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RELATIONSHIP BETWEEN ECONOMICS OF TRUST AND TRANSACTION COST: A BRIEF EXPOSITION

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Abstract

Survival of enterprise to some degree depends on how to manage transaction cost. It is more so in a highly competitive market with competitive products such as technology-based products. In economics, the theory of transaction costs is based on the assumption that people are influenced by competitive self-interest. Transaction cost economy which was developed by Williamson (1981) is based on uncertainty and unpredictability in the world. Asset specificity, organizations that enter into transactions find it expensive to leave them, inherent opportunistic behavior of individuals in an economic transaction making it harder for contractual agreements to be enforced fully after a long period of time. Although the transaction cost has been extensively discussed and used in supply chain management field, no economic theoretical arguments has been advanced as to how transaction cost help improving economic growth. This paper attempts to explain how transaction cost could add to economic growth.

Keywords

Economic of Trust, Transaction Cost, Trust Cost, Search for Information Cost, Bargaining Cost, Policing and Enforcement Cost

1. Introduction

1.1 Information search costs

The journey of transaction cost theory starts from information search on potential business partners. This cost includes costs locating a desirable trading partner and then negotiating and writing a mutually acceptable contract (North, 1992). Assessing correct and complete information about potential business partners is a crucial first step for successful long-term business relationship. Search process is very extensive and could be expansive including such areas as potential partner's organizational structure, financial health and skill set that partner would bring to the table. Accordingly, this stage is NOT bound by time constraints as expenses (tangible as well as intangible) serve as a crucial foundation where future profitable business engagement can be established. The stockbroker's fee is a type of information search cost. Searching for better information in AI technologies as an investment opportunity could be a part of search cost.

1.2 Bargaining costs

Once search process provides a promising result, two parties commence negotiations for mutually agreeable and acceptable terms and conditions to draw up a contract. Bargaining process could be a short, simple and inexpensive (e.g. agreeing verbally on cost of replacing tires) to multi-billion dollars acquisition of major corporation (e.g. Nippon Steel Corporation acquiring U.S. Steel Company, or bargaining process between United Auto Work Union with three major auto manufacturing companies in Detroit). Successful bargaining process (both parties perceive the benefits from the bargaining outcomes) leads to signing a legally enforceable contract.

1.3 Policing and enforcement costs

These are the costs associated with making sure that the parties in the contract keep their words and do not default on the terms of the contract. In the real world, people often deviate from the contract, and thus, enforcement costs incurred while governing contracts. Lawyer fees or cost for quality inspector or CPAs are some of the examples of

such a cost. It is assumed that there will be no or little enforcement cost had a bargaining process incorporate every single area to the satisfactory to both parties. In reality, this seldom is a case.

According to the 2022 State of Corporate Law Departments Report from the Thomson Reuters Institute, total legal spend is, on average, 0.12% of revenue for global organizations with revenues of more than $1 billion. This indicates that there are many areas that parties are in disagreements in the contract.

2. Literature Survey: Trust and Transaction Cost

Contract calls for commitment to fulfilling the contents described in the contract between two parties. In spite of huge spending on legal areas to make sure that trading partners fulfill their obligation (commitment) specified in the contract, disputes do occur and legal recourses are sought to settle the disputes. The tenet of the trust and transaction cost is that these two constructs are presumed to have an inverse relationship, the higher the degree of trust between two trading partners, the lower the transaction cost (Kwon, Hamilton and Hong, 2012).

Transaction cost can be decomposed into ex-ante, and ex-post costs. If one assumes it obtains a trust status with its partner, it is reasonable and to some extent nature to expect an equitable sharing of benefits and risks. Thus, it tends to minimize/prevent the partner's opportunistic behavior which in turn precipitates lowering both ex-ante and ex-post transaction costs (Williamson, 1985; Dyer and Chu, 2000; Chickland *et al.*, 2012).

The role of trust in reducing the ex-post transaction cost (policing cost) is relatively easy to understand since the trust tends to by-pass unnecessary inspection, search for additional information on partner and assigning unnecessary layers of preventive measures. One study even suggests that trust between two organizations altered the governance structures in an organization (Chiles and McMackin, 1996). The heuristic nature of the decision-making behavior on the basis of trust as opposed to a decision based on a more classical economic model seems to foster "opportunities/risks" behavior. This approach is very new for a firm, since such "presumptive" trust reduces opportunity costs while creating a conductive climate favorable to solve many disputes and the challenges ahead without recourse to legal options.

It should be pointed out, however, that the transaction cost approach is not without risks for the trading partners. One of the major risks of the transaction cost approach is potential opportunistic behavior by the parties. When the parties are disproportionately involved in inter-organizational relationships (power structure), a party or parties who are in less committed position may take advantage over one who is more engaged, and may take advantage of its position through opportunistic behavior (Shell, 1991). Opportunism is a process with a strong negative connotation for the relationship between two parties (Kwon and Suh, 2004).

Trust formation process starts with relationship fostered by information sharing (Hong *et al.*, 2013). Trust which is based on relationship creates a continuous and sustainable commitments even after current commitment in the contract expires, whereas task-based relationship ceases to exist when the current task/project is completed. It is argued that relationship-based trust reduces transaction cost in the areas of bargaining and inspection/policing cost (Kwon and Kim, 2023). On the other hand, lack of trust among trading partners limit collaboration that further erode potential economic gains in optimization process (Fawcett, Andraski and Magnan, 2009).

3. Economics of Trust and Transaction Cost

Institutions are key in the determination of transaction costs. North (1992) argues that institutions that facilitate low transaction costs boost economic growth. A long-term economic benefit from relationship-based trust is not clear. But it is reasonable to speculate that average cost of doing business should be reduced as the transaction cost (searching, bargaining and enforcing cost) will be steadily declining as each trading partner begins to build trust-based relationship that ultimately reduce transaction cost. As a result, it is expected that the marginal cost for doing business for the "next" project with a business partner within the framework will be also reduced steadily as there should be no extra (marginal) resources are needed to consummate the "deal" in the contract. Transaction cost will be further reduced and total revenue will increase accordingly. Extra revenue (marginal revenue) will be reinvested into productive business ventures which fosters a growth of long-term revenue cycle.

Figure 1 is a 3-dimentional graph among and between transaction cost, the level of trust and economic gains. We speculate that transaction cost will be higher if there is no trust between business partners. They spend a considerable resource to "figure out" the entire business map spending a good deal of resources (expenses) to remove some of the uncertainties in the contract. As the level of trust improves, the transaction cost will be declining (Zone A). The transaction and the level of trust form downward slope like demand curve in production theory. The higher the level of trust, lower the transaction cost. It is entirely possible that the Transaction Cost Curve (TRC) and Trust Curve (TC) could be shifted to downward (less transaction cost) with the same level of trust if a thorough preliminary investigation is in place. On the other hand, if such preliminary work is not carried out, the transaction cost curve and trust curve could move upward creating higher transaction cost with the same level of trust.

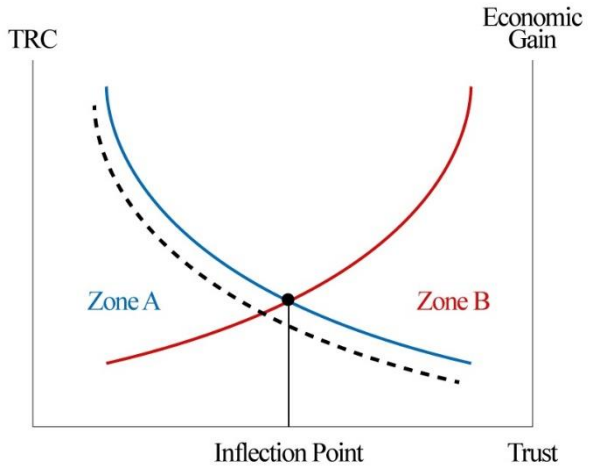

Figure 1. TRC Trust and Economic

A decrease of transaction cost and subsequent increase in revenue in financial statement would create a net economic surplus (Zone B). It should be pointed out, however, that the economic surplus so created is not through "tangible" production cost. Rather it is generated by soft/invisible managerial skill called "trust" that enables to lower transaction cost such as search for information cost, bargaining cost and policing and enforcement cost. Once the relationship based on trust is firmly established, it is possible to see the transaction cost curve shifts downward creating additional economic surplus (see dotted line). As mentioned, this surplus is created without additional production cost, and the Zone B (Economic Surplus) will be expanded. Once trust and commitment are firmly established, transactions become efficient and results oriented. Lower unit cost through a reduction of transaction cost may make it possible to speeds their products to the market capturing a bigger market share in a global scale. The economic surplus zone (Zone B) will be further expanded (Covey, 2006).

The "inflection" point where the transaction cost curve intersects economic surplus curve indicates that the marginal transaction cost equals to marginal economic gain from trust-based activities. This Inflection Point provides an important decision criterion. Any managerial decision to shift this point to the left will create additional economic surplus. The components of transaction cost play an important role in making such shift possible. If the transaction cost is heavily based on task-oriented relationship, economic benefit ends with the task. However, if the negotiation is based on relationship building process, the impact will last beyond the contract as each partner tries to build the economic gain based on positive experience they enjoy during prior experiences. As a result, the TRC shifts downward creating a large economic surplus (Zone B).

4. Empirical Evidence of Trust: Relationship and Economic Performance

Literature survey and Figure 1 above seem to indicate a set of sequential relationship between transaction cost and trust-based economic activities. According to this framework, trust leads collaboration that opens up commitment to agreements in the contracts (Kwon and Suh, 2004 and 2005). Once commitment is in place, transaction cost starts to decrease and returns from economic activities improve. Cotton (2009), for example, discusses a return on capital investment based on degree of collaboration. Those in top tier of trust group, according to his study, enjoys 4 to 8% return on capital vs. 2 to 2.8% for the average tier trust group. The difference of return on capital between these two groups (4 to 8% vs. 2 to 2.8%) will undoubtedly make easier for them to attract additional capital for business growth and expansion.

Duffy (2009), on the other hand, explored operational cost saving based on the degree of collaboration. According to Duffy's study, companies with strong collaboration with their trading partners save better than average collaborator 10 to 20% investment in inventory, 20 to 30% in administrative cost, 3 to 8% in logistics cost and 1 to 2% production cost. Business leaders understand the stakes of trust and economic return at least in principle. In its 2016 global CEO survey, PwC reported that 55% of CEOs think that a lack of trust is a threat to their organization's growth. The best collaborator based on relational trust in supply chain cut the inventory carrying cost almost by 50% (Partidas, 2015).

There is a strong correlation between performance index and collaboration index. On average, a company's level of trust and its satisfaction were the highest and the level of perceived conflict was lowest in the relationships when there is a high level of interdependence based on trust (Simatupang and Sridharan, 2004). Employees in high-trust organizations are more productive, have more energy at work, collaborate better with their colleagues, and stay with their employers longer than people working at low-trust companies. They also suffer less chronic stress and are happier with their lives, and these factors fuel stronger performance (Kumar, 1996). Lack of collaboration is the biggest obstacle to improving supply chain processes (American Productivity and Quality Center, 2022). On the other hand, loss of trust cost Chrysler $24 billion in profit over the past 12 years (Henke *et al.*, 2014).

5. Summary and Conclusions

Transaction cost has been extensively discussed mainly in the area in supply chain field. Many examples cited so far are limited to this area. This short article expanded the transaction cost theory beyond supply chain realm and presented theoretical basis on how transaction cost if managed properly contributes to economic growth. This paper borrowed trust-relationship-commitment framework to illustrate the framework for economic growth. If trust-

relationships-commitment is properly in place, transaction cost will be reduced creating economic surplus. Since the foundation of such framework is based on relationship, there will be no tangible production cost enters into the process, creating even larger economic surplus. However, this paper also acknowledges a difficult and challenging roadmap to achieve the maturity where economic surplus can be achieved through managing transaction cost. It is challenging argument because there has been no clearly defined framework where trust-relationship-commitment managerial tool is firmly established. We are hoping that this pioneering work encourages others to expand and advance this paper to the next level.

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Biographical Sketches

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