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Trust and its Implications for Economic Activity, Welfare and Globalisation

ABSTRACT

According to *The Macquarie Dictionary*, the word ‘trust’ has more than 20 interpretations in English. Therefore, it is important to specify the way in which the word is being used in any discourses about managerial and economic issues. In what respect and to what extent are economic agents to be trusted in their dealings with others. When economic agents are untrustworthy, this adds to economic transaction costs, reduces the level of economic activity and the achievable level of economic welfare as well as potential gains from growing globalisation. Several adverse economic consequences of lack of business trust are explored along with their consequences for the process of globalisation. Business co-operation and alliances can be important for gaining access to international markets, particularly for small and medium-sized firms. Middle traders can play an important role through their cooperation with smaller producers in enabling their products to be exported. However, suppliers at the bottom of the exchange chain tend to become locked into such cooperative arrangements. This can result in their economic exploitation and growing mistrust of such arrangements. Furthermore, once exploitation by a few middlemen occurs, competitors may be forced to follow their practice. Hence, the bad middlemen drive out the good and cooperative institutional arrangements can be expected to collapse with adverse impacts on economic activity, welfare and exports. Trust is also important in relation to most contracts and the sale of goods. As pointed out by Williamson, most contracts are incomplete and rely for their full execution on some degree of trust or unspecified expectations. There ‘reasonable’ expectations may vary from country to country and this creates a challenge for global transactions. Furthermore, trust problems are important in relation to principal-agent contracts which are invariably incomplete. Global operations of businesses can provide extra scope for agents to engage in deviant behaviour. Sale of goods can also involve distrust. Scope for fraud and misrepresentation of goods can increase when there is considerable distance between the traders as is often the case in global exchanges. This limits the incentive for trade and can result in market failure and a loss of economic welfare. It reduces the potential extent of and benefits from economic globalisation. Measures that can or have been adopted to reduce these problems are outlined.

Trust and its Implications for Economic Activity, Welfare and Globalisation

1. Introduction

In a society in which individuals can be trusted, economic activity will be a greater and economic welfare higher than in a society in which trustworthiness is lacking. Furthermore, trustworthiness will encourage economic exchange even when buyers and sellers are located at considerable distances from one another. The presence of trust is, therefore, favourable to the process of economic globalisation. However, the word 'trust' (which is Scandinavian in origin) has more than twenty meanings in English (Delbridge, 1981, p.1855). Trustworthiness is used here to mean that one can rely on the integrity of a person (or legal entity) to honour commitments, including customary expectations which accompany such commitments. Similar expectations apply in relation to the sale of goods, for example, one trusts that a good is as represented by the seller and is able to fulfil the purpose for which it is normally intended. Furthermore, when individuals are placed in different social roles in society, it is important that they can be trusted to carry out the functions that are normally assigned to these roles. In the case of business managers of public companies, for instance, it is important that they pursue the basic objectives of their shareholders which in many cases is to maximize the market value of their shares.

Business cooperation and alliances can be important means for firms to extend their access to markets, including international markets. This is particularly so for small and medium-sized firms. They often have to cooperate with larger firms to increase their market access. Trust is a significant influence on whether such alliances form and whether they last. Trust is also important in relation to the fulfilment of business contracts and for the sale of goods. These aspects are explored in this article in turn and their implications for economic globalisation are examined.

2. Business Cooperation and Trust

There is often scope for businesses to make mutual economic gains by cooperating or forming alliance (Tisdell, 1996, Ch. 13; Tisdell, 2007). For instance, it is not uncommon for a larger business to enter into cooperative supply arrangements with smaller enterprises. If the large enterprise is a manufacturer the small and medium-sized firms co-operating with it may supply the larger enterprise with components. In return for maintaining a particular quality and regular supply of components, the larger firm may assure its cooperating smaller firms of their market and provide them with technological knowledge. Or the smaller firms may supply a larger cooperating firm with finished products which it retails as, for example, has been the practice of Marks and Spencer (Tse, 1985; Tisdell, 1996, Ch.13) or the larger firm may act as a middleman in the sale of products produced and supplied by the small firms they cooperate with.

The vertical product chain in the latter case is one in which the large firm in the chain cooperates with several small and medium-sized firms to supply it with products which it then retails to end purchasers. This is illustrated in Figure 1. However, there can be many more steps in this chain. For example, the large firm (or firms) in the chain may sell to intermediate buyers or middlemen who in turn sell to retailers.

Figure 1: A simple cooperative vertical supply chain involving several small or medium-sized enterprises and a large retailing firm.

What is the likely economic advantage of the type of relationship illustrated in Figure 1? One advantage from the point of view of final purchasers is that the large firm in the chain is able to reduce their market transaction costs by ensuring that the products supplied reach acceptable quality standards. This may be reinforced by a promise to buyers from the retailer to refund their purchase price if they are not fully satisfied with the goods purchases. In most cases, it is likely to be valuable to the retailer to maintain its reputation and goodwill.

The larger firm in the chain is likely to find it more economical to check the quality of the products supplied than final purchasers and is able to impose a higher penalty on suppliers who do not meet agreed standards in their supplies, such as by no longer purchasing from them. As part of its cooperative agreement, the larger firm in the chain may provide smaller suppliers with credit, technical knowledge and market information. Normally, the main advantage to the smaller firm of cooperating is an assurance of the market for its products.

Nevertheless, while such cooperative arrangements can be mutually advantageous to business firms, whether or not such alliances are formed and last depends on trust. To some extent, businesses become locked into their cooperative arrangements. However, it is the small and medium-sized enterprises in the chain which are at most risk from 'lock-in'. As a result of the cooperative arrangement, SMEs (small and medium enterprises) may fail to develop alternative markets or only do so to a limited extent. They are, therefore, vulnerable to exploitation by the larger firm in the chain. Furthermore, if the larger firm has **specific** requirements for the products supplied to it, small firms may have to adjust their machinery or production methods to satisfy these requirements. This adds to their lock-in because if the cooperation fails, they incur sunk costs due to the specificity of these items. Therefore, it is important for a small firm to be sure that a large firm with which it cooperates can be trusted to act according to the spirit of their agreement.

Often a larger firm in the type of chain illustrated by Figure 1 has the choice of several small and medium-sized firms from which it can source supplies. This provides scope for unscrupulous middle traders to exploit primary suppliers by enticing some of the primary suppliers into cooperative arrangements and subsequently reducing their profit margins. Once these cooperative arrangements break down, other 'gullible' primary suppliers may be sought and the process may continue. The problem is that this behaviour by unscrupulous traders puts economic pressure on trustworthy secondary traders who have entered into cooperative arrangements with primary suppliers. The unscrupulous traders are able to undercut the prices of the scrupulous in their trading. Consequently, those firms that are normally trustworthy may also be forced to act in an unscrupulous way in order to survive. Once these practices become widespread, small and medium-sized firms will shy away from cooperative trading agreements. Consequently, unscrupulous traders will drive out the scrupulous and interfirm trading cooperation or alliances will no longer occur. As a result of this institutional collapse, there is an economic loss; traders are unable to make mutually advantageous trading arrangements involving cooperation and consumers may have less quality assurance. This case has parallels the type of situation analysed by Akerlof (1970).

In cases where cooperative trading arrangements improve the access of a national industry to international markets, the formation and survival of co-operative business trading arrangements are important if businesses are to take advantage of greater trading opportunities made possible by growing economic globalisation. Furthermore, business cooperation can be important in enabling firms to withstand growing incursions into their home or national market as economic globalisation gathers momentum (Tisdell, 2007).

There are, of course, many other ways in which business enterprises can cooperate. They may for example, enter into joint ventures and into franchise agreements. Whether or not such alliances will eventuate and how durable they prove to be will depend on the trustworthiness displayed by the business partners. In such cooperative arrangements, it may, as pointed out by Tisdell (1966, Ch.12), pay for dominant partners or those with the greatest threat power to be generous to the weaker partners (there with less threat power) since this may provide an incentive for superior performance by the weaker partners. This is because the total benefits from cooperation are unlikely to be a fixed pie. The size of the pie is likely to depend on how those benefits are shared between partners. The solution of von Neumann and Morgenstern (1944) to cooperative games, and that of Nash (1950) to such games (based on the relative threat power of the players) assumes the division of a fixed cooperative pie of gains.

While it is recognized in the relevant literature that trust is a major factor influencing the make-or-buy discussion of enterprises, (because increased business trust reduces market transaction costs and increases the likelihood of a firm buying more of its inputs rather than making them itself thereby increasing economic specialisation by businesses), there is usually no in depth discussion of what leads to the development and maintenance of business trust. There appears also to be no quantitative estimate of the amount by which increasing trust between cooperating firms can reduce market transaction costs. However, an empirical study by Latif Adam (2007) of producers in the garment industry in Indonesia identified factors that were important in the development and maintenance of business trust between enterprises and provided rankings of the types of economic benefits that cooperating firms said they obtained from their interfirm cooperation.

3. Contracts, Principal-Agent Issues and Trust

As Willliamson (1975) points out, most contracts or agreements are incomplete. Those entering into such contracts trust that the partners will carry out their formal obligations as specified in the contract or agreement as well as their expectations about loosely specified conditions or customary performance associated with such contracts. Therefore, a major element of trust is involved. Although a party to a contract is likely to have legal recourse for its non-fulfilment, this is in most cases inadequate consolation for the non-fulfilment of a contract. The extent of damages to be paid for non-fulfilment when legal action is taken is uncertain, especially as far as ‘implied’ conditions of the contract are concerned. Consequently, legal action is often only taken as a last resort.

Where there is a widespread expectation that partners to a contract are not likely to perform the agreement faithfully in accordance either with the conditions specified or its spirit, this can be expected to reduce the extent of economic exchange or add to the costs of monitoring potential parties to contracts and the execution of contracts. Consequently, lack of trust then adds to the cost of economic activity and adds to the transaction costs involved in such activity. As a result, potential economic well-being is less than it would otherwise be.

The problem of incomplete contracts is particularly acute in relation to agents and in relation to employees. This is because it is often difficult to monitor their behaviour, that is, for the principal to monitor and control the behaviour of his/her agent and for an employer to regulate the behaviour of an employee. The monitoring costs are high. Therefore, the principal or employer has to be able to trust the agent or employer to carry out his/her duties faithfully. Considerable time may, therefore, be spent in selecting an agent or an employee, trying not only to assess their competence but how trustworthy they are likely to be in carrying out their duties. Once again, lack of trustworthiness can be expected to reduce reliance on agents and to decrease employment prospects. It can also result in increased monitoring by the principal or employee, all of which adds to transaction costs. A reduction in the amount of economic transactions and an increase in transaction costs reduces the attainable level of economic welfare in society.

4. Sale of Goods and Trust

Economists have given considerable attention to mistrust as a source of market failure in the sale of goods (Akerlof, 1970; Varian, 1987, Ch. 35; Tisdell and Hartley, 2008, Ch.5). The problem arises because there is often asymmetry of information between buyers and sellers involved in the exchange of goods. In particular, consumers (especially in the sale of complex commodities or the provision of services relying on specialized knowledge, such as the servicing of motor vehicles) are likely to be less knowledgeable about the qualities of the good or service being sold than the seller. This provides scope for cheating by sellers. If such cheating becomes widespread, this can lead to the collapse of the market for commodities of superior quality even though they are in demand. This is because buyers come to believe that there is a high probability that goods which are represented as being of superior quality are in fact defective or of inferior quality. Consequently, the whole market for the product concerned may collapse or only inferior products will be traded and priced accordingly. In essence the bad products drive out the good ones. Both suppliers of superior products and consumers who wish to purchase superior products suffer an economic loss because a sufficiently large number of sellers cannot be trusted.

Another possibility in this situation is that consumers incur search and monitoring costs to distinguish between superior and inferior products. For example, in the case of a used car sale, they may have the vehicle checked by an independent expert. This all adds to transaction costs and reduces economic welfare. Increased transaction costs reduce the size of the market and in normal circumstances reduce the economic benefits available to consumers (that is consumers' surplus) and also lowers the economic gains of producers, that is producers' surplus.

This is illustrated in Figure 2. In this case, it is assumed that consumers cannot trust sellers and as a result their market transaction costs are higher than they otherwise should be. For example, suppose that if sellers are completely trustworthy, the market demand for product X is as indicated by line AD. Market equilibrium would then correspond to E_1 if the line GS is the industry's supply curve. But if buyers find that they cannot trust sellers, they may incur market transaction costs equal to AB on each unit of the product purchased. When this is taken into account, the market demand for product X will fall from AD to BD' and a new market equilibrium will be established at E_2. As a result, the quantity traded of X falls from X_2 to X_1 and its equilibrium price falls from OC to OF. There is a decrease in both consumers' surplus and producers' surplus. Consumers' surplus falls from an amount equivalent to the area of triangle ACE_1 to an amount equal to the area of triangle BFE_2. Producers' surplus declines from an amount equal to the area of triangle CGE_1 to an amount equivalent to the area of triangle FGE_2. It can be shown that the combined loss in economic welfare of buyers and sellers due to sellers being untrustworthy is equivalent to the area of the trapezium ABE_2E_1. If in addition, the seller cannot trust buyers (for example to pay their bills or do so promptly if the good is sold or credit), this will add to the market transaction cost of sellers. This would result in the supply curve of the industry being higher than GS. This will further reduce the economic benefits obtained by both buyers and sellers of X and will reduce the quantity traded of the product. The economic impact of supply-side market transaction costs are illustrated in Tisdell 1966 (Ch. 16).

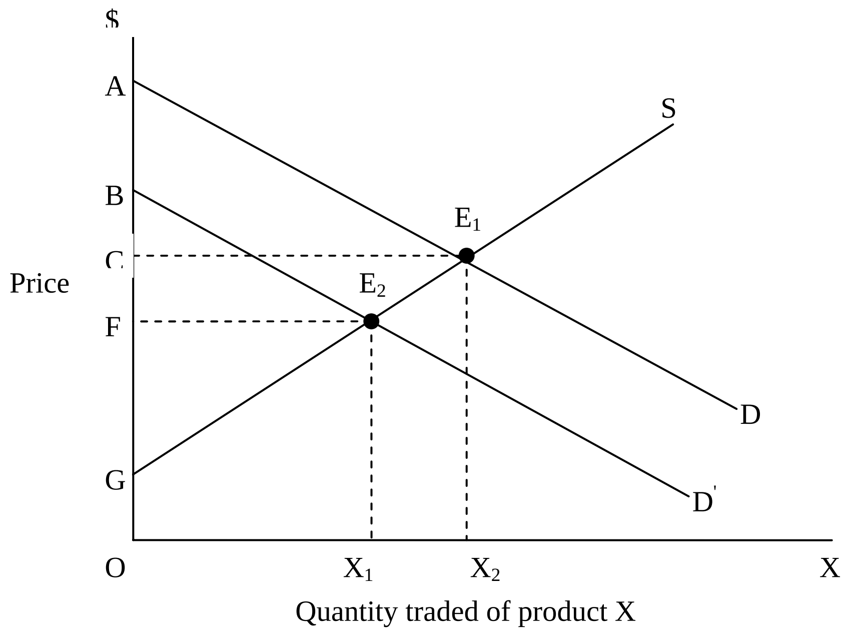

Figure 2: Mistrust of either buyers or sellers in the sale of goods reduces the size of the market and usually damages both buyers and sellers. This diagram illustrates the economic consequences of buyers mistrusting sellers. A similar situation also occurs when buyers cannot be trusted.

Thus, it is clear that the market system operates most economically or efficiently when traders can all be trusted. A deterioration in trust amongst traders reduces economic benefits from economic activity and exchange. In the normal situation both buyers and sellers have reduced economic benefits from trading when trading parties are not to be trusted. In the long run, all lose if traders become unreliable in making their transactions.

5. Trust as an Element in the Facilitation of Economic Globalisation

Reductions in man-made barriers to international trade and exchange (such as reduced levels of tariffs on imported goods, the abolition of trade quotas, fewer restrictions on foreign investment and fewer qualitative restrictions on imported commodities for example, an easing of phytosanitory restrictions, as well as favourable technological change which for example, lowers transport and communication costs) are important factors that have stimulated the rapid rate of growth of economic globalisation in recent decades (Tisdell and Sen, 2004; Tisdell, 2005). However, the extent to which the business community (and the wider economic community) is able to take advantage of the extra trading opportunities opened up by growing globalisation and withstand the new economic challenges it poses depends on their trust in making economic deals both internationally and locally.

International trade and exchange do not occur in a social vacuum. They can hardly take place in the absence of trust between the parties involved. Trust has an important direct influence on the level of international economic activities and can be important indirectly in making local or national producers who form alliances or cooperative arrangement to be more competitive internationally. This may occur either because business cooperation lowers their costs of supply, improves the quality of their products or more effectively signals the quality of their products to buyers than otherwise. For example, a large secondary supplier acting as a middleman for smaller primary supplier may be able to signal effectively the quality of their products and reduce the market transaction costs which they would otherwise have if trading internationally. Indeed, the problem of gaining access to international markets encountered by small producers may be so acute that they may fail to trade internationally in the absence of cooperative business arrangements.

Cole (1988) and Sandee and van Diermen (2004) provide specific examples of how small Indonesian manufacturers have as a result of cooperation with buyers cum consultants from developed countries been able to access markets in developed countries. They respectively provide a detailed account of this for the export of garments from Bali and for Indonesia’s exports of furniture. They emphasize that this business cooperation has been successful because it has been profitable for all the parties involved (Adam and Tisdell, 2008).

Trust proves to be important in influencing the extent of international trade, exchange and investment through its influences on the occurrence of business cooperation and the formation of alliances, sale of goods, contracts, and principal-agent issues. The ways in which these factors are relevant for the process of globalisation are listed in Table 1.

Table 1: Business Relationships Involving Trust and Their Relevance to Globalisation

1	**Business cooperation and alliances**	Trust is important in fostering these relationships and this can result in cooperating enterprises being more competitive in the international markets or able to withstand increased competition in domestic markets from imports.
2	**Sale of goods**	Trust lowers the transaction costs of exchanges and expands the size of international markets. The more trustworthy business partners are, the lower is likely to be the cost of insuring against default and the lower is the cost of completing sales.
3	**Contracts involving international partners**	Similar observations apply as in the sale of goods case
4	**International direct investment**	Where this investment involves joint ventures, trust is important in influencing whether such joint ventures are undertaken and the amount of resources which partners commit to such undertakings. The greater the level of trust between investment partners; the more likely joint ventures are to form and the greater the amount of resources likely to be committed.
5	**Principal-agent issues**	In the case of multinational companies, managers of overseas subsidiaries may be difficult to monitor by central management in a company's headquarters and this provides scope for 'deviant' behaviour by the former. Consequently, whether or not an overseas subsidiary is established or is sustained can depend on the trustworthiness of available managers for it. Improvement in communications and transport, however, make monitoring of overseas managers easier than in the past.

6. Discussion

The above considerations raise the question of what contributes to the development of trust and the maintenance of it. The knowledge which any potential parties to situations involving trust have of one another is important in judging the extent to which the parties are trustworthy. Experience obtained from previous business dealings with individuals or business entities appears to be widely used as a basis for developing sustained business cooperation (Adam, 2007; Adam and Tisdell, 2008). In some cases, shared values with ethnic or religious groups may also play a role and often, family connections can be very important.

However, penalties for breach of trust and threat power, which can be applied if there is a breach of trust, can play an important role in ensuring that agreements are fulfilled. The lower is the legal cost of obtaining damages for a non-fulfilment of an agreement, the higher the claim upheld by the court for damages and the more certain is the legal redress; the more likely are contracting parties to fulfil their agreements. Thus, low legal cost and certainty of the law are factors that reinforce trust.

This can be illustrated by the prisoners' dilemma type of problem shown in Table 2. Two parties, 1 and 2 enter into an agreement to respectively adopt strategy s_{11} and s_{21}, or undertake actions corresponding to these. Each has an alternative strategy, s_{12} and s_{22} respectively which would involve breaking that agreement. The payoffs are shown in the body of the matrix in Table 2. If each party keeps to their agreement, each will gain 10 units of payoff. However, if one double-crosses and the other does not, the untrustworthy party gains 12 units of payoff and the trusting party is left with 4 units of payoff. The aggregate benefit of the parties is reduced as a result of this behaviour (from 20 units to 16) but the untrustworthy party benefits. However, the worst outcome occurs when both parties fails to keep to the agreement, that is the strategic combination (s_{12}, s_{22}) is adopted. Each party then only gains 5 units and their potential aggregate benefit is reduced from 20 units to 10 units.

Table 2: A case in which parties to an agreement have an incentive to break it unless adequate external sanctions can be applied for non-compliance.

		Strategies of 2 →	
Strategies of 1 ↓		s_{21}	s_{22}
	s_{11}	(10,10)	(4,12)
	s_{12}	(12,4)	(5,5)

If in the case illustrated by Table 2, an injured party to the contract is able to obtain damages from a party that fails to fulfil the agreement of 6 units with certainty plus legal costs, no party will have an incentive to break the agreement. There will be greater trust in the fulfilment of the treatment. However, the lower the probability of obtaining damages of 6 units and the greater the uncertainty about recovery of the amount of legal costs, the lower would be the level of trust in fulfilment of the agreement. The law, therefore, can help to reinforce trust in an agreement being fulfilled.

Nevertheless, there are some types of agreements for which there is no legal redress. Their fulfilment depends entirely on parties acting in complete good faith. Prisoners' dilemma type situations in which no third (external) party (such as the state) can be called upon to penalize parties who fail to carry out agreements, rely completely on trust to ensure completion of the actions desired by parties involved in these situations (Tisdell, 1966). That is true, for example, in the case illustrated in Table 2.

Improvements in the law internationally can help to contribute to the growth of economic globalization. Such improvements can include the harmonization of the laws of different nations, the simplification of laws and of legal procedures as well as increased precision in the application of laws. Furthermore, institutional developments that allow contracts to be specified in a more precise form can also assist in clarifying and enforcing contracts internationally. The International Standards Organization (ISO) has made (and continues to make) important contributions in this regard. Its classifications help to reduce uncertainty in international trading.

7. Concluding Comments

While artificial restrictions on trade and exchange limit the size of markets, the level of economic activity and welfare, the removal of such restrictions may only reduce these consequences to a limited extent if trust is lacking in relation to economic exchange and business agreements. If wealth maximization is an important goal for society, is for example Posner (1981,1985) claims it to be, it is therefore important for society to foster a culture in which reliability and trustworthiness are valued, and to back this up wherever possible with a supportive and economical legal system. It will also be in the interest of a nation or society to encourage other nations and societies with which it has economic links to do likewise. The spread of such an ethos can increase the magnitude of economic globalisation and add to global wealth.

In many societies, individuals who are trustworthy and conscientious are highly regarded. In this article, it has also been observed that if these qualities are widespread in a society, they are of substantial economic value because they foster the maximization of a society's economic wealth.

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