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Trust and Economic Development

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Trust, or the lack of it, affects economic development. Trust-based relations appear to foster development, mistrust undermines it. High-trust and low-trust societies are easily recognizable, but how to promote trust as part of a development strategy is less obvious. This paper provides a non-calculative definition of trust and distinguishes between the minimum trust required for basic economic transactions and the extended trust which provides the basis for inter-firm cooperation. Different forms of trust production are discussed. This discussion is used to analyse, first, the problem of the absence of minimum trust in the transition economies of Eastern Europe and the role to be played by the state in creating the framework within which trust can develop. Second, trust in customer-supplier relations and in industrial clusters in developing countries are analysed, and the potential for state intervention, both for creating a stable framework for cooperation and for directly fostering inter-firm cooperation, is considered. The paper concludes with an optimistic view on the possibility of fostering trust.

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TRUST AND ECONOMIC DEVELOPMENT

1 INTRODUCTION[1]

The importance of trust in economic life has long been recognized. John Stuart Mill in his **Principles of Political Economy**, first published in 1848, asks what explains the differences in productiveness between people in different regions and countries of the world. He singles out trust as one of the main factors, alongside natural resources, popular education, skill and knowledge. 'The advantage of mankind of being able to trust one another penetrates into every crevice and cranny of human life: the economical is perhaps the smallest part of it, yet even this is incalculable' (Mill 1900: 68). He emphasizes that an increase in trust helps to bring down a community's cost in terms of lawyers, the judiciary and 'the whole apparatus of punishment' (1900: 68):

> But this positive saving would be far outweighed by the immense increase in the produce of all kinds of labour, and saving of time and expenditure, which would be obtained if the labourers honestly performed what they undertake; and by the increased spirit, the feeling of power and confidence, with which works of all sorts would be planned and carried on by those who felt that all whose aid was required would do their part faithfully according to their contracts.
>
> (Mill 1900: 69)

The best known contemporary recognition comes from Kenneth Arrow (1975: 24) who asserts that 'virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can plausibly be argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence'. More recently, trust has surfaced as a critical issue in several strands of social science, including transaction cost economics (Williamson 1993), economic sociology (Granovetter 1992) and political science (Putnam 1993). More than that, the debate is being conducted not just within but across disciplinary divides.

The debate suffers, however, from confusion over what trust means. The term has multiple usages, designed to address different questions. This paper is concerned with trust because without it there would be little exchange and no cooperation between enterprises. The need for trust arises from irreducible uncertainty over whether commitments will be honoured. **That trust matters for economic development is now well established. It is also clear that trust is often missing. What is less clear is how it grows and how it can be made to grow. This is the main question which is pursued in this paper.** In order to do so, a fair amount of groundwork is needed for which we draw on the work of Gambetta (1988), Luhmann (1979), Sako (1992), Zucker (1986) and others. Sections 2 and 3 together provide the conceptual map for the remainder of the paper.

Most of the theoretical literature deals with the question of what we would call 'minimal trust', that is, the level of trust needed to make economic transactions possible in a situation of imperfect information. This is an important threshold, especially for the economies which are in transition from a centrally planned to a market economy. In current Eastern Europe and Central Asia, building up trust between economic actors is the key to establishing an effective market economy in these countries. The obstacles for doing so are discussed in Section 4. It shows why 'post-communist societies are trapped in a deep syndrome of distrust' (Sztompka 1995: 3), and exposes different views on whether and how trust can be made to grow in fledgling market economies. Platteau (1994a; 1994b) has provided the most thorough survey to date of the social and institutional conditions upon which the reliability and efficiency of the market system rests. While not focused on the ex-communist countries, his analysis implies a cautious, if not pessimistic, view on the possibility of fostering trust where it is absent or has broken down. Moore (1994) has challenged this view, arguing that trust can be built up quickly between economic agents through the act of trade itself. Our discussion of these views does not resolve the issue and present a cure for missing trust. The objective is more modest, namely to identify research questions which need to be addressed to move forward the debate on how to develop trust and help markets function better.

The problem is that these countries do not have the luxury of first establishing a market economy and later worrying about competing with imports or in foreign markets. Such competitiveness is hard to achieve without higher levels of trust, especially in manufacturing. This is elaborated on in Section 5 which draws on the recent literature on industrial organization and suggests that a rise in competitiveness is associated with increasing interdependence between firms. An example is the adoption of Japanese principles of quality at source and just-in-time delivery in supply chains throughout the world, including developing countries (Humphrey 1995a; Kaplinsky 1994). It is also exemplified by the clusters of small- and medium-sized enterprises which have conquered international markets on the basis of their collective efficiency, not only in advanced but also in developing countries (Schmitz 1995). Interdependence is nothing new, but the recent literature on supply chains, clusters and networks, suggests a degree of interlocking which can only function when relations between firms are sustained by more than minimal trust (sufficient for anonymous market transactions). The purpose of Section 5 is to discuss the different ways in which such trust has emerged. As stated above, we are concerned with change: how and why did the change from low to high trust occur, does it depend on socio-cultural factors? Why should it occur at all when there were previous bad experiences? Can it work when relationships are asymmetric? Did the basis of trust change over time?

Section 6 focuses on the role of policy in promoting trust. Clearly the key, if minimal, role of the state is to provide a legal framework and ensure the enforcement of property rights and contract law. While recognized in principle, the practice of legal reform is complicated as apparent in the transition economies. Their experience gives rise to questions such as how to avoid the 'private state' in the form of the Mafia, should the new law be home grown or imported, should it follow a Western or Eastern model? Both the importance and limitations of the legal apparatus are generally recognized. The state can pass laws but cannot legislate that people trust. Public agencies can however help private actors to overcome distrust and facilitate new forms of cooperation as seen in recent experiences in both advanced and developing countries. Finally, Section 7 sums up why we have come to an optimistic view on the possibility of fostering trust.

Two caveats are in order, one concerned with efficiency, one concerned with equity. In this paper trust is taken to be a good thing. We are aware that this is not always the case, that there are instances in which trust is not conducive to general economic performance. Trust can be conducive to mischief, for example when entrepreneurs collaborate to fix prices or bar others from entry. Adam Smith was particularly wary of the anti-social possibilities of cooperation in exchange:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less to render them necessary.
>
> (Smith 1776: 232-3)

Practices of price fixing continue to exist but are not a preoccupation in this paper. We acknowledge such practices but do not see cooperation and competition as mutually exclusive.

The second caveat concerns equity. Trust benefits economic performance, but the benefits can be uneven in the community in which trusting relations prevail. Such internal differences can be along gender lines, size of enterprise or follow other patterns. They are acknowledged, but not explored in this paper. Finally, we recognize that trust is critical to both the relationships between enterprises and within enterprises, we also recognize that the two are connected. This paper, however, does not deal with trust between managers and workers and focuses on exchange and cooperation between enterprises.

In summary, this paper has a four-fold purpose. First, it draws together and seeks to sharpen concepts. Second, it seeks to shift the debate towards the dynamic questions of how and why trust changes. Third, it explores the role of policy in promoting trust. Fourth, it identifies questions for further research. While drawing on the experience of advanced countries, the main concern is with transition and developing countries.

2 THE MEANING OF TRUST

There are different views of what trust means and how it should be defined. A simple definition of trust in human relationships might be, 'Trusting a person means believing that when offered the chance, he or she is not likely to behave in a way that is damaging to us' (Gambetta 1988: 219). The way one refines this definition depends on the purpose of the investigation. This paper focuses on the role of trust in economic development: market economies characterized by high levels of trust seem to perform better than those with low levels. It is concerned with the **relationships between economic agents** (people and enterprises): how trust affects the ways they engage in exchange or collaboration. It is **not** concerned with issues such as trusting that the economy will recover or trusting that pound sterling will not fall further; such issues are in any case captured better by the term 'confidence'. Our starting definition is that agents exhibit trust when they expose themselves to the risk of opportunistic behaviour by others and when they have reason to believe that the others will not avail themselves of this opportunity. This section of the paper discusses under what circumstances agents come to do this and how trust can be seen both as a characteristic of exchanges between particular agents and as a characteristic of broader systems of exchanges.

The question of trust arises from the element of risk in economic transactions. Under perfect competition, economic exchanges do not involve risk. Agents can assume that contracts will be honoured. Risk is ruled out by the assumptions of candid rationality and perfect information. The first assumes that people pursue self-interest, but only in an honest way. Therefore fraud and opportunism are ruled out. The second assumes that agents are fully and costlessly informed about all aspects of transactions and therefore run no risks from fraud, uncertainty and the like. No agent will be able to gain advantage by being dishonest because the potential partner to the transaction will know that cheating is taking place. Similarly, risks in the market arising from uncertainties about future events are ruled out, by assuming (i) spot contracting - there is no future, and no contract made now will have an impact on future contracting - or (ii) assuming perfect information about all future events and the ability to take appropriate action. In contract law, this perfect information position is approximated by the notion of contingent-claims contracting 'which entails comprehensive contracting whereby all relevant future contingencies pertaining to the supply of a good or service are described and discounted with respect to both likelihood and futurity' (Williamson 1979: 236).

In the real world, however, contingencies cannot be specified completely because information is incomplete, specification of contingencies is costly, and legal redress in case of contract default tends to be expensive. The difficulties of going to law are evidenced by the limited use made of legal redress for settling disputes (Granovetter 1992: 65-6; Williamson 1983: 520). Thus agents face risks when they enter exchange. Transactions costs economics has identified these risks as arising from bounded rationality and opportunism.[2] Bounded rationality refers to the fact that agents have limited capacity to collect, store and process information, and that such collection, storage and processing itself incurs costs. Therefore, there are limits to how far contingencies can be predicted and incorporated into contracts. Opportunism refers to the pursuit of self-interest with guile (Williamson 1979). Agents cannot assume that a partner is being honest and candid. This leads to risks associated with fraud, misrepresentation and transaction-specific investments. If these types of risk cannot be handled effectively, exchange will still take place, but many exchanges which would be of benefit to both parties and would increase the welfare of society as a whole will not materialize because of the risks involved. Either the risks will be too great, or the costs of reducing the risks will make the transaction unprofitable.

Risk is an inevitable part of economic life, but agents constantly seek ways of reducing the risk involved in particular transactions. Agents are more likely to participate in a transaction when they have reason to believe that their partners will not act opportunistically. Trust arises when one exposes oneself to the risk of opportunism because one believes that one's partner will not act opportunistically. Gambetta has defined trust in a way which captures this exposure to the consequences of the actions of others:

> trust (or, symmetrically, distrust) is a particular level of the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action, **before** he can monitor such an action (or independently of his capacity ever to be able to monitor it) **and** in a context in which it affects **his own** action.
>
> (Gambetta 1988: 217, stress in original)

We trust people when we act on an expectation of good behaviour and mistrust them when we act on an expectation of bad behaviour. But how does one arrive at this sense of subjective probability and then act on it?

One approach to this problem is to see trust in calculative terms. This interpretation is seen most clearly in game theoretic approaches to the question of risk and trust. The agent decides on the likelihood of default and then decides whether or not to take the risk. In this case, then, trust is extended to the other party, and the risk taken, following a calculation of the benefits of honesty from the other agent, the losses from dishonesty and the probability of each of these outcomes. Trust involves making informed choices in situations of uncertainty which make one vulnerable to the actions of others. In Coleman's words, 'the elements confronting the potential trustor are nothing more or less than the considerations a rational actor applies in deciding whether to place a bet' (Coleman 1990: 99). A decision to trust occurs, in this model, when:

(1) $G * p > (1-p) * L$

in which

G = returns to a particular transaction

L = the loss arising from a default.

p = the probability that the partner honours the commitment

This equation can be amended to include the cost of safeguards and monitoring, S, as follows:

(2) $(G-S) * p > (1-p) * L$

In certain types of transactions, agents merely decide the potential returns and losses and the likelihood of default (Equation One). First, they can become more self-reliant, avoiding exchange altogether (the vertical integration option). Second, they can raise G to reflect the greater risk involved in particular transactions. Third, they can spend money, S, to introduce contractual or other safeguards to protect against opportunism, or increase monitoring of their partners or take out insurance against loss. These either increase p or reduce L. Expenditure on S will be increased when it widens the gap between the two sides of Equation Two.

To what extent is trust involved here? Risk is certainly involved, but in what sense are the agents trusting each other? Williamson has argued that given the calculativeness of such strategies, there is nothing trusting in them at all and that the use of the term 'trust' obfuscates the relation:

> transaction costs economics 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 1993: 463)

Calculations are being made, and the more explicitly this is recognized, the easier it is to isolate the factors which affect such calculations - the return from the transaction, the price at which the transaction takes place, the exposure, the hazard and the existence of safeguards (Williamson 1993: 467-69). Trust is 'irrelevant to commercial exchange' (Williamson 1993: 469).[3]

Williamson's arguments have great force against a purely calculative view of trust. If calculation is merely about risk and reward, then there is no obvious element of trust. It is merely an assessment of risk. One does not trust playing cards when one bets on them.

However, it is possible to construct an alternative view of trust which considers trust as a substitute, or as a necessary complement, for calculation. It is precisely because it is impossible to calculate that trust is required. One well-known critique of the view that business decisions are nothing but the outcome of calculation comes from Keynes:[4]

> Most ... our decisions ... can only be taken as a result of animal spirits - of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.
>
> (Keynes 1973: 161)
>
> ... if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die.
>
> (Keynes 1973: 162)

Of course Keynes was not against calculation. He observes that calculation alone is insufficient: 'individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits' (1973: 162). In other words, there is irreducible uncertainty, and most exchange requires a leap into the dark. Trust is a device to deal with this uncertainty:

> Exchange is always in part a leap into the unknown; it is a "*salto mortale*" (death leap) to quote a phrase of Marx ... The argument here is not simply to recognize the world of uncertainty in which such a leap exists. For such a dangerous act to become commonplace it must be enforced to a large degree by routine and guided by a good measure of trust. How else would we make frequent and vulnerable transactions if we were not to assume away many of the volatilities of the external world or act, on habit, as if they did not exist?
>
> (Hodgson 1988: 167)

Hodgson draws upon the work of the German sociologist, Niklas Luhmann, who provides an account of trust as indifference to certain types of uncertainty based on past experience. Luhmann, like Williamson, regards calculativeness as antithetical to trust, but he arrives at the opposite conclusion:

> Nor is trust a prediction, the correctness of which could be measured when the predicted event occurs and after some experience reduced to a probability value. These types of techniques which are significant within the framework of decision-making models ... are functional equivalents for trust but not acts of trust in the true sense. As far as they extend, trust is unnecessary.
>
> (Luhmann 1979: 88).

Whereas Williamson sees calculativeness in economic life as making trust redundant, Luhmann sees the impossibility of calculativeness as making trust essential. The complexities of social organization are so great that some assumptions have to be made before calculativeness can operate. For Luhmann, uncertainty and lack of information threaten to overwhelm our capacity for action. Trust allows us to close off certain possibilities, making decisions about others possible. In this view, trust is not antithetical to calculation, but rather complementary to it: the complexities of calculation are so great that they have to be reduced in order for calculativeness to operate.

For Luhmann, the essential point of trust is not that it should be given or denied as the result of conscious calculation, but that it should become part of the fabric of our actions. In other words, trust is most effective when it is taken for granted. Social life (and the economic aspects of that life) is possible precisely because we take so much for granted:

> trust, by the reduction of complexity, discloses possibilities for action which would have remained improbable and unattractive without trust - which would not , in other words, have been pursued. For this

> reason, the benefit and the rationale for action on the basis of trust are to be found ... less in the definite mastery of longer chains of action or more extended causal connections (although this can also be a result of trust) than in, and above all, a movement towards **indifference**: by introducing trust, certain possibilities of development can be excluded from consideration.
>
> (Luhmann 1979: 25)

How do we arrive at what Luhmann calls indifference? The movement to indifference can be seen in two distinct ways. First, it can be seen as the property of a system. Relations and mechanisms can develop in such a way in trading systems that many risks are discounted by the agents. In this case, trust takes on what we will call a generalized form. This idea of trust as indifference finds an echo in the idea of 'conventions':

> In reality, virtually all production systems involve uncertainties of several kinds; between producers in the input-output chain; between producers and workers, in securing labour at the desired price; between producers and consumers, especially over time, for all markets involve fluctuations of some sort. The main way that such uncertainty is resolved is through **conventions**, which are taken-for-granted rules and routines between the partners in different kinds of relations defined by uncertainty. There are different combinations of such uncertainties, giving rise to different possible conventions that producers attempt so as to cope successfully with uncertainty. These constitute "frameworks of economic action", and different frameworks are possible for different kinds of products, markets, and kinds of labour; these are "possible worlds of production", defined by the ensemble of their conventions
>
> (Storper 1995: 208, stress in original)

The extent to which high-trust and low-trust frameworks for economic action have an impact on economic efficiency will be discussed below.

Trust then has a systemic aspect. However, the development of 'indifference' through the exclusion of particular possibilities can also be seen as a strategy by economic agents. A process of repeat transactions and experimentation and of carefully increasing exposure to risk, allows agents the chance to betray or display trust. The basis of trust is inductive. According to Luhmann, there are in the final analysis no decisive grounds for trusting, except extrapolation from the past. But once we trust, complexity is reduced and the possibility of calculative action opens up. This calculation extends to deciding how much we are willing to risk and how risks will contained by mistrust - the use of devices to limit exposure to risk. Trust, therefore, is having a basis on which to estimate p in Equation Two, not on the basis of the characteristics of the transaction, but on the basis of knowledge about the other agents involved. The agent has a basis for trusting one partner rather than another and deciding what level of risk it is wise to incur. This can be combined with steps to prevent opportunistic behaviour by the partner and to limit the losses from such behaviour. I may trust firm A with custody of one hundred pounds, because it has shown itself to be worthy of the trust in the past. I trust A but not B about this, either because I have no experience of B or because B has betrayed trust in the past. But I will not give A custody of ten thousand pounds without taking further precautions. These precautions would probably be less than I would require if B were to take custody of the same amount of money.

This conception of trust, then, incorporates four elements which are not captured by the calculative approach:

- We tend to trust not on the basis of looking forward towards what agents might do in the future, but rather by looking back at what they have done in the past. In other words, we extrapolate from the past actions of agents, or from the actions of others we consider to provide a guide to the agent's behaviour. Williamson's conception of calculativeness is different from this. He derives, the likelihood of opportunism from a calculation of future gains and losses.

- Trust is bound up with mistrust. According to Gambetta, we can 'circumscribe the extent to which we need to trust agents' (1988: 220) by the use of safeguards. Leaving aside situations of 'blind trust', which are not being considered here, the boundary of how far we are prepared to trust is defined by mistrust. Trust and mistrust are two sides of the same boundary line.

- Trust is not only a characteristic of individual behaviour, but also a characteristic of systems of exchange. Individual agents do often have to decide whether to trust each other, but they also very often enter into exchange without conscious calculation at all. They exhibit a high level of trust in the system of exchange within which they are operating, but this is not based on altruism, but on perceptions of how the system has operated in the past.

- Trust provides the framework for calculations to take place. Trust simplifies interactions between agents so that they can then get on with the business of calculating.

To conclude, enterprise A trusts enterprise B about X when A accepts a level of risk which is only acceptable because A has a basis for believing that B is not likely to avail itself of the chance to behave opportunistically. This belief might arise either from what A knows or has come to take for granted about patterns of exchanges - generalized trust - or from the specific knowledge A has about B or can infer about B (but not about all enterprises) from what it knows of other enterprises - selective trust.

3 THE DEVELOPMENT OF TRUST

This section will examine how trust is established between people and enterprises. It will consider the different bases on which trust can develop. Prior to this discussion, however, it is important to establish some basic parameters for the discussion, distinguishing what people trust about, the bases for trust and the scope of trust.

First, what do enterprises trust about? Sako (1992: 37-38) distinguishes three different areas:

> **Contractual trust**. That people will act honourably, obey the usual rules of exchange (confidentiality, honesty etc.). Some minimal degree of contractual trust is needed for all but the most limited economic exchange.
>
> **Competence trust**. Confidence in the other's ability to perform properly. The other has the capabilities needed to keep the promises made. The minimal level of competence trust might be establishing that a firm has the capital or creditworthiness needed to fulfil an order, but Sako is more concerned with technical and organizational competence to meet stringent quality and delivery requirements.
>
> **Goodwill trust**. Sako defines this in terms of 'mutual expectations of open commitment to each other' (1992: 38). Similarly, 'someone who is worthy of "goodwill trust" is dependable and can be endowed with high discretion, as he can be trusted to take initiatives while refraining from unfair advantage taking' (1992: 39).

Contractual trust is needed in any exchange relation. Many exchanges also involve a degree of trust about the competence of one of the parties to meet the standards promised or expected by the other. Goodwill is a characteristic of on-going relations between companies.

Second, how is trust is produced? Zucker (1986) distinguishes three forms of trust production:

> (1) process-based, where trust is tied to past or expected exchange, such as reputation or gift-exchange; (2) characteristic-based, where trust is tied to a person, depending on characteristics such as family background or ethnicity; and (3) institutional-based, where trust is tied to formal societal structures, depending on individual or firm-specific attributes.
>
> (Zucker 1986: 53)

These three forms of trust production will be discussed below and related to the different types of trust specified by Sako. Third, we distinguish between trust relations of differing scope. In particular, we differentiate between generalized trust and selective trust. Generalized trust occurs in situations where trust is a characteristic of the system of exchange as a whole and its context. In such situations trust is accorded to a wide range of agents. In contrast, selective trust is accorded to particular individuals, groups or institutions.

THE BASES OF GENERALIZED TRUST

The importance of generalized trust as the foundation of systems of exchange has been emphasized recently by Platteau (1994a; 1994b), who poses the question, 'how, in a world characterized by imperfect information and opportunism is it possible to contain risk and have efficient exchange?' Platteau argues that liberalization and market development only work well when certain types of social structures and moral norms are present. These structures and norms cannot be created overnight. Therefore, one should be cautious about imposing market solutions where social structures are not likely to sustain them.

Platteau makes use of game theory to lay out the problem. Games incorporate the two assumptions which are held to make exchange problematic - imperfect information (the first player does not know what the second will do) and opportunism (players can choose freely to be honest or dishonest).[5] The Prisoner's Dilemma - a one-shot, simultaneous game with a pay-off favouring defection - is a well-known example of a sub-optimal outcome for both parties arising from opportunism. Even though both sides could benefit from an 'honest' exchange, neither will run the risk of engaging in it. Cooperation may occur when repeat games with no fixed end-point are played, but it is only one of the possible Nash equilibria (Platteau 1994a: 547-48). Trust, which Platteau often equates with the willingness to cooperate, is all too easily driven out by defection.

Platteau then analyses the results of an 'assurance game', one in which honest players gain utility from playing honestly. In this game, honesty strategies will not be driven out by dishonest players if the honest players in the population receive a pay-off from the act of being honest and believe that many others in the population are also honest. In this case, potential losses from encountering a dishonest player are offset by the gains from acting honestly. In this case an honesty equilibrium will emerge:

> for honest dealings to prevail **on a large scale** in an anonymous society, it is not sufficient that a significant majority of people deem honesty preferable to dishonesty but it must also be the case that these people feel confident that their bent for honesty is shared by many others, too. Therefore, if there are many would-be honest agents who however believe that many people are not similarly given to honest urges, no honesty equilibrium will arise
>
> (Platteau 1994b: 759).

Platteau concludes from this analysis that, first, calculative self-interest is not enough to support efficient exchange, and that opportunism has to be constrained by moral norms. He concludes further that a **generalized morality** is needed to make markets work well. A generalized morality will ensure that there is a prevalence of honest people in the population, a general expectation that others will be trustworthy and a tendency for breaches of trust to be sanctioned. Such a morality will ensure the survival of honest trading even in the presence of some dishonest players. He thus arrives at the conclusion that markets will only work well in the context of a suitable generalized morality.

In response to Platteau, Moore (1994) has argued that generalized morality is not the only basis for establishing such trust and that, in a complex modern society, institutions can provide information about agents, which restricts opportunism and plays an important role in establishing generalized trust. This is where we return to the work of Zucker (1986), who asks what happens when characteristic- and process-based trust are insufficient to sustain exchange and examines this question in the context of the United States in the latter part of the 19th century. The combination of waves of migration from Eastern and Southern Europe, a high level of geographical mobility and a high rate of enterprise births and death undermined the bases for both characteristic- and process-based trust. Consequently, new, institutionalized forms of trust production arose (Zucker 1986: 69-85). Rules were needed to make markets more orderly in situations where economic life was volatile and transactions were interdependent, leading to the risk of recession and panic (1986: 89). In this context, an institutionalized system of market regulation grew up. This laid down procedures and regulations which gave agents a basis for risking exchange with other agents. Institutional-based trust may apply to individuals or to institutions, and it can provide a basis for both contractual and competence trust.

Institutions offer us a basis for both trust and distrust. When we enter exchange with individuals we wish to be assured about their probity and competence. Institutions can validate both. The individual may be able to provide bank guarantees or be a member of a deposit scheme which assures the purchaser that their money will not be misused. Membership of an organization or certificates of competence will also provide assurance that the person is competent to perform the services offered Institutions can also provide indications of individual competence through the training credentials they confer and the norms and procedures they expect members to follow. Upon hiring a solicitor, for example, one might be reassured by the training required to gain the qualification, the rules solicitors are expected to follow (not using clients' money for their own ends etc.), the penalties for professional misconduct and the existence of a compensation scheme. These systems of validation of individuals perform two operations. First, they provide us with a guide to the individual's skills. We want to deal with a trained person, who we can expect to follow suitable procedures. Membership of the organization tells us about the person's past - training and performance. We would expect defects in either to have debarred him/her from membership. This provides a basis for trust. Second, the validating agency institutionalizes our distrust by providing compensation, or the threat of punishment to the agent, which alters the pay-offs from the agent's actions, both to us and to the agent. Even without a compensation scheme, institution-based trust/distrust offers an effective means of promoting reputation effects. We might be reassured by the fact that we have a guide to past transactions of the agent with others, and the knowledge that our transaction will be made known to future clients.[6] However, in institutionalizing our distrust, we are necessarily placing our trust in the validating agency.

Similar processes operate with regard to our trust/distrust of institutions. We take risks about the probity and competence of banks and insurance companies when we trust our money to them. We cannot possibly know anything about the anonymous individuals who are responsible for our money, nor can most of us know enough about banks or their activities either to monitor them effectively or to specify/enforce a contract. However, we are reassured by the procedures adopted by companies, the external regulatory framework and self-regulation. If we cannot possibly monitor the actions of those acting as our agents, then at least we have the reassurance that (i) the institution has performed adequately in the past and follows accepted procedures, and (ii) penalties and compensation schemes are in place. Once again, of course, this involves trusting the regulatory agencies.

Such mechanisms help us to move towards what Luhmann (1979) calls 'indifference'. We are sufficiently assured by the probity, competence and regulation of the banks that we trust them to do a good job. This is convenient. We can make a decision about depositing our money in any bank on the basis of factors such as convenience and rates of interest, without having to worry about which bank is less likely to go bust. Of course, such regulatory mechanisms do break down. Institutional trust shifts some of our risk from the agent to the regulatory agency.[7] The recent decline in investments in the private pensions industry in the UK following revelations of widespread mis-selling of pensions, and the insecurity created by global financial risk from derivatives show how inconvenient it is when system trust is not established. It increases the complexity of our decision making. If we cannot trust pensions advisers to give good advice in an area where we cannot easily acquire competence, where can we go for advice? Are we forced to fall back on personal contacts and process-based trust, or do we look for new sources of institutional trust - independent advisers?

Institution-based trust can also extend to inter-firm transactions. One obvious example of this are systems of bank references and guarantees and the auditing of accounts. It enables one firm to have confidence in the financial security of another. Another increasingly important example of institution-based trust is the ISO 9,000 certification system. This certifies the quality procedures of a firm. Possessing the certificate gives confidence to buyers that the products will meet quality standards consistently. ISO 14,000 certification should assure firms that their partners reach certain environmental standards. In both cases, the certification tells the buyer something about the past competence of the firm. Once again, however, the buyer has to have confidence in the certification system.

Institutional trust is not a complete substitute for a general morality. This type of trust can be abused by opportunists and fraudsters. However, it is an important means of sustaining and extending exchange. In countries in which levels of trust are low, the development of institutional trust can help to get exchange onto a firmer footing. The importance of establishing this kind of trust will be discussed further in later sections.

THE PRODUCTION OF SELECTIVE TRUST

Compared with generalized trust, selective trust might appear to be an inferior type of trust - to be used only when morality and institutions do not provide a secure basis for exchange. In some situations, it can indeed perform this function, but selective trust can also provide the basis for greater exposure to risk and higher levels of dependence. We will argue in Section 5 that it is at the heart of the two new models of inter-firm organization in industry.

Trust is selective when it is restricted to particular groups of agents. Such trust can be based on the **characteristics** of the exchange partners, that is family, ethnic or other attributes. As mentioned above, Zucker (1986) calls it characteristic-based trust, we prefer the simpler term 'ascribed trust'. Alternatively, selective trust is derived from the **process** of trading and based either on one's personal trading experience or that of others (reputation): process-based trust.

Ascribed trust develops among groups with a strong identity, and it provides only a limited basis for transactions. It may, however, be an important stage in the initial development of trust. If people do not know whom to trust, then family, ethnic or community ties are one basis for discriminating between potential partners. This discrimination will be based on both the presumed ties of solidarity and the potential for redress in case of default when the defaulter is part of an identifiable community with whom the agent also has social ties. However, such ties limit the extent to which trust relations can develop, as will be seen in Section 5.

Process-based trust, on the other hand, can extend more widely. It is particularly important for repeated, inter-firm transactions, where enterprises can build up a relationship over a period of time. It can form a basis for contractual and competence trust. The analysis of the case of trust-based relations used by Chinese traders in Singapore (Menkhoff 1992) provides a good example of the development of process-based trust. He shows how traders establish their credibility locally and how traders come to decide with whom they will carry out long-distance trade. To start a business in Singapore involves establishing credibility. Being of Chinese origin helps, but it is not enough. Menkhoff describes how small businessmen have to slowly build up a track record of trustworthiness through their performance. As they do so, the risks wholesalers are prepared to take increase (1992: 269). Wholesalers will not trust just anyone, even someone of Chinese origin living in Singapore. Clearly, community and business sanctions are not enough - otherwise the wholesalers would trust the client from the outset. But they do not do so; trust has to be 'earned' by the client. Similar processes are evident in the case of overseas trade. Traders like to meet their overseas partners and to slowly build up their relationship. In this way, they learn who can be trusted to supply on time and who can be trusted to pay. Those who can be trusted are extended more important contracts where the potential losses are higher. In this case, the reasoning is clearly inductive. It takes the past as a guide to the future and may depend in part on the trading relationship itself developing affective ties which limit malfeasance and opportunism.

These processes are at the heart of Luhmann's analysis of the development of trust. Luhmann argues that a deepening of trust involves a learning process, and that 'such learning processes are only complete when the person to be trusted has had opportunities to betray that trust and has not used them' (1979: 45). While this form of trust may appear to be limited and time-consuming to produce, it can be extended through reputation effects - where more than one agent benefits from knowledge of another agent's transactions.

Exchange would be severely hampered without process-based trust. An example is provided by Kollock (1994), who offers a simulation of trading strategies in a market characterized by information asymmetries. Kollock considers trading in rice and rubber markets. Rice is a commodity whose value can be determined at the point of sale without difficulty. This facilitates interaction between traders and the growth of spot markets. In contrast:

> Rubber is an interesting commodity in that at the time of sale it is impossible to determine its quality. It is not until months later, after extensive processing, that the buyer can determine whether the grower took the extra time and expense to insure a high-quality crop.
>
> (Kollock 1994: 314)

Kollock notes that this is a perfect recipe for market failure through Prisoner's Dilemma - high quality benefits all, but each seller has the incentive to cheat (defect) and each buyer should guard against this. In fact, the market has developed 'long-term exchange relationships between particular buyers and sellers. Within this framework it is possible for the growers to establish reputations for fairness and trustworthiness' (Kollock 1994: 314).

Taking this as his starting point, Kollock constructs a simulation game to test the emergence of commitment in markets characterized by different information about the product. Groups of buyers and sellers engage in repeated rounds of trading (up to 20 rounds) for two commodities - one like rubber where information asymmetries are high, and one where the value of the commodity is clear at the point of contract. Parties can make bids and offers freely, and they can decide whether to cheat or not. Their own aim is to maximize their income by the (unknown) time at which trading finishes. The key assumption that Kollock makes is that traders can choose with whom to trade, unlike most games where trades are random or the identity of the partner is not known. In the experiment, buyers and sellers moved to closer, process-based commitments when dealing in the commodity with greater uncertainty as to quality (Kollock 1994: 328-33), although the emergence of cooperation may depend on the early strategies of buyers and sellers. This is the best way to avoid the problem of defection, and it also avoids all the problems and pitfalls of backward integration. Buying rubber plantations is one solution to the risks of rubber trading, but it has many risks and inflexibilities of its own.

While calculativeness is involved here, it is not based on calculations based on the possible opportunism of the partner. The strategy involves developing an understanding about how partners behave - selective trust! One might argue that recurrent trading promises a stream of future income which outweighs the short-term benefits of default, but it seems equally plausible to say that experiential trading is actually a form of isolating those suppliers and traders who are willing to think about such long-term benefits. In a world of bounded rationality, partners cannot calculate all the gains and losses which might accrue from particular courses of action. The chains of causality are too complex. They have to develop strategies. Part of the process of building up process-based trust is precisely finding out what sort of strategies one's partners are using.[8] Actors are boundedly rational and face different resource constraints. Therefore, there is a choice of strategies in the market, and it is not possible to predict how a partner will act by simply calculating a stream of losses and benefits accruing to a given action.

The examples of the Singapore traders and the rubber market illustrate how process-based trust can extend and deepen exchange. It can, first, provide the lubricant for a trading system, reducing transaction costs and speeding up exchange. Second, it can make possible economic activities which would not otherwise occur because the costs of protecting transactions against opportunism would be high and the costs of internalizing exchange within the firm would also be great.[9]

Trust built up in the process of exchange is also central for the third type of trust discussed by Sako, 'goodwill trust'. She defines this in terms of 'mutual expectations of open commitment to each other' (1992: 38). 'Someone who is worthy of "goodwill trust" is dependable and can be endowed with high discretion, as he can be trusted to take initiatives while refraining from unfair advantage taking' (1992: 39). Such a definition of an on-going commitment to the relationship is, in fact, very close to Williamson's definition of how contracts would look in the absence of opportunism:

> A general clause, to which both parties would agree, to the effect that "I will behave responsibly rather than seek individual advantage when an occasion to adapt arises," would, in the absence of opportunism, suffice.
>
> (Williamson 1979: 241)

While Williamson regards this as unrealistic, Sako sees this abandonment of opportunism as a key part of effective trading relations. If firms are constantly *concerned about opportunism, they will not be able to relate to other firms in an* efficient way. Goodwill trust is developed and maintained by the way the relationship is handled over time. As Nishiguchi observes of contracting relationships in Japanese industry, 'asset specificity is not the cause but a **consequence** of a **strategy** to maintain continual contractual relations in the interest of preserving long-term reciprocal benefits' (1989: 272, stress in original).

To conclude, the distinctions between the scope of trust and the different levels of trust, which are important for the ensuing discussion are summarized in Table 1. Markets function well when generalized minimal trust is present. This is provided by a combination of generalized morality and institutional trust. Clearly, when such trust is not available, traders may resort to selective trust strategies. This type of trust is necessarily limited to small groups of traders. In Section 4, it will be argued that in Eastern Europe minimal trust is absent and that in order to overcome this problem fostering an institutional basis for generalized minimal trust and developing selective trust are both important. Extended trust is most often developed through experience (process-based trust), which is by definition restricted. Section 5 will show why competitiveness in manufacturing increasingly requires extended trust and how such trust developed in concrete situations, including in developing countries. We leave open the possibility that there may be a generalized form of extended trust in a society such as Japan. Dore (1983) hints at this possibility.

Table 1: Levels and scope of trust

Level of Trust	The Scope of Trust	
	Generalized	**Selective**
Minimal	The moral and institutional basis for generalized trading relationships in a society	The interpersonal relations and reputation effects required to sustain exchange in a society in the absence of generalized trust.
Extended	Inter-firm relations in Japan?	The interpersonal relations and reputation effects which sustain cooperation between formally independent enterprises.

The purpose of Section 3 was to unpackage the notion of trust and prepare a box of tools for the subsequent analysis. Most of the categories needed could be found in the literature. We sought to explain them, relate them to the previous section on the meaning of trust and systematize the instruments needed for studying trust and economic development. What was thought to be merely a stepping stone became a big task in itself.

4 MINIMAL TRUST FOR AN EFFECTIVE MARKET ECONOMY

Having defined a set of principles about trust, it is now possible to discuss the emergence of trust in two situations. The first concerns those countries which are trying to build effective market economies but often lack even minimal levels of trust required to do so. The obvious case in point are the transitional economies of the Former Soviet Union and Eastern Europe (discussed in this section). The second concerns the construction of higher levels of trust essential for firms trying to compete in international markets. This will be discussed in Section 5.

The importance of minimal levels of trust for markets to work well is put succinctly by Platteau:

> if individuals do not trust others to fulfil their terms of an agreement, they will not wish to enter exchanges with one another - except in so far as exchanges are constituted by spot transactions - and economic specialization will not develop.
>
> (Platteau 1994a: 545-6)

In the transitional economies of the Former Soviet Union and Eastern Europe, the production of trust is a particularly urgent issue; so much so that the Polish sociologist Sztompka (1995) has entitled his recent work 'Trust: the missing resource of post-communist society'. In order to substantiate his conclusion that 'post communist societies are trapped in a deep syndrome of distrust' (1995: 3) he provides a wide range of empirical indicators, but few are directly useful for the purpose of this paper. Sztompka works with a notion of trust which is much wider than the one adopted in this paper (Section 2) and covers confidence (or rather the lack of it) in, for example, the local currency or politicians. More importantly, he does include questions which are of direct interest to us such as how is business conducted when there is no trust and what explains the deep distrust.

> The early phase of capital accumulation (transition) produces brutal, aggressive, untamed business conduct. Raising prices, lowering quality, taking false credits, forging documents, negative advertising become common practice.
>
> (Sztompka 1995: 27)

Such practices are of course not unique to economies in transition, nor are the Mafias which control economic life and which Sztompka refers to. This is the stuff of which many movies are made and most of those are inspired by American or European experiences. Perhaps a good way to bring out the difference between transition and advanced economies is that in the former the majority of cinema-goers has direct recent and repeated experience (as victim or perpetrator) of dishonest business whereas, in the latter, the majority would know it more from the movies.

Sztompka (1995) goes further than this. He discusses **current** reasons for the pervasive distrust such as the ineffective law enforcement agencies and the frequent changes in regulations and economic policies since 1989. And, in an earlier article, Sztompka (1993) traces the **historical** reasons for the distrust, concluding that most of the current problems are due to a deficiency of cultural and civilizational resources. One of the legacies of the communist system and its command economy is what he calls 'civilizational incompetence'.

In discussing what this means there is a danger that we drift into Sztompka's much wider agenda of the transition to effective democracy and market economy. For our more narrow concerns, the most relevant elements of his work are: first, the distinction between two groups of factors which need to be addressed in the transition: 'the "hard" institutional and organizational frame- works (of economy, law, administration) ... and the "soft" intangibles and imponderables (of interpersonal bonds, loyalties, values, identifications, networks)' (Sztompka 1993: 86). Second, the suggestion that 'the former is easier and quicker' since the latter requires fundamental transformations of mental, cultural, civilizational fabric of society' (*ibid.*). Third, the insights into why laws and regulations are flouted and dishonesty in economic life is deep seated. In the previous command economy,

> to "beat the system", to outwit the authorities, to evade public regulations, rules, laws - is one of the widely recognized virtues, and successful rogues evoke admiration tainted with envy. Excessive egoism, attempts at appropriation of common goods, "grab and run" tactics to safeguard personal well-being, are condoned, or at least excused.
>
> (Sztompka 1993: 90)

In other words, Sztompka suggests that the moral norms necessary for an effective market economy have been eroded under communism and that rebuilding trust (which is part of his 'civilizational competence') takes a long time.

It is most striking how these conclusions coincide with those of Platteau, referred to earlier on. They arrive at the question of the fundamental role of trust in building an effective market economy by rather different routes but share the views that law and its enforcement (while important) is only a limited basis for trust, that social norms are paramount, that such norms are rooted in a long historical process and that therefore the creation of trust - and hence of an effective market economy - is a slow process. In Platteau's words:

> norms of generalized morality - perhaps contrary to moral norms in small groups - cannot be easily expected to evolve spontaneously when they are needed to make economic exchanges viable. Ultimately, the cultural endowment of a society plays a determining role in shaping its specific growth trajectory, and history therefore matters.
>
> (Platteau 1994a: 533-4)

This scepticism about the scope for rapid and effective extensions of market relations has been criticised by Moore. Moore's argument, while directed specifically at Platteau and concerned with developing countries, is worth exploring also for the transition economies:

> I am optimistic that the social relations that underlie effective markets (in "advanced" societies) may be **created** more rapidly than he (Platteau) implies, and created through the market process itself - through the social ties and trust built up through the experience of market transactions - rather than through the more pervasive changes

in social norms on which Platteau focuses. I am more optimistic than Platteau about the scope for the market to create and sustain its own social order.

(Moore 1994: 818)

This difference is rooted in the greater role which Moore accords to reputation mechanisms, both of the interpersonal and institutional kind. Here it is useful to refer to our earlier discussion of the bases of trust, especially Zucker's categories of process-based and institutional trust. Essentially, Moore argues that Platteau underrates the self-reinforcing nature of process-based trust, that he ignores institutional trust, that this results in the great weight given to generalized morality or cultural endowment and leads to a more pessimistic view of building effective market economies. He also emphasizes that there is insufficient evidence to justify either position. Nevertheless, there are a number of points worth exploring. Doing so is not just an academic exercise. The reality of transition economies makes this a policy relevant debate, even though it was not prompted by the problems of these countries.

'Market order can be produced incrementally through the experience of market transactions themselves' (Moore 1994: 824). This argument rests on seeing personal reputation mechanisms (process-based trust) as self-reinforcing. Cheating in business transactions does not pay; it may bring an immediate gain but ruins reputation and hence future business. We agree with Moore that this is the most powerful dynamic at play not just in traditional agrarian market economies but even more so in advanced industrialized market economies. However, **when great ruptures in the economic order occur, this reputation mechanism is less effective** - and it is hard to imagine a greater rupture than the transition from a communist centrally planned economy to a market economy with private ownership of the means of production. In order to explain, it is worth recalling a lesson from game theory: cooperation becomes more likely when a game is **repeated** and a final round is not fixed in advance. The transition to a new order is a unique occurrence and **in the course of that transition many economic acquisitions take place which are not repeated**. Wagener (1994: 647) points out that in such a situation it pays the individual to be ruthless; enormous and lasting gains can be made at the expense of others. Hence, even minimal trust is so difficult to achieve in the transition phase. Perhaps it is not an exaggeration to say that **transition is only accomplished once personal reputation mechanisms become self-reinforcing**.

Analyses of the transition experience in Russia show that opportunism tends to be rewarded. How can process-based trust develop, 'if conditions continue to make it more rational for entrepreneurs to renege on commitments and re-negotiate at every step in the process' (Sheppard 1995:187)? A survey of private sector manufacturing in St Petersburg concludes :

Given the degree of uncertainty in the economy, it is rational for most entrepreneurs to focus on quick profits which obviates the need to develop a reputation. A pervasive lack of trust impedes the development of sophisticated business relationships and narrows the scope of private activity.

(Webster and Charap 1995: 211)

To some extent the uncertainty and instability is inevitable, given that economic and political transformation is what the transition in Central Asia and Eastern Europe is all about. However, the problem is sometimes exacerbated by policy advice which is aimed at a minimalist state. As emphasized by Wagener (1994: 655), 'experience shows ... that the stable state and not the minimalistic state favours the unfolding of the market economy'. Indeed, Webster and Charap suggest that in Russia 'most regulations were not major obstacles for entrepreneurs even though compliance was far from straight-forward. The problems with regulations were linked to the rate at which they changed and the ambiguity of their content' (Webster and Charap 1995: 211). (The role of regulations and laws is discussed further in Section 6).

We have seen why process-based trust is slow to develop in the transition phase. What about ascribed trust, that is the trust which comes from belonging to the same social group? In the Moscow region, Webster *et al.* (1995: 175) found 'a strong network among managers of privatized firms' who knew each other from their work in sectoral ministries that formerly coordinated production among state enterprises. This network helped them to secure inputs but it could not always save them from suddenly being charged monopoly prices by their former colleagues (Webster 1995: 177).

Kharkhordin and Gerber (1994) distinguish between two groups of Russian industrialists. Those who reject the old ties and those who cultivate them. The former see themselves as reform-oriented and regard the latter as reactionary. Here we concentrate on the latter. Kharkhordin and Gerber conclude that the old social ties are not just a remnant of the past but could in some cases be the basis of new effective networks. The dynamic is interesting. Apparently the crisis conditions of 1991-92 (collapse of state system of planned supplies in 1991, price shock in 1992) led to a strengthening of the old ties: 'directors tended to maintain old ties with major traditional partners from the days of central planning. These personal ties ... became pervaded by a sense of loyalty, mutual help and joint responsibility. In the extreme, the rhetoric of mutual help demanded a continuation of deliveries to a partner even when that partner did not have any funds to pay for the supplies' (1994: 1076). By 1993, the rhetoric and practice of 'mutual help' had declined and become more selective: 'Interviews indicated that "mutual help" did not disappear altogether, but that each enterprise had to choose 'the essential few' with whom it would sustain these demanding relations' (1994: 1089). The significance of the network of the 'essential few' showed in a number of ways. First, 'although prepayment became an almost universal requirement in industrial exchanges in 1993, deliveries to core partners were still frequently shipped without it' (1994: 1078). Second, economic ties with new suppliers were sometimes established through the 'essential partners'. Third, there are signs that the networks of the 'essential few' could develop into 'systems of interlocking stockholding reminiscent of Japanese *keiretsu* concerns' (1994: 1078). These conclusions are an interesting contrast to the widespread views that the old ties have become irrelevant or that (where they survive) they obstruct the rebuilding of the economy. Clearly there is a case for follow up research on the networks of the 'essential few'.

For our analysis it is important to remember that the starting point for these networks seems to have been ascribed trust. This triggers a question about the potential of other social ties providing a basis for trust. Ethnic groups come to mind. Their existence is generally seen as an obstacle to political and economic transformation. New research with a focus on trust may help to re-evaluate the role of ethnic communities. More generally, a focus on selective trust whether ascribed or process-based seems to be the most promising way of exploring whether and how the transition economies are overcoming the mistrust which prevailed, particularly in the early 1990s. According to a poll undertaken by Russia's Public Opinion Centre in 1992, 'two thirds of the respondents believed that a business' success was a result of swindling, fraud and crime' (Sheppard 1995: 202).

5 EXTENDED TRUST FOR INTERNATIONAL COMPETITIVENESS

The economics and politics of the 1990s are unprecedented. In no period of economic history have so many countries been forced to abide by the rules of international competition. This applies to the transition economies analysed in the previous section and to the developing countries discussed in this section. In some countries the market economy barely functions, yet they are forced to compete with imports or sell in international markets. Against this background, developing countries have been looking for models of how to compete internationally. The Japanese and Italian experiences of organizing manufacturing industry have been presented as such models (Humphrey 1995b). In both cases, close relations between formally independent firms appear to involve a high degree of trust.

It is not to be expected that Japanese-style supplier-customer relations or Italian-style Industrial Districts will start to spring up across the developing world. Both patterns of development are strongly related to their contexts. However, elements of both are clearly in evidence. In both India and Brazil, for example, large firms are paying a lot of attention to supplier development, consciously emulating the Japanese experience, as part of their attempts to cope with the new competitive climate. This pattern can be seen in other developing countries (Humphrey 1995a; Kaplinsky 1994). Similarly, small- and medium-sized firms which cluster together may well be able to cope with liberalization and entry into export markets and indeed successful experiences in developing countries have come to light (Nadvi 1995a; Schmitz 1995). The advantages of such collective efficiency are increasingly being explored for policy purposes aimed at supporting existing clusters and promoting new networks (Humphrey and Schmitz 1996).

TRUST AND SUPPLY-CHAIN DEVELOPMENT

For a long period after the Second World War, the options of market and hierarchy, both of which only required minimal trust relations between firms, seemed capable of delivering economic success. Firms grew larger and larger. What they could not buy in the market effectively, they made in house. But in the past decade, the issue of inter-firm relationships has acquired prominence. Networks of firms and alliances have come to be seen as an important source of competitive advantage. For this reason, the issue of trust has come to the fore.[10] In part this is the result of the discovery of the advantages of inter-firm alliances and the development of close relations with suppliers. In part, it results from the need for manufacturers to compete not only on price, but on quality, delivery and innovation as well.

The advantages and disadvantages of different patterns of relations between customers and suppliers has been studied extensively in the US auto industry. In the post-war period, the leading firms sought efficiency through a high level of vertical integration and, for products sourced from outside the company, maintaining arms-length relations with a large number of suppliers by short-term contracts awarded predominantly on the criteria of lowest price (Helper 1993: 143-4). Supplier and customer had little commitment to each other. Short-term contracts are policed by the threat of non-renewal, and companies are geared to ensuring that alternative sources of supply are available. To do this, firms must (i) keep design capability in-house so as to minimize supplier expertise, (ii) source the same part from a number of different suppliers, and (iii) place orders for small, easy-to-make parts, which can then be assembled in-house (Helper 1993: 143-44). These types of relationship are characterized by Sako (1992) as 'arms length contractual relations', and by Helper as the 'exit option'.

In the US auto industry, such relationships were acceptable until Japanese producers showed that by working closely with suppliers, they could develop new products more rapidly and more efficiently, as well as reduce costs (Helper 1993). The Japanese model of supplier relations is termed 'obligational contracting' by Sako, and as 'voice' by Helper. In the 'voice' strategy, companies maintain close relations with fewer suppliers, offer incentives for long-term commitment and establish dense flows of information in both directions. There are fewer suppliers for each part, and 'first-tier' suppliers produce more complex components or sub-assemblies (whole seats rather than parts for seats, for example), which may be produced entirely in-house, or put together with items bought from second-tier suppliers. Innovation gains are also achieved. The two sides in the arrangement share the gains from increasing efficiency and are in a better position to expand market share.[11]

This type of relationship is often characterized in terms of trust. According to Womack, Jones and Roos, 'the [Japanese] system replaces a vicious circle of distrust with a virtuous circle of cooperation' (Womack, Jones *et al.* 1990: 150). Similarly, Sako refers to 'a sense of mutual trust' (1992: 9), and argues that: 'What underpins heavy mutual dependence as an acceptable, and even preferred, state of affairs is the existence of "goodwill trust". "Goodwill trust" is a sure feeling that trading partners possess a moral commitment to maintaining a trading relationship' (Sako 1992: 10).

Similarly, Helper's characterization of the 'voice' relationship (see above) puts trust as a central element: 'A powerful incentive to participate in voice is a share of the joint profits that result from performance improvements. However, since many of the payoffs to voice are long-term and difficult to observe, trust is a prerequisite to making the necessary investments' (Helper 1993: 151).

The argument is clear. Firms will gain competitive advantages from cooperation. The message from the **Machine that Changed the World** is that unless firms develop such co-operative relationships, they will go out of business: neither hierarchy nor the market are competitive. But cooperative relationships provide ample scope for opportunism because they involve increasing asset specificity and produce pay-offs which are uncertain and long-term. In effect, firms exchange one type of risk for another. They cooperate in order to reduce risk and uncertainty in competitive and volatile markets. The price they pay is the risk of cooperating with partners which might act opportunistically in the future. This risk is reduced by the strategy of selective trust described in Sections 2 and 3. In Sako's terms, Japanese firms build up mutual trust, which helps to 'reduce the controllable element of uncertainty associated with people's behaviour' (Sako 1992: 14-15).[12]

The potential importance of trust in supplier relations can best be illustrated by instances where trust is lacking. Two recent examples encountered in our research illustrate this point. First, a British company making electric motors wanted to develop a new material for a particular component in order to meet new environmental standards. It wished to do this jointly with one of the two European suppliers of this component. The supplier expressed an interest in collaborating but would not proceed when it became clear that the motor manufacturer would not guarantee to give it the production order for the new component. The supplier feared that it would develop the new component only to find that the production work (and design secrets) would be given to its competitor. Second, an electric motor manufacturer in India wanted to upgrade its suppliers. A supplier refused on the grounds that its competitive position *vis-à-vis* other suppliers lay in the way it organized its production. The customer could use the upgrading process to find out these secrets and then pass them on to its other suppliers. In addition, the supplier probably feared that any cost improvements achieved by the upgrading process would be fully discounted in lower prices.

In both these cases, trust is lacking. In principle, both sides might gain from cooperation, but the suppliers are fearful of opportunistic behaviour. In the second case, the customer had a discourse of 'growing with its suppliers' and wanting closer and more productive contracts with a smaller number of suppliers, but the supplier was sceptical. The possible pay-offs to the supplier are long-term, deriving from a partnership in which both sides benefit, but the risks are all short term. Suppliers with alternative customers might not want to take this risk.

In the absence of trust, the risk is not acceptable. To change this situation trust has to be built up. This is a slow process. Far from appealing to past behaviour as a source of trust, firms wishing to change their supplier strategies will want to disown what they have done in the past. For both sides, building trust involves the extension of trust - giving the partner an opportunity to betray trust in order to prove that trust will not be betrayed - and circling this trust with distrust - contracts, penalties etc., so as to keep the risks from betrayal to an acceptable level. Part of the process of constructing trust involves the partners coming to understand each other's decision making processes. For example, faced with recession, a firm may take a short-term or long-term view of the problem. In the context of uncertainty and bounded rationality, there is no one, unambiguously correct strategy. Unless one firm knows what kinds of calculation the other makes, it cannot assess the risks. Once trust is built up, however, the companies can get on with the business of assessing market risks, free from worries about each other's behaviour.[13]

In many developing countries, shifting contractual relationships is a matter of urgency. In countries such as Brazil and India, where relatively sophisticated but inefficient industries were built up behind protective barriers, large firms often resolved supply problems through internalization. Supplier relations may not always have had the short-term nature of typical arms-length contracting, but the informational content and degree of cooperation would tend to be low. Trade liberalization has suddenly and drastically exposed firms in these countries to new levels of competitive pressures. International management magazines feature just-in-time production and obligational contracting as the means to making the big leap in quality and productivity.[14]

In Brazil, for example, liberalization led to a sudden influx of imported cars. Local manufacturers have been forced to cut costs and raise quality standards rapidly. Improvements within their own plants are not sufficient. Many quality problems arise from defects in parts and materials bought from suppliers. Similarly, introducing new models rapidly requires closer coordination with suppliers. Not surprisingly, redefining relations with suppliers has been a priority for the assemblers. The average number of first-tier suppliers per assembler fell from 720 to 480 between 1990 and 1994 (Ferro 1995: 10). Those suppliers remaining are under pressure to cut costs and improve quality. The major car producers - Fiat, General Motors, Ford and Volkswagen - have introduced new supplier development programmes, offering technical assistance to a reduced supplier base. General Motors, for example, offers free specialist technical assistance on questions of cost structure, layouts, labour costs and production indicators (Posthuma 1995: 10-12). In return, it expects lower prices and higher quality.

The talk is of 'partnership', but the assemblers recognize themselves that the power relation is very uneven, and this produces contradictory effects. The supplier base is being reduced and information flows are being increased. There is greater help from the customer and more input into design from the suppliers. However, trust is not easy to develop. Williamson observes that 'voice' needs the final threat of 'exit' to be effective (Williamson 1993: 461), but exit must be seen as a last resort if trust is to be established, and the opportunistic use of market power must be curtailed by mutual obligation if trust is to be developed. As Dore observes, breaking a tie in Japan is painful and involves recrimination (Dore 1983: 163). In Brazil, the threat of exit is all too present. One leading producer claims to have a policy of global sourcing. It buys locally but threatens importation as a means to drive a hard bargain. The import threat becomes the benchmark for negotiations. Other companies have increased imports of components. The pressure to cut costs quickly may undermine any emergent trust. Longer-term contracts, for example for the life of a particular component, and single-sourcing can be important elements in building trust. At the same time, macroeconomic instability may undermine efforts to develop close relations. Finally, given a history of distrust and abuse of power, how is it possible to convince suppliers that the assemblers have any good intentions at all?

A similar problem can be seen in India. A factory producing electrical items has increased its market share at the expense of local competitors by focusing on improving quality and reducing the time it takes to fill customer orders.[15] In-house reorganization has taken the firm so far, now it wishes to restructure its local supply base. Instead of having 70 or 80 local suppliers delivering small items to the plant, the company wants to have 15 first-tier suppliers who are responsible for making sub-assemblies, who then organize the second-tier producers of small components. This will allow for easier communication directly between the production departments and the first-tier suppliers, and facilitate the introduction of just-in-time delivery. The company wants to grow, and it wants dedicated suppliers to grow with it. But why should the suppliers trust the company? In the past it has not treated them well. Should they believe in either its good faith or its competence? Without overcoming this distrust, the new system will not work.

In these situations, the customer needs to redefine supplier relations as a result of a shift in manufacturing and competitive strategy. Markets are more competitive and the bases of competition have moved from price towards quality and delivery. Clearly, the companies concerned cannot change the generalized morality existing in society, nor can they wipe the history of past relations from the memory of their suppliers. Instead, they have to overcome the fear and uncertainty of their suppliers, who in the past were confronted with offers of 'take it or leave it'.

The issues of uncertainty and opportunism arise acutely in this situation. If, as Helper suggests, the benefits to the suppliers are mainly long term, then they are uncertain because external factors are uncertain. At the same time, the promotion of greater cooperation in the short term in return for benefits in the long-term opens both customer and supplier up to opportunistic behaviour. The issue here is one of paths of change. The end-point is more or less well specified - obligational contracting - the starting point usually some form of low cooperation contracting.

Management texts provide many recipes for how can this be done. It seems more important, however, to recognize that no single recipe will work. What is possible in one context is impossible in another. While Bosch in Germany can seek to have suppliers no more than 20 per cent dependent on its orders (Herrigel 1990: 697), in India suppliers may be highly dependent on their major customers. Trust has to be developed in spite of, or through, this dependency. It cannot be changed overnight. Similarly, in Japan goodwill trust may mean that contracts are unspecified. In India, a history of exploitation of small firms by large may require the latter to offer contracts with more explicit guarantees. This forms the point of departure for greater trust.

A number of research questions arise out of this discussion:

- The reduction in the supplier base itself can act as a gesture of good faith, increasing the dependence of the customer on each of the remaining suppliers. It can also lead to increasing dependence of suppliers on customers. Do suppliers fear this, and how can this fear be allayed?

- Sako suggests that the closer relations occasioned through the contact needed for competence trust to develop may create the foundations for goodwill trust. Are there signs of this sequentiality, and does it arise more from the evolving competitive needs of the customer?

- Does the development of a long-term relation itself create a mutual dependence through the development of specific human resources on both sides? In cases where asset specificity is one-sided, is the partner taking most risk compensated in some way? Is transfer of design work to suppliers an example of assemblers giving a hostage to their suppliers?

- Efforts may be made to reduce uncertainty by increasing the length of contracts and the bases upon which they are renewed. While Sako characterizes goodwill trust as being low on contractual specificity, in situations where suppliers are dependent on more powerful customers, do these customers offer compensations, such as increased contractual rights and specifications, as gestures of goodwill?

- Are offers of technical assistance and support viewed with favour or suspicion by suppliers? Are they seen as help, or as a means of opening up the firm to the examination of the customer?

TRUST IN INDUSTRIAL CLUSTERS

The main argument which underlies Section 5 is that a rise in competitiveness is associated with increasing interdependence between firms. The previous subsection showed that adopting the new industrial disciplines spearheaded by Japan implies high interdependence and requires high trust to function effectively. This subsection is concerned with a form of industrial organization which is also characterized by high interdependence and which has shown - previously unexpected - signs of international competitiveness. The industrial organization in point is the cluster of small and medium enterprises. The international attention given to such clusters was prompted by the Italian experience (Brusco 1990; Piore and Sabel 1984). The relevance of clustering was then explored for other advanced countries (Pyke and Sengenberger 1992) and for developing countries (Schmitz 1989). More recent research on developing countries suggests that clusters of small and medium enterprises are common in a wide range of sectors and countries (Nadvi and Schmitz 1994). The growth experiences of such clusters vary, but they include notable success stories of international competitiveness. In order to explain this competitiveness, it is essential to consider trust. This subsection explains briefly why and then shows what the trust was based on and how the foundation of trust changed over time.

The reason why trust matters for industrial clusters to grow and become competitive requires but a short explanation. Clustering in itself, that is the sectoral and geographical concentration of enterprises, brings few benefits. It does, however, facilitate a deep division of labour and specialization as well as cooperation between enterprises (often coexisting with fierce local rivalry). In other words, clustering opens up efficiency gains which individual enterprises can rarely attain. These gains are captured in the concept of collective efficiency, defined as the competitive advantage derived from local external economies and joint action (Schmitz 1995a).

A cluster which competes on the basis of collective efficiency is a system of production which consists of a multitude of formally independent actors with a high density of transactions among them. For these to function smoothly and result in cumulative (not merely one-off) gain, trust is of great importance. It is easy to see why. Vertical integration within the firms tends to be limited, they buy in rather than make in house and/or specialize in a particular stage of the production - hence the term 'stage firms' (Brusco 1990). For most firms there is total exposure. What they make individually is useless to the outside world, what they make together conquers distant markets. This is a caricature but captures the essence of interdependence and the need for trust.

In practice this does not mean harmony but it does require that transaction costs be minimized - handshakes, telephone orders or brief instructions by fax are acceptable means of contract. Clusters which seek to move into market segments of higher value added need to raise quality, respond to small orders, and deliver at short notice and yet reliably. Product specifications and production schedules become tighter as does the interdependence between producers.

The critical question is how the necessary trust develops to sustain such collective efficiency. The recent industrial district debate has drawn attention to the communities in which enterprises are embedded and to the socio-cultural ties which facilitate trust. Becattini (1990: 38) has defined the industrial district as a 'socio-territorial entity which is characterized by the actual presence of both a community of people and a population of firms in one naturally and historically bounded area'.[16] Dei Ottati (1994: 530), building on Becattini's work, defines the 'social environment of the ideal-type industrial district' in terms of a common culture, frequent face-to-face relations, and 'norms of reciprocity accompanied by relevant social sanctions'. She recognizes that 'because of its industrial specialization and the connected necessity of importing and exporting ..., the environment of the district cannot be as closed to the external world as a traditional community' (1994: 531), but the values and social relations in the community are considered functional to the economic performance of local enterprises.

Recent research on industrial clusters in developing countries confirms that such social ties matter. It shows also that - as a basis for trust - their importance diminishes with growth. This comes out clearly in a case study on shoe manufacturing in the South of Brazil which developed over two and a half decades from a cluster of small enterprises producing only for the local market to one of the world's main exporters of leather shoes (Schmitz 1995). Non-economic ties between the shoe makers - clustered in the Sinos Valley - used to play a major role. Some were to do with ethnicity - being of German descent; others with geography - being local. The existence of such ties exerted pressure to keep commitments and to cooperate but their importance changed over time. Three phases can be distinguished:

- Trust based on socio-cultural identity seemed to work well until the early 1970s - when the export boom began. Knowing each other socially furthered mutual reliance and limited fraud. It also underpinned the collective action which led to the setting up of a shoe fair organization and of training and technology centres.

- In subsequent years (most of the 1970s and 80s) socio-cultural ties weakened and had less of an influence on inter-firm relationships. This seems to have been a result of the speed at which growth and differentiation occurred and of the key role of outsiders, the export agents, in this growth process.

- In the 1990s, there has been a return to a greater spirit of cooperation, not because of socio-cultural ties, but because of the economic cost of not cooperating. The new quality and delivery standards induce shoe manufacturers to invest in their relationships with suppliers. This investment is expected to engender commitment and trust.

Similarly, Nadvi (1995b) explored whether social identities provide a framework for trust relations in a cluster in Pakistan which produces surgical instruments for the international market. After Germany, Pakistan is the second largest exporter of such instruments; the bulk of the production coming from the town of Sialkot. Nadvi found multiple and interwoven social identities in Sialkot. Social ties between producers fall into three categories: caste or *'biradari'*, family ties, and social networks based on being 'local'. The relative weight attached to each of these categories changes with time.

The metal based surgical instruments industry, by the very nature of its work, has traditionally been associated with the Muslim *biradari* of *'Lohars'* (literally iron smiths). Nadvi concludes that the *Lohar biradari* was critical in the cluster's initial formation, but has since lost its significance. Today *biradari* plays little role in inter-firm relations. Family ties (which in the Punjab includes extended family and close friendships) continue to matter. But they do so unevenly: they are an important (though not always sufficient) basis for trust in intra-firm organization, they have facilitated some forms of horizontal inter-firm cooperation, but are not key to vertical relationships with subcontractors.

> Being local, although a "weaker" social tie compared to family, appeared to have a more important function in strengthening inter-firm relations than either *biradari* or family kinship ... Social reputation based on "knowing and being known" locally is a critical part of the social capital of the cluster where the costs of failure or default on the part of an interacting agent can be extremely high for the other partner.
>
> (Nadvi 1995b: 17)

What does 'being local' mean for our discussion on trust? Nadvi suggests that local social and business reputations are inseparable. (We are reminded of Becattini's (1990:38) words that 'in the [industrial] district, unlike in other environments, ...

community and firms tend to merge'.) To put it in Zucker's (1986) terms, there is both characteristic based (ascribed) and process based trust.

Nadvi's fascinating account of the local social embeddedness of export manufacturing does, however, carry a warning: 'localness as the primary category for constructing social and production linkages may be vulnerable as the cluster develops and external actors (such as buyers and foreign buyers), with whom local manufacturers have no social bonds ... gain in influence' (1995b: 22). Indeed it seems that sorting out the local (being inserted in a conducive economic and social network) is a necessary but not a sufficient condition. The strategic linkage is with the foreign buyer. The fight for such buyers pitches local manufacturers against each other. And the quality assurances sought by the foreign buyers force local manufacturers to be increasingly selective with their suppliers.

To summarize, an industrial organization which competes on the basis of collective efficiency requires a high degree of trust. Recent case studies of industrial clusters in Brazil and Pakistan support the argument that socio-cultural bonds facilitate trust and help explain competitiveness.[17] However, they also suggest that this line of reasoning is static: the influence of socio-cultural ties lessened over time, it was eroded by growth, notably the increasing differentiation within the community and the key role of outsiders. Trust has not therefore ceased to be important for collective efficiency. On the contrary, foreign buyers have imposed ever higher standards in product quality, speed of response and reliability - which no enterprise can achieve on its own. The question of trust has therefore become more critical, but its foundation is changing from trustworthiness being ascribed to being earned. It seems that operating in the world market has both eroded and created trust. It has undermined the socio-cultural ties and now demands new ties - from those who succeed in it. Those new ties are based on conscious investment in inter-firm relationships. The business partners do not necessarily have to change - but the basis of trust does.

In emphasizing the change from ascribed to process-based trust we are **not** suggesting that the latter is absent in the early phase or the former absent in the later phase. The existence of a local community does not mean that enterprises trust indiscriminately. There are crooks and incompetent people even in high trust communities. But in such clusters a double screening seems to operate. Having the right characteristics (being local and/or of particular social group) is the first filter. It helps but is not sufficient. The second and more difficult hurdle is to prove honesty and competence. Both filters play a role, but their relative importance changes over time. The former seems to help the formation of the cluster but the latter carries increasing weight when local firms enter the international market. Attaining international quality and delivery standards rarely leaves much choice.

Does this mean that in exporting clusters the issue of trust ends up being the same as elsewhere and resumes itself to trial and error - trusting only those with whom one has had a good experience? Not quite. The cluster has two advantages when it comes to the production of trust. Producers do not have to rely on their own experience but can draw on the experiences of others. Of course, reputation effects also work in other settings, but in a cluster they are more immediate, if not relentless. Second, it is easier to build up institutional trust. Schemes or centres which promote, assure and certify quality are unlikely to emerge without joint initiatives from foresighted manufacturers. Clustering facilitates such joint action. A good example is the Quality Assurance Centre of Gosheim (in Baden-Württemberg, Germany) a cluster of 400 independent small metal-turning firms (Semlinger 1995). The Pakistan and Brazilian clusters referred to earlier, have technology centres which could carry out similar functions but a lot more remains to be done. Whether it will is hard to tell, but progress on institution based trust is more likely to come from joint action of local producers and involving local government than from central government.

Further research will need to show whether the conclusions presented in this section are generalizable. Other questions need adding:

- Competitive pressure from outside the cluster can contribute to closer cooperation and greater trust between local enterprises but it can also trigger an avalanche of opportunism. What are the key factors which determine the direction of the response?

- How does increasing differentiation[18] and asymmetry between local enterprises affect the possibility of fostering trust and cooperation?

- Social ties between local enterprises are not always conducive to trust and growth? Under what conditions are they?

- Social embeddedness seems an important feature of successful clusters (particularly in the early growth phase). Is it a necessary feature for collective efficiency and trust? This latter question is addressed in the course of the next section concerned with public policy.

6 THE ROLE OF PUBLIC AGENCIES IN FOSTERING TRUST

If trust is a source of competitive advantage, the question arises whether and how it can be fostered by public agencies. This question is explored in this section with regard to both fostering minimal and high trust. The concern is **not** with trust in the public sector but with public agencies facilitating trust amongst private actors. This section first discusses the question of fostering minimal trust in the transition economies, and then considers the promotion of extended trust in developing countries.

FOSTERING MINIMAL TRUST

We start with the role of the state in providing the basic framework for minimal trust. Certainly introducing and enforcing law is a matter for the state. According to the World Bank's **Governance and Development**, a good legal framework for economic development has five critical elements:

(a) there is a set of rules known in advance;
(b) the rules are actually in force;
(c) there are mechanisms ensuring application of the rules;
(d) conflicts are resolved through binding decisions of an independent judicial body, and
(e) there are procedures for amending the rules when they no longer serve their purpose.

(World Bank 1992: 30)

The relevance of the rule of law for trust is obvious. It helps to reduce uncertainty. As stated earlier, we only trust up to a point. The smaller the leap into the unknown, the easier it is to make. In this sense, the rule of law eases economic transaction and helps markets to flourish. The relationship between law and markets is not, however, as straightforward as it seems at first sight. Two further questions need to be considered: is the rule of law a necessary condition for markets to develop? If/where it is necessary, do Western countries provide the best models to follow? The relevance of these questions is discussed with particular reference to transition economies.

Research and policy documents concerned with private sector development in Eastern Europe and Central Asia have a recurring theme: the urgent need for a better legal system (Boycko and Shleifer 1995; Grey and Hendley 1995; Sheppard 1995; Webster and Charap 1995). Is the rule of law a necessary condition for markets to develop? The history of economic development is full of examples of flourishing trade without legal backup (Clay 1996; Greif 1989; Platteau 1994a, 1994b; Zucker 1986). Taiwan and Japan provide contemporary examples of where the law is insignificant in regulating business transactions (Moore 1993; Wade 1990). Does this mean that in Eastern Europe and Central Asia, legal reform is not a central requirement for the transition? Certainly not! It is hard to see how the transition can succeed without the state creating a legal framework in which trust can develop. The reasons are clear from Section 4: the bases on which trust developed in capitalist countries could not develop or were destroyed.

While introducing a legal framework in itself cannot solve the problem, not having an effective legal system compounds the problem of trust. In the ex-Soviet Republics, the transition to a market economy was not accompanied by clear property rights, contract law and enforcement. 'The result, of course, is that organized crime enters to protect property rights and enforce contracts' (Boycko and Shleifer 1995:78). Varese (1994: 230) goes a step further and warns that 'the future of Russia may be in some respect similar to the history of Sicily'. His work on the Russian Mafia is an empirically based account of the consequences of not having clear property rights and contract law. Their absence 'undermines not only trust in the state, but also among citizens. The business community so far has not developed a set of rules of the game which holds in the absence of an enforcing central agency. There is, in fact, a high degree of crimes committed by business people against other business people' (1994: 245). Varese's main conclusion however is that 'in an untrusting world like present day Russia, it is highly rational to buy private protection despite all the collective evils it produces' (1994: 231). His argument is worth elaborating.

> Economic reforms from 1986 onwards have produced a dramatic increase in the number of property owners and transactions ... which has not been matched by clear property rights legislation and administrative or financial codes of practice. Not has it been matched by a corresponding ability on the part of the authorities to enforce such legislation as does exist.... As a consequence, fear of losing property and vulnerability to frauds increased and so correspondingly did the demand for protection. An independent supply of potential 'protectors' has also appeared on the scene: an increasing number of dismissed officers and soldiers from the Army, the KGB and the police are looking for jobs and the only skill they possess is physical force. They perfectly qualify as autonomous private suppliers of protection!
>
> (Varese 1994: 231)

> Despite obvious drawbacks, the price paid for the services of the Mafia has a rational justification in an untrustworthy world.
>
> (Varese 1994: 257)

If trust begets trust, mistrust begets mistrust. Could this downward spiral have been avoided? Is there a lesson in the sequencing of reform measures? Should 'proper' legal reform have come before privatization? Boycko and Shleifer argue that this is a technocratic point to make, that before privatization 'the political demand for legal reform did not exist. At this post-privatization point in the Russian economic reform process, however, legal reform is both essential and politically feasible' (Boycko and Shleifer 1995: 78). Implicit in this position is that the space filled by the Mafia is temporary, that the private state which feeds on mistrust is temporary and that it will gradually be replaced by a public state which creates conditions for trust. Examining the situation through a Sicilian lens makes for a less optimistic outlook, but the transition economies have their own dynamic which is hard to predict.

Other important questions concern the **kind** of legal system that is to be put into place: should it be home-grown or imported, should it model itself on the West or East? In a paper on reform priorities, the economist Dornbusch argued that the transition economies should 'adopt wholesale and without question the entire civil code, including corporate law, of a well-functioning legal system, say the Netherlands or Finland' (quoted from Varese 1994: 241). In contrast, in a paper on company and contract law in Russia and the CIS, the legal expert Butler (1995:178) concludes that 'law reform has a greater chance of succeeding when it draws on the positive strengths, culture, terminology, and legal consciousness of the domestic legal system being reformed'. The transition economies have embarked on the latter route[19] but also drawn on advice from outside, mainly from the West (Grey and Hendley 1995).

A critical question is what this advice is modelled on. In order to explain why, it is useful to draw on Moore's (1993) critique of **Governance and Development**, the World Bank's main policy document on 'good government'. While agreeing with much of what the document says on the legal framework, Moore's critique focuses on the implicit assumption that legal reform would follow the Western (if not American) model and on the silence concerning other choices available. The drawbacks of the 'user friendly' and adversarial American legal system are seen to lie in: a) the high direct resource costs of litigation to the parties involved; b) encouraging recourse to courts; c) long term rupture of relationships inherent in the adversarial court procedure. In contrast, Japanese enterprises have stronger incentives to settle issues out of court. 'In the Japanese system, legal judgements are made in such a way that they constitute guidelines for the peaceful resolution of analogous disputes outside the court process - a clear contrast to the high degree of unpredictability and 'pro-court bias' of the Anglo-American adversarial system' (Moore 1993: 46-47). The key point however is not to recommend the Japanese system but to point out that there are choices. The need to make an informed choice is highlighted by the statistic which shows that countries with a higher percentage of lawyers grow more slowly (Murphy, Shleifer and Vishny 1991).

To conclude, the relevance of the law for trust varies between countries and over time. There is no doubt, however, that in transition economies legal reform and the enforcement of the law are indispensable for trust to develop. The problem is that the rule of law - in order to be effective - cannot rely on coercion but requires confidence in the state. Some transition economies have made more progress than others in rebuilding that state. Overall, Central European countries seem to have made more progress than Russia and the CIS in the reform and use of law, but within each country progress has been uneven in different parts of legislation (Grey and Hendley 1995). Increasingly, these countries will be able to learn more from each other than the 'old capitalist countries' which had centuries rather than years to develop their legal systems. Such learning will need to feed on comparative research.

While the concern with law and enforcement is a priority, there is a danger that other institutional ways of resolving conflict are neglected. Because the law is 'heavy', mediation services have been developed in USA, Japan and other countries: 'Mediation is cheaper, quicker and conducted in an atmosphere in which the parties' willingness to discuss settlement is not seen as a sign of weakness, thus pre-empting the need to adopt a war posture' (Sako 1992: 172). The existence of such 'light' ways of dispute resolution can facilitate minimal trust but they are also relevant for developing or preserving extended trust. Sako refers to their importance in Japanese supply chains where subcontractors and customers are keen to preserve this relationship but are locked in a dispute over a specific order. 'The mediation services fulfil a useful function of restoring 'good-will trust' between trading partners before it is too late' (Sako 1992: 172). Similarly, Sabel emphasizes the importance of arbitration in European industrial districts: 'whenever the parties to these conflicts regulate their disputes through arbitration boards or councils ... the districts flourish; when not, then not' (1992: 228).

The point of discussing these mechanisms is that their existence makes it easier to trust. Clearly they are not useful for dealing with blatant fraud, but they help to deal with the more common messy situation where both parties cut corners (for fear that the other may also do so). Knowing in advance that arbitration exists makes it easier to leap into the unknown. It would seem that such alternative institutions for dispute resolution are an important complement to legal reform, especially, but not only, in transition economies. The trouble is that little is known about how they work, under what conditions they are effective, whether they work better as public or private self help schemes. From a trust perspective, these are important issues for research and policy.

Other schemes through which public agencies can facilitate trust include the development of common industrial standards, services for measuring and testing products, the certification of products and processes, or accounting and auditing reform. All these are and tend to be seen as technical matters. A concern with trust shifts them onto the agenda for economic policy. The first step of gaining recognition that they are important is easy. The second step of translating this concern into concrete policy proposals is difficult. Research has a role to play here in showing under what conditions these seemingly technical schemes become an effective way of fostering institution-based trust.

FOSTERING EXTENDED TRUST

The responsibility of the State to provide a basic framework for minimal trust is undisputed. Economic development is promoted by stable, clear and enforceable rules. Such rules limit uncertainty and make efficient market transactions possible. There is less agreement about what role the State might play in fostering extended trust. In this sub-section, the potential role of the State in fostering the institutional context in which extended trust can thrive and in directly promoting the formation of networks of cooperating enterprises will be explored.

Enterprises cannot be forced to cooperate with each other, but they can interact with each other in contexts which are propitious to the development of extended trust. Sako, for example, demonstrates the importance of arbitration services in Japan in establishing a stable framework for relations between large and small firms (Sako 1992: 158-172). This is contrasted with the problems facing small firms in Britain because of late payment by large firms. A recent article by Lane and Bachmann, which compares supplier relations in two industries in Britain and Germany, takes this point further. It is argued that the legal and institutional frameworks existing in Germany reduce risk and uncertainty and make trust possible (1996: 6-10). First, they point to the role of law in Germany in regulating relations between enterprises. In Britain, for example, terms of payment are a frequent source of conflict and uncertainty in inter-firm relations. Unregulated payment conditions both increase uncertainty for suppliers, raising their exposure to risk, and produce tensions which prevent close relationships developing. In Germany, terms of payment are regulated by law and institutional arrangements. This provides a stable relationship on which relations can develop (Lane and Bachmann 1996: 35-36). Second, Trade Associations in Germany play a role in standardizing relations in particular sectors - raising predictability and providing a clear framework for enterprises:

> In Germany, Chambers of Commerce are statutory bodies with compulsory membership for firms within their sphere of influence. They execute quasi-political functions, such as issuing licences, settling disputes and advising banks on firms' creditworthiness, as

> well as providing collective support for smaller firms, such as assisting with export promotion or the provision of further training ... Being part of this associational network encourages conformity to common norms and standards and thus reduces risk of individual failure. Reputations are more in the public domain and industry associations offer a forum for the exchange of information and the development of contacts. All these knowledge-generating activities reduce risk and are conducive to the development of a high level of trust in German business relations.
>
> (Lane and Bachmann 1996: 24-25)

This institutionally-based trust provides a stable framework for partnership-based relations to develop because (i) the risks associated with partnership are reduced, and (ii) firms can discount the risk from opportunism and focus on other aspects of their relations with enterprises.

Institutions can foster extended trust, but can the State change the institutional environment? Lane and Bachmann refer to national 'industrial orders' which include not only legal and institutional frameworks but the financial, educational, training and industrial relations systems as well (1996:18). These systems are then reinforced by distinctive patterns of industry structures which arise as a result of them. Clearly, these will change only slowly. Governments can intervene in these systems, even if the effects will only become apparent in the long term, but it is an open question as to how firms will respond to these interventions. For example, one might expect that the development of the ISO 9000 quality standard would raise competence trust. But in a system based on short-term profit-maximization, ISO 9000 might encourage short-termism because basic quality systems will have been institutionally certified.

Short-term interventions can be surprisingly effective when States attempt directly to foster cooperation between enterprises. The State can play a catalytic role in fostering trust relations in networks of enterprises by bringing firms together in networks. There is now documentation of this process in both developed and developing countries. Sabel (1992) discusses initiatives in the USA, while Semlinger (1995) has analysed a case of network promotion in Germany. Similarly, Humphrey and Schmitz (1996) have described not only the Danish experience, but also experiences in developing countries. These experiences have been particularly marked in relation to small- and medium-sized enterprises.

The competitive advantage which clustering and networking seem to provide has prompted States in both developed and developing countries to reproduce these advantages through policies which focus on inter-firm relations. By promoting networks of small and medium firms and by encouraging better linkages between large firms and their suppliers, governments hope to promote efficiency. The development of trust is central to these initiatives. With trust comes greater willingness to share orders, establishment of new divisions of labour, cooperation in marketing, etc., which lead to economies of scale and scope and competitive advantages.

Sabel suggests that the changing industrial structures themselves, notably the increasing interdependence, provide a foundation for the development of cooperative behaviour. He argues that in the case of Pennsylvania, contact around a diagnosis of the problems and possibilities of a particular sector led to a change in perceptions of the costs and benefits of cooperation, (Sabel 1992: 239). Through a diagnosis of the industry, firms came to realize how interdependence between firms was increasing and making cooperation both feasible and necessary.

While enterprises may obtain advantages from closer cooperation based on trust, there is a paradox. The development of cooperation between SMEs is a costly exercise which can only be reduced by the trust which should later develop:

> These costs, however, can be reduced if cooperation does not rest on continuous renegotiation but on a mutually shared set of aims and values, and if reciprocal control does not call for recurrent supervision and scrutiny but is guaranteed by mutual trust. Unfortunately, trust, defined as the experience-based expectations of cooperative and benevolent behaviour, cannot be unconditionally presumed. Accordingly, cooperation based on trust has to cope with a severe starting problem.
>
> (Semlinger 1995: 274)

The State can kick-start networks. The provision of a 'broker' or 'facilitator' appears to be central to this process. In the case of Baden-Württemberg, for example, the Regional Trade Bureau provided consultants to organize such networks and subsidized the expenses (Semlinger 1995: 276-77). The most significant initiative of this kind has been the Danish Network Programme of the early 1990s, which has since been copied, in modified form, in a number of other advanced countries (Humphrey and Schmitz 1996).

The development of networks through the use of brokers or facilitators is not limited to Europe or North America. The Proyectos de Fomento (PROFO) programme in Chile is similarly concerned with networks.[20] This programme is based on the idea that small firms can benefit from closer contact and cooperation, and groups of firms in the same locality and sector are targeted. Owners of small businesses in Chile are as individualistic and mistrustful of their competitors as anywhere else, and they are also suspicious of government. The first steps in the programme are to provide an incentive for firms to participate, and a demonstration of the capability of the State. For each group, a manager is appointed who provides an interface between the group and the outside world, gaining and accessing available State support and exploring opportunities. This gives the programme credibility and provides a reward for participation. From here, regular meetings of participants help to build up mutual understanding. Out of this contact emerge opportunities for cooperation which would not have been considered before. In effect, the owners begin to know enough about each other to decide to take the risk of cooperation. Once the first steps are taken, the experience of the relationship will determine whether or not trust develops further.

This kind of policy will only work in certain situations, just as clusters of enterprises do not always develop fruitful forms of cooperation (Schmitz 1995). First, such cooperation is more likely to emerge when firms face challenges they cannot easily address on their own. The incentive to cooperate is greatest when enterprises can gain from such factors as economies of information gathering, economies of scale or scope arising from a division of labour, or sharing risks. Conversely, firms in non-competitive markets, or firms whose profit strategy is based on rent-seeking behaviour have much less of an incentive to cooperate. The success of the PROFO programme in Chile can be related to the risk-taking orientation of its entrepreneurs (Montero 1992) and the export-orientation of Chilean industry, which forced firms to improve their competitiveness. Second, the obstacles facing the promotion of trust depend on both the entrepreneurs involved and the State. The more the entrepreneurs targeted for the programme have a history of cooperation and the more the State is seen as having a legitimate role in sectoral arrangements, the easier it is for such projects to succeed. The contrast between Semlinger's account of Baden-Württemberg (1995), and Dini's account of how suspicion of the State had to be overcome in Chile (1993) is instructive. In the former case, local institutions, State and NGOs had a history of intervention and support, while in the latter case the broker at the centre of network of activities has to work hard to overcome suspicion of the State. If the State can deliver practical support to entrepreneurs - helping to solve their immediate problems, then the network programme has more credibility. But this requirement also shows how difficult it is to promote trust. How many governments can delivery effective locally-operated services in cooperation with representative sectoral associations?

7 CONCLUSION

The recognition that trust matters for economic development is old. Only recently, however, has the relationship between trust and economic development become an explicit and deliberate focus of debate. Why only recently? Is it just academic fashion with Fukuyama's (1995) book the most visible product? We believe not. The reason is implicit in Section 5. There are forms of economic organization which have proven to be superior and they require more than minimal trust to function. The cost of not trusting is becoming more obvious. This is what has put trust on the map and made it a concern for practitioners and researchers. At least this is what we observe in our own field of industrial development.

Enquiries into whether high trust where it exists is culturally based adds to the mystique surrounding trust. Whatever the answer, producers elsewhere have to find their own ways in their own conditions of reconstructing relationships with suppliers and customers. And they are doing so in advanced and less developed countries, especially where industry is moving into market segments of higher value added. It remains selective, and there are winners and losers, but it is happening.

The academic debate remains hampered by the difficulty of defining trust. Section 2 showed that there is no easy solution. The willingness to expose oneself to the consequences of someone else's action is a result of **both** calculation and trust. Where one begins and the other ends is impossible to determine. Attempts to reduce decisions to a calculation of likely gains and losses are misguided. Nor is trust a residual. On the contrary, as recognized by Luhmann (1979), trust makes calculation possible, often it is a way of minimizing calculation. Since part of the business decision is not entirely calculable (and often not entirely conscious), the problem of measuring trust is in the end irresolvable. This is not to argue against a search for indicators which can serve as proxies. On the contrary, this is an important part of the research agenda.

In order to move the debate forward, the most important step probably lies in distinguishing between different kinds and bases of trust. Such distinctions can be found in the literature. The purpose of Section 3 was to draw them together, explain their significance and provide a conceptual map for our own work and hopefully that of others.

The question which drives our work is whether and how trust can be fostered. In developing and transition economies this question is particularly acute. Generalized trust rarely exists - their societies tend to be more fragmented than those of advanced countries. Yet trust is particularly critical to their growth. Critical because trust offers particular advantages in turbulent environments. The more unpredictable the market, the greater the difficulty of covering eventualities through contracts, and the greater the need for trust - if specialization and exchange are to take place.

This paper leans towards an optimistic view on the possibility of fostering trust. The view one takes is not just influenced by empirical observation and data but by the way one approaches the question. If one's starting point is a society with generalized trust - approximated by Japan - and asks how can developing countries such as Ghana or transition economies such as Kazakhstan reach this situation it is easy to fall into pessimism. This pessimism deepens if trust is seen to depend above all on generalized morality. It is undoubtedly true that generalized morality is the ideal and most effective base for trust but it takes a long time to grow (few societies ever succeed) and is not the only base for trust.

The outlook becomes different if one starts with examples of existing trust in developing and transition economies and asks how such cases can be built on. In other words, one starts with selective (rather than generalized) trust and asks how these 'islands of trust' can grow. Understanding this process requires recognition of the different bases of trust. The least controversial is the trust which grows with positive trading experience - Zucker's (1986) process-based trust.

More controversial is whether ascribed trust offers a base for growth. Most modernization theory, whether in its conventional or Marxist version, regards social ties as obstacles to the building of modern economic relations. As shown in Section 5, we do not entirely share this view and agree with those who say that social ties facilitate trust and can contribute to becoming competitive. However, the cited case material also suggests that - in order to continue to grow - trust needs to change from being ascribed to being earned. Distinguishing between different bases of trust and phases of growth is essential.

Institutions can help to make trust more generalizable but government, the one institution which is in charge of the whole society, cannot simply decree that economic agents are trustworthy. Institutions which are effective in certifying that economic agents are competent and honour commitments usually originate from small groups with a proven track record. The institution becomes a transmission belt from selective to generalized trust. Again, the starting point is selective trust and the question is how trust can be fostered from such an initially small base.

This paper has included examples from different parts of the world of how trust has grown. In some cases this trust was consciously fostered (Section 6). They add up to an optimistic view. Of course, we also need to know more about cases where trust has collapsed. Indeed, the debate has only just begun - at least with regard to developing and transition economies. One of the main arguments of this paper is that this debate has now become more urgent. Recent years confirm that production by command, whether in a centrally planned economy or Fordist factory, yields poor results. They confirm that economic agents are more productive when they have some autonomy. But few can compete on their own in an age of liberalization and globalization. Becoming competitive means accepting interdependence. The interlocking between enterprise in the new models of industrial organization requires more than minimal trust. And they are not just models, they exist in practice, not just in advanced countries, also in developing countries. The practice is messier than the models, but it shows how trust can be fostered. Further research will need to show how relevant such industrial experiences are in other sectors.

NOTES

1 We thank Mick Moore, Judith Tendler and John Toye for their valuable comments on a previous draft. Dominic Furlong helped us to assemble and digest the (unexpectedly large) literature on trust, and Bridget Byrne helped us screen the literature on transition economies.

2 For an overview of trust in the history of economic thought, in particular transaction economics, see Furlong (1996).

3 For this argument to hold, it is not necessary to assume that all potential partners will act opportunistically if it were profitable to do so. Williamson does not have to make such a depressing assumption about human nature, even though he is sometimes accused of doing so. He merely has to assume that it is not feasible to determine *ex ante* who will act opportunistically and who will not: 'It is not necessary that all agents be regarded as opportunistic in identical degree. It suffices that those who are less opportunistic than others are difficult to ascertain *ex ante* and that, even among the less opportunistic, most have their price' (Williamson 1979: 234).

4 Keynes was more concerned with confidence than trust but his observations on the psychology of business decisions are nonetheless valid for our purposes.

5 It does not, however, include the assumption of bounded rationality. Most games assume a high level of calculative skill and understanding of pay-offs.

6 For a game-theoretic analysis of reputation effects which focuses on the latter aspect - the constraints on opportunism arising from the spread of information about transactions beyond the parties involved, see Raub and Weesie (1990).

7 Needless to say, such trust production mechanisms suffer from two defects. First, one must trust the honesty and competence of the endorsing agency, which has proved problematic in self-regulation of the UK financial system. Second, endorsements themselves can be obtained fraudulently. Shapiro (1987: 648) notes that the most successful frauds are those which appear to offer institution-based trust. As Granovetter (1992) points out, the most effective financial frauds overcome the initial distrust of the victim by having a fraudulent institution to guarantee the transaction.

8 In the case of the Rover-Honda partnership, the unfriendly divorce was a shock to Honda not because it had miscalculated the potential benefits to Rover's parent of a split, but rather because Honda was working on a different set of business calculations altogether, oriented towards long-term growth, commitment to all stakeholders etc.. Similarly, trading can allow companies to work out the bases of calculation of their partners.

9 This disadvantages of internalization can include not only the loss of potential economies of scale and market pooling, as outlined by Williamson, but more importantly costs arising from the inefficiencies and lack of control

evident in many large organizations, as outlined by Granovetter (1992: 68-69).

10 The development of trust relations concerns not only supplier development, but also the formation of strategic alliances or networks. Jarrillo defines a strategic network as a: 'long-term purposeful relationship among distinct but related for-profit organisations that allows those firms in them to gain or sustain a competitive advantage *vis-à-vis* their competitors outside the network' (Jarillo 1988: 32, quoted in Sydow 1992: 114). Discussion of such networks is outside the scope of this paper.

11 This supplier strategy is far from costless, but the costs and risks are less than might be predicted by transaction-cost theorists. First, while the costs of maintaining dense information flows between firms are high, the number of firms with whom the assemblers maintain a relationship is considerably reduced. Japanese automobile producers had only one third the number of suppliers as North American automobile firms (Womack 1990: 157). Second, in spite of maintaining long-term relationships with just a few suppliers, pressures for efficiency are retained through such means as comparing market prices with the suppliers' prices, encouraging the suppliers to compete against each other, building price reductions into contracts and rewarding good suppliers with larger contracts in the longer term (Dore 1983; Lamming 1993: 60; Nishiguchi 1989: 215-16; Sako 1992).

12 The extent to which supplier relations in the Japanese automobile industry are characterized by trust, rather than control or coercion is one which cannot be discussed here.

13 As mentioned earlier, this view of the development of cooperation differs from the account of Transactions Costs Economics. Asset specificity arises from the development of trust. It is not an exogenous variable which determines patterns of governance. This point is made with force by Nishiguchi (1989), who analyses patterns of subcontracting in Japanese industry. Companies develop the trust relations which make investing in specific assets viable. They do not develop close relations because of the need for specific assets.

14 See, for example, Business India, 14/6/1995, which started an article with the sub-heading 'companies are cutting down the number of suppliers and forging closer ties with the ones that remain'.

15 Based on research-in-progress conducted with Raphie Kaplinsky.

16 The industrial district debate has its origins in Alfred Marshall's (1920) Principles of Economics. For a brief summary of Marshall's contribution, see Schmitz (1995: 535-36). The terms 'industrial district' and 'cluster' are often used interchangeably, but it is worth pointing out that while an industrial district is always a cluster, the reverse is not always the case. This arises because the existence of a deep inter-firm division of labour or of embeddedness in a local community is often defined into the term industrial district (as in Becattini above). An advantage of using the term cluster is that it refers merely to a sectoral and geographical concentration of firms and the existence of other features (such as embeddedness in local community) is

thus considered a matter for empirical research and not subsumed in the definition.

17 Social relations can also have a negative effect on a cluster's growth. According to Knorringa (1994), in the footwear cluster of Agra (India), the economic divisions between producers and traders were heightened by the distinct social castes to which they belonged. While the producers were largely backward caste hindus (*jatavs*) and poor Muslims, the traders were forward caste Hindus (*banias*) and rich Muslims. Knorringa suggests that the antagonistic exchange relationship between producers and traders was reinforced by the distrust and social contempt which the two castes had for each other, thereby weakening the prospects for cooperation.

18 Differentiation between local enterprises increases with growth. This is now well documented - not just for the Brazilian and Pakistani clusters referred to above, but also for cases in India (Knorringa 1995) and Mexico (Rabellotti 1995).

19 The main exception is East Germany which adopted West German law. This is obviously a special case.

20 For further details of the PROFO case, see Dini (1993), Henriques (1992) and Humphrey and Schmitz (1996).

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