Staff Paper

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OF TRUST IN GLOBAL AGRI-FOOD
SYSTEM TRANSACTIONS

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Abstract or Summary

The concept of social capital is defined as a third process (along with individual incentives and authority relationships) for assuring transaction cost efficiency. Social capital is especially relevant to international transactions because cultural differences, large distances, and limited international institutional scope lessen the effectiveness of incentives and authority relationships while social capital can be built within the context of specific international transactions. Methods for building social capital in international settings are explored. A research agenda is articulated as well as a list of managerial implications for using social capital in an international context.

13 pages

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The agri-food system has become increasingly global with continued pressures to open trading relationships further. More and more firms are engaging in and expanding relationships with firms in other countries and at long distances. International supply chains have also been established, and their use in global business strategy will likely expand. Creating and enhancing trust between distant transaction partners could play a key role in improving the effectiveness and efficiency of this increasing web of international inter-firm relationships. The purpose of this paper is to further the development of a theoretical and applied framework for understanding the origins, role, and economic impacts of trust in global transactions.

To accomplish this purpose, the paper draws upon three bodies of literature: (1) the transaction costs literature, (2) the emerging literature on social capital, a concept that helps explain the existence and evolution of trust within economic relationships, and (3) the international market entry literature. The paper is organized into five sections. First, social capital and its relationship to transaction cost theory is defined. Second, social capital's particular relevance in international transactions is discussed. Third, the process for building social capital in international transactions is argued to be a predominantly trust-based phenomenon. Fourth, a research agenda for further studying trust and social capital in international transactions is laid out. The final section presents some managerial implications of these various concepts.

Social Capital: A Third Way

One of the critically important contributions of the transaction costs literature has been Williamson's exposition of alternative institutions for governing economic transactions (Williamson, 1985). In a world of bounded rationality, opportunism, and asset specificity, there are argued to be only two pure institutional forms for efficiently governing transactions--the market and hierarchy. The market relies on the strong economic incentives of competing self-interest to assure efficiency while hierarchy relies on authority and the ability to monitor and discipline self-seeking behavior. Beyond these pure forms, Williamson and others (Barkema, Mahoney, Martin *et al* to name just a few) have defined hybrid forms of organization, including various forms of contracting, strategic alliances, and joint ventures. All of these various forms of institutional organization utilize individual incentives, authority/monitoring relationships or some mix of both to align the potentially conflicting interests of transacting parties and thereby bring about an economically efficient transaction. This creation of aligned or mutual interests minimizes the costs of transactions by limiting the impacts of opportunism and bounded rationality, i.e., the impacts of imperfect contracting.

According to this theory, all efficient coordinating institutions are built on only these two underlying processes--harnessing selfish incentives and establishing authority relationships--both enforced within a context of legal institutions and various monitoring procedures. But what if the problems of opportunism and bounded rationality could be limited by the existence of *actual* (rather than artificially induced) mutual interests? Actual mutual interests could reduce incentives for opportunism, the costly need for monitoring, and the potentially negative consequences of renegotiating contracts when uncertainty is later resolved. This idea is hardly new to economics (Frank). However, the concept of true mutual interest is treated with some scepticism by economists, in no small measure, because the incentives of mutual interests are presumed to be weak in a world of private utility. In responding to this concern about the reliability of mutual interests, one needs to return to the presumption that all real contracts will in some way be incomplete and even the processes of incentive contracting and authority relationships are themselves imperfect. If the underlying process for creating and maintaining actual mutual interests could be better understood and predicted, mutual interests' reliability would be much less in question and the means for improving transaction efficiency increased.

A growing body of literature relevant to the process of mutual interests centers on a concept called social capital. It is a term that comes from sociology (Coleman; Portes and Sensenbrenner; Sandefur and Laumann), but has become of increasing interest to economists (Kanck and Keefer; Schmid and Robison). Social capital has the potential to be studied and used as a third way to assure the efficiency of economic transactions.

As an emerging concept, the definition of social capital remains fluid with different authors taking different approaches. According to Coleman, social capital consists of relationships found in social structure that are appropriable for productive use by an actor. He talks of various forms of social capital including trust, effective norms, and voluntary organizations. Portes defines it as the capacity of individuals to command scarce resources by virtue of their membership in networks or broader social structures. Putnam refers to social capital as features of social organizations, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions. Robison, Schmid, and Siles argue that social capital needs to be defined in a manner constant with other forms of capital, i.e., as a good that is capable of producing other goods and services. Their definition is adopted here and can be paraphrased as follows:

> Social capital is the sympathy or sense of obligation that a person or group receives from another person or group that may produce a potential benefit, advantage, or preferential treatment from that other person or group beyond that which might be expected in a selfish exchange relationship.

Under this notion of social capital, the basis for mutual interest is the sympathy or obligation of one transacting partner for the other. It arises from the social connectedness of the two parties and not from self interest or authority. In the context of transaction cost theory,[1] the potential benefit of social capital is that each partner will forego opportunistic behavior (and thus avoid its associated costs) because of the sympathy or obligation felt for the interests of the other partner. Mutual caring about each other's interests thus has economic benefits.

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[1]The concept of social capital is quite broad, and there is no intention here to limit the range of the concept to only transaction cost theory. The intent is to show the relevance of the concept within this theory.

The use of the term "capital" is critical to the concept. Like other forms of capital, e.g., physical or human, social capital is presumed (1) to be valued on the basis of the potential services it can provide, (2) to be built or accumulated through an investment process, (3) to be depreciated or maintained by the nature of its use, and (4) to have durability and some flexibility in use. This paper will not attempt to address all these issues, but two are particularly relevant to the arguments presented later. First, the value of the potential service from social capital is, as already noted, the avoidance of transaction costs as partners forego opportunism. Second, it seems reasonable to argue that actually foregoing opportunism when the opportunity presents itself is a likely investment mechanism for building social capital. Foregoing opportunism becomes a form of credible commitment that signals the existence of sympathy and obligation. A later section of the paper will discuss in more detail how social capital is built and used. For now, it is enough to motivate some initial face validity to the notion that social capital as defined could be an effective basis for assuring efficient economic transactions.

Beyond this face validity is a limited body of empirical work that supports the notion that social capital does create economic value. Knack and Keefer took data from the World Values Surveys administered in 29 market economies. They operationalized social capital through two variables--generalized trust of others and strength of norms of civic cooperation. The social capital variables had a statistically significant positive impact on both per capita income growth and investment rates by country when used in a regression that also included education levels, beginning period per capita income, and price level of investment goods as independent variables. The Knack and Keefer analysis also indicates that social capital becomes even more important in facilitating economic activity in countries where more formal substitute processes, e.g., secure property rights and reliable enforcement of contracts, are unavailable. In other words, social capital can substitute for selfish incentives and authority.

On a more micro level, Schmid and Robison report on several empirical tests of the social capital concept and its economic impact. Social capital was operationalized in terms of relational closeness between transaction partners, e.g., family member, friend, neutral third party, etc.. Across a variety of situations, social capital was shown to have beneficial impacts on the price of a used car, the interest rate necessary to entice customers to switch banks, the acceptance or transference of catastrophic risk, the choice of farmland leasing contract (share vs cash), and the probability of loan approval. The presence of social capital had significant measurable benefits.

Social Capital and International Transactions

The characteristics of international transactions make an ideal subject matter for studying the existence and usefulness of social capital as an efficiency enhancing process. First, international transactions can and do occur over large distances. Such distances make most forms of transaction monitoring both difficult and expensive. Monitoring thus becomes much less useful as a means of aligning interests and limiting transaction costs. Second, differences in legal institutions across national boundaries and the limited scope and enforcement of international law make another standard tool of incentive contract enforcement of limited value. The current conflicts between the United States and Europe over sources of bananas and hormone-treated beef and the seeming ineffectiveness of related WTO rulings are an excellent case in point. Third, international cultural differences create variations in what constitutes effective individual incentives and legitimate authority relationships. Hofstede defines five distinct cultural dimensions that differentiate managerial environments internationally--small vs. large power distance, individualism vs. collectivism, competitiveness vs. cooperativeness,[2] little vs. much uncertainty avoidance, and long-term vs. short-term orientation. Each of these dimensions can dramatically effect both incentive structures and authority relationships. Differing cultures thus make both incentives and authority much more difficult to structure across an international transaction. Given these three characteristics alone, the standard tools of transaction cost theory--strong incentives and authority--would appear to have limited use in assuring the efficiency of international transactions.

At first blush, social capital would also seem to be of limited value internationally. A sense of sympathy or obligation would be much less likely in international transactions then in most domestic transactions. Again, differences in culture, ethnicity, language, etc. would all seem to conspire to make any sense of sympathy or obligation ineffective. The difference however between social capital and incentives or authority is that social capital can be built. It is a variable potentially under the control of the transacting partners. Social capital can be created within the confines of the transacting relationship. The nature of incentives and authority are more fixed by broader context. The structure of incentives and authority lie well beyond the confines of a single relationship in the very fabric of a culture itself. Changing the culture or its macro institutions, e.g., its legal system, is not generally feasible for any given relationship. Changing the nature and strength of interpersonal connections is feasible.

The explicit hypothesis being advanced is that social capital may be a more effective process for efficiency in international transactions than either incentive contracts or authority relationships. If this hypothesis has any validity, then the literature on international business should show some evidence of the social capital concept either theoretically or empirically or both. The authors searched this literature and did find much anecdotal evidence that culture and relationships matter. However, little if any systematic research has been done on the topic. What follows reports briefly on the state of what exists.

The anecdotal evidence appears quite broadly. Textbooks, popular press works, and journal articles all cite cases of specific transactions that performed poorly because of cultural misunderstandings, limited attempts to create effective interpersonal relationships, missed opportunities to understand the nuances of communication, friendship, and partnership, or lack of knowledge of how business was done in a particular country setting. Every standard international business, marketing, and supply chain text appears to have at least one obligatory chapter on culture that also touches on the nature of interpersonal relationships. The student is advised to understand culture and interpersonal relationships as critical to international effectiveness, but little is every done to justify why these things are critical. It appears that the argument is simply that because culture and interpersonal relationships have proven important in practice it must be so, even if the reasons for their importance are not systematically understood. However important culture and relationships appear to be, based on anecdotes, no systematic empirical studies appear to exist. The concept of social capital gives an underlying rationale to the

[2]Rather than competitiveness and cooperativeness, Hofstede used the terms masculinity and femininity. The authors have chosen to use more neutral terminology for the same phenomenon.

importance of studying culture and relationships as well as a framework for pursuing empirical work.

The more specific literature on international market entry modes provides some additional insight into where the concept of social capital could be useful. When a firm formulates an international business strategy, one of its most important decisions is entry mode, i.e., what institutional arrangement will the firm use to enter a particular host country market. The international market entry literature has coalesced around three modes (Anderson and Gatignon; Root; Young *et al*) that bear a striking resemblance to Williamson's market-hybrid-hierarchy continuum. The **export entry mode** involves a firm producing an exportable product in a home location and selling it abroad through some form of relatively open market transaction. The **contractual entry mode** includes a variety of arrangements such as licensing, franchising, management contracts, non-equity or limited-equity joint ventures. In these arrangements, the entering firm shares production, marketing or other significant activities with host country partners. This mode is clearly an example of what Williamson would call a hybrid structure. Finally, firms enter international markets through **foreign direct investment (FDI)**. FDI involves substantial commitments of capital and direct management of facilities in the host country. FDI represents a hierarchy approach. (See Table 1 for a summary of the characteristics of each entry mode.)

A model of the entry mode decision by Driscoll is both comprehensive and representative of the work found in this literature. The Driscoll model is thus used to illustrate how social capital could contribute to this arena of study. Driscoll presents a number of interrelated factors that affect a firm's entry mode choice. First, the threat of opportunism is recognized in the model through the concept of dissemination risk, i.e., the extent to which a firm perceives that its know-how will be expropriated by a contractual partner. This risk is highest for contracting and lowest for FDI and exporting. Social capital could provide a context for how this risk might be managed, especially within partnership.

Second, the international experience of the managers making the mode decision is considered critical. Driscoll and others (Buckley and Casson; Johanson and Vahlne) argue that such experience, even if only very generalized, reduces the costs and uncertainty of servicing international markets and tends to favor more resource intensive entry modes. Interestingly, like the textbooks, the literature appears mute as to why experience in and of itself should have this effect. Other literature on a firm's readiness-to-export also tends to include the experience of decision makers as critical (Miller). There must be some underlying process at work that makes even quite generalized international experience valuable. But, what is it? Is all experience equally valuable? How would one know? Social capital could help expose this underlying process. With experience comes sensitivity to the nuances of international relationships and to the establishment of social capital. The next section will address this issue more fully.

Table 1: Characteristics of International Market Entry Modes

Characteristic	Export	Contract	FDI
Nature of exchange	Limited or nearly so to product sales	Some form of significant partnership with host country firm	Direct investment in significant assets for production and marketing
Examples	Direct selling Sales agent	Licensing Management agreement	Wholly-owned subsidiary Joint venture
Control by entrant	Low	Moderate	High
Resources committed	Low	Moderate	High
Dissemination risk	Low	Moderate to high	Low
Coordination form	Market	Hybrid	Hierarchy
Prospects for developing and using social capital	Low	High	Moderate to high (depending on the need to cooperate with others in the supply chain)

Third, socio-cultural conditions are deemed critical to the entry mode choice.

> "Socio-cultural differences between a firm's home country and its host country can create internal uncertainty for the firm, uncertainty which influences the mode of entry desired by that firm. In particular, increasing socio-cultural distance (dissimilarity) multiplies the perceived costs of using high commitment modes as compared to lower resource commitment modes. Further, socio-cultural dissimilarity discourages investment because of the difficulties involved in transferring marketing skills, technology, and human resources . . . . Being unfamiliar with dissimilar cultures creates high information acquisition costs as firms strive to acquire information needed to bridge the cultural gap between home and host country." (Driscoll, p. 27.)

Again, the importance and value of socio-cultural conditions are asserted, but what is the underlying process that explains why knowing these conditions reduces transactions costs? Social capital may again be a helpful concept to supplement this past work.

Gesteland provides one final reference point for social capital's potential legitimacy in the international marketing literature. Like Hofstede cited earlier, Gesteland defines a number of cultural dimensions that differentiate how business is done around the world. One of his four dimensions is deal-focused versus relationship focused. Being relationship focused implies building rapport before dealing, having patience in relationships, and emphasizing trust. This dimension is a remarkably close parallel to social capital. U.S. business people tend to be the most deal-focused in the world, while most other countries are relationship-focused. For example, in China, *guanxi* refers to one's ability to draw on personal connections in order to secure favors. As defined, *guanxi* is social capital. In part, the centuries of influence from Confucianism have resulted in power residing with people rather than with law or the system. The current underdeveloped legal system is another reason for *guanxi* being heavily used in business. Personal business obligations substitute for government protection of economic transactions (Luo).

Building Social Capital: Trust, Reputation, and Identity

Two arguments have been advanced so far. First, in addition to individual incentives and authority relationships, social capital provides a third process for reducing transaction costs in exchange relationships. Second, social capital may be a particularly relevant process in international transactions because the nature of such transactions tend to limit the usefulness of either incentive contracting or authority. The third and final argument relates to how social capital may be built in international transactions. Without a reasonable process for investing in social capital, the concept is interesting but not particularly useful.

As with the definition of the concept itself, no consensus exists on the nature of how social capital is built (Robison, Schmid, and Siles). Some authors do differentiate types of social capital based on conceptual arguments as to where it comes from (Sandefur and Laumann; Robison and Siles). Taking this approach, three types of social capital can be defined: (1) **direct social capital**, created by repeated direct transactions between two transaction partners, (2) **indirect social capital**, created by the reputation of each transaction partner in direct transactions with others, and (3) **identity-based social capital**, created by each transaction partner's association with broader norms, values, or characteristics shared or held because of group memberships not related to the direct transaction. (See Table 2 for a summary of the characteristics of each type.)

Direct social capital is built through repeated transactions between exchange partners. Within the context of these transactions, the partners would need to signal each other the existence of sympathy and obligation. Expressions of friendship, common values, common goals, and mutual respect would all be appropriate for building social capital. Social capital begins with the identification of kernels of commonality that provide a basis for mutual interests. Internationally, establishing this type of social capital would call for managers to commit to personal relationships, frequent visits and communications of a social nature, and a focus on understanding the partner's culture, values and interests. In short, doing all the things the international business literature suggests are needed but doing them with clear intention to build social capital.

In this sense, the establishment of trust between partners may be the key to building social capital. This brings the discussion back to the original concern about the origins and uses of trust. Unfortunately, trust is itself a troubling word that has several common-use meanings. Trust often

Table 2: Characteristics of Social Capital Types

Characteristic	Direct	Indirect	Identity-based
Foundation for trust between partners	Direct transaction experience	Reputation for trust relationships with others	Identification with or adherence to certain norms, values, or traits
Usefulness in initial contacts	Limited (built only through repeated experience)	High to moderate (reputation either exists or not; time needed to signal and verify)	High (partner tends to have or not have the desired identity characteristics)
Usefulness in continuing relationships	High	Limited (direct experience replaces)	Limited to moderate (persists if direct experience reinforces presence of identity characteristics)
Actions that develop and maintain social capital	Forego opportunism Express commonality and personal concern Establish personal/ social interactions	Forego opportunism Signal reputation (e.g., references) and act consistently with it	Forego opportunism Adhere to expected behavior based on identity characteristics

refers to predictability or dependability on the part of partners. It is a expectation of consistent behavior. Kumar criticized this sense of trust as being overly broad and provided an alternative that will be adopted here.

> "A partner that frequently promises to punish you and always follows through is honest and dependable but is not a company in which you place your trust. What really distinguishes trusting from distrusting relationships is the ability of the parties to make a *leap of faith*: they believe that each is interested in the other's welfare and that neither will act without first considering the action's impact on the other." (Kumar, p. 95.)

From this perspective, trust is an act that evidences the existence of social capital in a relationship. Kumar goes on to show, based on survey work, that high trust (social capital) relationships between suppliers and retailers result in less searching for alternative partners, more commitment to the supplier, more sales of the supplier's products, and better performance ratings.

Direct social capital is thus argued to be build on a foundation of trust in Kumar's sense. The ultimate act that communicates sympathy and obligation would appear to be foregoing short-run opportunism when it presents itself. The leap of faith only makes sense if this type of behavior is actually performed. The trouble with operationalizing this concept in reality is that acts of trust on the surface may not flow from the motivation of mutual interests. Deceptive partners way engage in small acts of commonality only to abandon mutual interest when it really counts. Reliance on social capital demands vigilance on the part of both transacting parties and significant signs of true mutual interests as the relationship progresses.

Direct social capital thus takes much time and effort to create based on successful attention to trust over many personal interactions and many economic transactions. Over the long-run, there is probably no substitute for this type of capital formation. However, in the short-run and when establishing first relationships, the other two defined types of social capital have importance.

Indirect social capital arises from ones reputation for trusting relationships with others. The transaction cost literature certainly contains much reference to reputation effects (Milgrom and Roberts). However, this literature tends to emphasis reputation as part of the incentive structure inherent in contracting as opposed to its use here as a reputation for pursuing common interests and engaging in acts of trust. The leap of faith with indirect social capital is that a reputation for trusting relationships will be extended to a new relationship. This obviously need not be true. However, a general reputation for trust reinforces the specific signals of trust arising in a direct relationship. In international settings, seeking out information about partners' trust reputations can be difficult, again in no small measure because the nature of trust itself probably differs according to broader social norms. The best evidence would likely come from other relationships with international partners. Indirect social capital may help establish an initial foundation for direct social capital, but it will be the character of on-going direct transactions that defines the long-run success of the partnership.

Identity-based social capital is also a more useful short-term and reinforcing foundation for trusting relationships. This type of social capital arises from a partner's particular identity with certain norms, values, and characteristics. One form of this is ethnic or racial identity. The partner has no control over this, but it can be the basis for initiating relationship. The interrelationships among Asian managers who share an ethnic Chinese background is an example of the existence and reliance upon this type of social capital. Family membership is another source of this type of capital. Culture is itself a source of this type of capital in that culture is a set of broadly held norms and values among a people whose members would be expected to act accordingly. In this sense, social capital can be built upon or be converted from cultural capital. Somewhat more under potential partner's control is common membership in international organizations, e.g., shared experiences as employees of a multi-national firm, common membership in international service clubs, shared alumni status from internationally recognized universities. Any of these sources of shared identity can create a foundation for social capital, but it will again be necessary to turn this generalized source into direct social capital through on-going relationships of trust and mutual interest.

Whatever the type of social capital built, the key is exhibiting behavior that confirms the existence of sympathy and obligation that can transform itself into shared benefits. Direct acts of trust within the history and current bounds of a relationship are necessary to this process, as is assessing the reasonable expectations that trust is warranted because of reputation or identity with others.

A Research Agenda

It has already been noted that research on the topic of social capital is in its formative stage. By extension, its application to international transactions is also quite tentative. This paper has however attempted to justify why both the concept of social capital and its relevance to international transacting are worthy of additional attention both in theory building and in empirical study. Further research work in this area would be facilitated by the articulation of an appropriate research agenda. While not an entire agenda, the following hypotheses are suggested by the analyzes made in this paper and would provide a starting point for the future.

1. International market entry via export results in the least development of social capital, and limits the long-run opportunities for building trust and improving global transaction performance. The contract mode results in the most social capital development because of the necessity for partnering. Foreign direct investment may result in high or moderate levels of social capital depending upon the need to partner with others.

2. Direct social capital is the most effective long-term foundation of trust in international transactions whatever the entry mode. Indirect social capital is the least effective continuing source of trust. Identity-based social capital may have an intermediate level of continuing usefulness depending upon consistency of actual behavior with identity characteristics.

3. Identity-based and indirect social capital are most effective in establishing initial international relationships but decline in effectiveness thereafter.

4. As a firm becomes familiar with the incentive and authority structures of a host country, the firm's ability to use incentive contracting and authority relationships improves across time. As a result, the reliance on social capital to control transaction costs will be greatest when entering a host market but will decline with experience.

5. In host countries with less developed and less reliable legal and incentive enforcement systems, social capital will be more heavily relied upon for controlling transaction costs than incentive contracting.

6. Strategies for international market entry that explicitly seek to build social capital and trust are more effective in creating successful transaction relationships than those that rely on incentive contracting or authority relationships.

7. Government policies that promote the building of social capital between firms at the micro level will be more successful in expanding international trade than those policies that seek to change and/or establish macro processes in the international environment, e.g., trading blocs, international commercial law.

This list merely suggests the potential scope of further research. The area is wide open, and the potential returns would appear to be high.

Potential Managerial Implications

The concept of social capital and its relevance to international transactions has a number of implications for agri-food system managers.

1. Explicit attention to building and maintaining social capital in international relationships holds the promise of economic benefit. Exposure to opportunism and other forms of transaction costs can be potentially managed through the process of social capital. Social capital would appear to be helpful when the processes of incentive contracting and authority relationships may well fail or be far less effective than in domestic situations

2. Building social capital involves exhibiting behavior that confirms the existence of sympathy and obligation. Direct acts of trust within the history and current bounds of a relationship are necessary to this process, as is assessing the reasonable expectations that trust is warranted because of reputation or identity with others. Managers need to seek information on culture, values, and shared background that will support the development of trusting relationships. They should avoid opportunistic behavior.

3. Managers need to understand and use the fact that power distance, individualism, cooperativeness, uncertainty avoidance, and time perspective differ broadly across cultures and therefore impact one's ability to rely on incentive contracts and authority relationships. Social capital may be a much more effective means to deal with these differences.

4. Entry into international transactions is an evolutionary process. Social capital may be most helpful in the earliest phases of international expansion. As social capital is internalized into continuing relationships, it may become more implicit than explicit. However, failure to nurture its existence is probably unwise, especially in those international settings where the formal institutions supporting individual incentive enforcement and authority relationships may be weak or non-existent.

Given the state of knowledge and research about social capital, these implications are more working hypotheses than confirmed truths. They appear to have face validity and conform to anecdotal evidence about the importance of culture and relationships in international business dealings. Much remains to be done to fully understand and predict the impact of social capital and trust on the efficiency of international transactions.

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