transactions.

In conclusion, we believe that institutions provide more than just a reassuring function for organizational actors. Depending on the circumstances, institutional-based trust should be viewed as a class of its own, categorically different from interaction-based trust. Various research opportunities exist to develop these ideas in more detail and we hope that this paper will encourage researchers to inquire into institution-based trust.

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Institutions and Trusts Building

Reihe Soziologie / Sociological Series 84

Editor: Beate Littig
Associate Editor: Iris Strohschein

ISSN: 1605-8011
© 2007 by the Department of Sociology, Institute for Advanced Studies (IHS),
Stumpergasse 56, A-1060 Vienna • ☎ +43 1 59991-0 • Fax +43 1 59991-191 • http://www.ihs.ac.at

ISSN: 1605-8011