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Discussing the Role of Trust in Behavioral Assumptions of Transaction Cost Theory

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Abstract
In its attempts to explain organizations based on their economical approach, transaction cost theory has a unique position among all organizational theories since it derives its assumptions from human behaviors. The basic behavioral assumptions of transaction cost theory are "opportunism" and "bounded rationality." Transaction cost theory includes a selection of governance mechanisms whose goal is to minimize transaction costs based on the aforementioned behavioral assumptions. This study discusses the notion that not only is "trust" one of the most important aspects of work ethics, but that it is also disregarded by the abovementioned governance mechanisms of transaction cost theory. This study also underlines the importance of building an environment of trust in an organization rather than selecting governance mechanisms under an "opportunist" and "bounded rational" paradigm, as is currently the case in transaction cost theory.

Key Words
Bounded Rationality, Opportunism, Transaction Cost Theory, Trust, Work Ethics.

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In an attempt to explain organizations based on their economic approach, new organization theories emerged in the 1970s which both refreshed the domain of organization theories and which were very inspiring in the 1980s and 90s. This collective movement in organization theory is generally known as economics-based theories (Barney & Ouchi, 1986). Of these economics-based organization theories, transaction cost theory is one of the most debated (Donaldson, 1995, p. 164). Specifically, while transaction cost theory seeks to analyze the performance of transactions within the organization rather than the actual organization, the main arguments purporting the validity of this theory are based on governance mechanisms whose goal is to minimize transaction costs.

Transaction cost theory is based on two central assumptions regarding human behavior; these being, "opportunism" and "bounded rationality." Opportunism refers to offering incomplete and/or inaccurate information during both the negotiation of and implementation of economic transactions; a concrete example being contracts in which middlemen are allowed the ability to put their interests before others'. Williamson, the pioneering theorist of this approach (1975, p. 26), defines opportunist behavior as incidents in which individuals behave cunningly, looking out for their interests and feeling little or no qualms in breaking previous promises made when things no longer continue to go according to plan. After opportunism, "bounded rationality" is the other central behavioral assumption of transaction cost theory. This assumption argues that individuals tend to be rational merely in intent rather than being rational in the absolute sense due to the imperfections inherent in humans' creation, and therefore, in their ability to rationalize. In practice, the assumption of "opportunism" made by transaction cost theory suggests that agreements based on unreliable promises might place individuals in difficult situations whereas the assumption of "bounded rationalism" suggests that all agreements will be, without exception, incomplete agreements.

The review of the basic behavioral assumptions espoused by transaction cost theory reveals the importance of the mechanism of "trust;" an issue although generally discussed in organization and management literature of social sciences, has a vital position within the literature of work ethics. A fact made apparent by the existence of several researchers indicating that both the concepts

of trust and work ethics are closely associated with each other (Brenkert, 1998). The issue of trust is an important field of study within work ethics, especially in virtue ethics due to the fact that "trust" is one of the most important aspects of transactions made between parties. The main reason behind this is that trust minimizes the need for concern as to whether parties will both respect an agreement reached and obey the terms of conditions delineated in a contract (Fraedrich, Ferrell, & Ferell, 2013, p. 265).

The primary argument of the present study is that levels of trust and integrity have a direct impact on organizational structure and processes and that honest behaviors will be effective in minimizing transaction costs (Bromiley & Cummings, 1992, p. 17). Accordingly, establishing organization-wide trust mechanisms gains a higher level of importance that does selecting possible governance mechanisms based on the assumptions of "opportunism" and "bounded rationality" as described by transaction cost theory.

Transaction Cost Theory and Basic Behavioral Assumptions: Bounded Rationality and Opportunism

In his 1937 article, "The Nature of the Firm," by Nobel Prize winner economist Ronald Coase laid the foundations of transaction cost theory by questioning the importance of market mechanisms within the neo-classical economics approach embraced of the 1930s. In the article, Coase (1937) discussed the question "why organizations exist at all, since resources are ostensibly allocated most efficiently by the price mechanism of the market" arguing that while deciding between the "market" and the "organization" as alternative governance mechanisms, one should make his choose based primarily on which of these mechanisms minimizes transaction costs. On the other hand, this approach, as Coase himself stated, was "more discussed, but rarely used" later on (1972, p. 63). The main reason behind this is the difficulties present in measuring transaction costs coupled with the disputes regarding which transactions should be made in the market and which transactions should be made within the organization (as cited in Barney & Hesterly, 1996; Geyskens, Steenkamp, &

Kumar, 2006). Transaction cost theory, itself based on Coase's (1937) question of "why do organizations exist?" was expanded when Williamson (1975; 1979; 1981; 1985) introduced new fields and dimensions into the theory. As a matter of fact, transaction cost theory is generally mentioned in reference to Oliver Williamson within organization literature (Foss & Klein, 2008, p. 425).

Williamson (1975) introduced two alternative instruments for completing transactions. One of these alternative instruments is the "market" and the other one is "hierarchy." Coases' concept of "organization" (1937) was replaced with Williamson's concept of "hierarchy" (1975). Generally, these two instruments are known as governance mechanisms in transaction cost theory (Barney & Hesterly, 1996, p. 117). Transaction cost theory generally focuses on performance while at the same time attempting to answer whether transactions would be more *productive* "within the organization (hierarchy)" or "within the market." In reality, this question is referred to as the decision of produce (which refers to hierarchy) or to buy (referring to market) in the theory (Williamson, 1998, p. 30). As the basis of this theory, individuals desire to protect their own interests during contract negotiations when deciding whether to buy or sell goods and services in the market.

Holt (2004, p. 1025) argues that it is vital that behavioral uncertainties in organization contracts be discussed as one of the reasons for this uncertainty is "adverse selection" and the other "moral hazard." It is true that actors are playing a sort of language game while also having implicit knowledge when making sense of their actions. Economic actors attempt to explain the actions of others by referring to these language games and implicit knowledge, thus finding meaning for their actions. Consequently, we will never be in a situation where we know everything; in other words, where uncertainty does not exist. In this aspect, we can argue that "bounded rationalism," one of assumptions of transaction cost theory discussed by Simon (1979), also applies here.

Opportunism, one of the behavioral assumptions of transaction cost theory, mainly invoices behaviors displayed by economic actors concerned for their own interests. Williamson (1985, p. 47) argues that opportunism is basically a series of personal actions based on deliberate preferences which involves telling

lies, stealing, and deceiving as well as abstaining from providing complete and accurate information in economic transactions, such as contracts. Ghoshal and Moran (1996, p. 17) summarized Williamson's opportunist behavior model as illustrated in the following drawing (Figure 1).

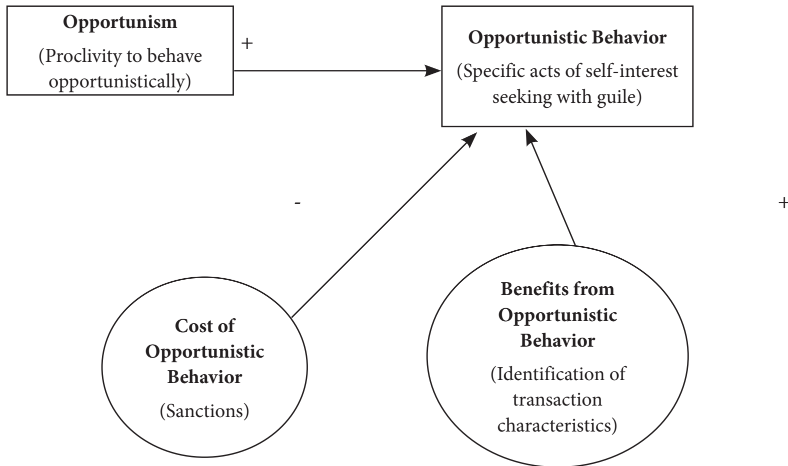

Figure 1.

Williamson's Model of Opportunistic Behavior

Definition of Trust and Organizational Trust

Trust is a universal concept studied by psychology, political sciences, sociology, economy, business ethics, and management. Gambette (1988, p. 219) defined *trust* as "a person's expectation of usefulness rather than damage from others' behaviors." The issue of trust has been studied in several analysis units; such as, trust between (1) individuals, (2) between organizations, (3) in individuals and public institutions, and (4) between the individual and organization. Furthermore, trust between individuals within a public institution and trust as a general characteristic are other aspects of trust generally studied (Manuel & Anil, 1999).

Trust is able to be built and maintained within a social system if its members assume that their expectations from each other will be met and then act based on this assumption (Lewis & Wigert, 1985, p. 968). If we are to discuss building

trust in terms of the symbolic interaction approach, there are two main assumptions regarding trust analysis. These are: (1) people behave according to the manner that they have learned and which has given meaning to their social conditions and (2) these meanings are achieved through interaction with other people thereby working to define this social condition over the course of time (Blumer, 1962).

In the case of building trust, there is a social contract created between two or more parties who use or develop similar interpretative schemes while defining their social condition. Then, the parties agree on the level of trust to be built within this social condition thereby establishing harmony. More specifically, this harmony is based on the amount of similarities between the values and pre-assumptions held by the parties in question (Jones & George, 1998).

Trust based on behavior involves parties either restricting or not restricting their actions. Many researchers agree that trust theory has emerged with contingency (Rousseau, Sitkin, Burt, & Camerer, 1998), mentioning two general conditions in relation to this. One of these conditions is the possible risk of "losing" (Chiles & McMackin, 1996). There is an evident relationship between foreseeability and trust (Mayer, Davis, & Schoorman, 1995). Foreseeability and trust mean reduced uncertainty (Lewis & Wigert, 1985).

While organizational trust studies are discussed as a mechanism alternative to the organizational audits and especially to the market and hierarchy, these studies have adopted a governance belief and philosophy approach to the discussions of opportunist individual mentioned on economics-based organizational approaches, such as transaction cost (Miles & Creed, 1996). Bradach and Eccles (1989, p. 104) defined trust as the concept having the most general structure of all organizational audit mechanisms which have increased in popularity while designing organizational structures. Bradach and Eccles (1989) discussed three primary elements forming the basis of economic actions: Trust, power, and the market. Bradach and Eccles explained that just as these three important elements rarely work independently of the others, there is a sequential relationship between these elements. Here, the term sequential requires explaining; it means "an output of a party offers an input to another

party" (Pfeffer & Salancik, 1978, p. 41). However, in the case of trust, market, and power relationships, this sort of relationship would activate the elements described herein. The majority of the literature on this subject associates the concept of trust that of cooperation.

The gradually increasing importance of collective economic behavior brings with it a higher level of focus on the concept of trust (Kroczynaki, 2000).

Review of Trust within Cost Transaction Theory

Bromiley and Cummings (1996, p. 303) defined trust as the joint confidence of an individual, or group of individuals, toward another individual, or group of individuals, stating that trust brings with it (1) having explicit or implicit faith in someone else, (2) being honest, and (3) not deriving personal benefits even if the conditions are available to do so. Williamson (1993) developed a "calculative" trust approach in his article titled "Calculativeness, Trust, and Economic Organization." He explained that trust would be established if a party expects to derive personal interests by appearing to be weak before another party whose actions cannot be controlled.

If this matter were to be analyzed from a sociological point of view, it becomes apparent that building trust is structured on mutual interaction and is embedded in society, and that the level of trust specific to transactions, as discussed by Williamson (1993), is not enough. Granovetter (1985) used the theory of "embeddedness" for commercial transactions. According to him, economic actions are highly influenced by social interaction between parties and a network. Granovetter's concept of "embeddedness" attempts to explain that organizations cannot act independently due to the fact that a series of past actions and relationship structures have impact on organizations' decision-making processes. Butler (1991, p. 643) stated that social norms cause "global trust which can be generalized to others." Social norms include the agreement of norms, what the norms associated with liability are, and stability/integrity. The norms mentioned herein lead to common expectations among people at various social levels, including large societies (Gouldner, 1960). Economists

argue that "the cost of not impairing someone's prestige is a person not inclined to deceive" (Granovetter, 1985, p. 490). This sentence suggests that economists assume that virtually all parties taking part in any economic transaction are opportunist.

Even more interestingly, a different situation manifests itself when an organization's reputation is added to the equation. The importance of an organization's positive reputation is evident in that it must be regarded as a reliable, high-class organization with an honest approach if it wishes to conduct business over the long term (Chiles & McMackin, 1996). If this matter were to be considered from this point of view, it becomes clear that earning a positive, trustworthy reputation might be considered as an investment in and of itself. Accordingly, if the issue of building trust were to be considered in terms of establishing a positive reputation, this would then be effective in limiting opportunist behavior. On the other hand, Hill (1990) criticized Williamson for associating economic transactions with opportunism, stating that such transactions would, in fact, further contribute to cooperation. Likewise, Ghoshal and Moran (1996) also criticized transaction cost theory, arguing that these assumptions would cause even further costs.

Bounded rationalism, one of the main assumptions of transaction cost theory, leads to uncertainty in the case of "complex" situations. Simon (1976) argued that bounded rationalism emerges when individuals experience difficulty solving those problems which they consider ambiguous. As such, it would be useful here to review what complexity involves in terms of trust. Luhmann (1979, p. 69) argued that although trust does not necessarily mean having all the facts about any given situation, it successfully minimizes complexity. This complexity is a condition experienced in every step of our social life, especially in modern and industrialized societies which have this kind of complex structures. It is very unlikely for individuals to develop action plans that take into consideration all possible scenarios that might be encountered during social interactions. Lewis and Wigert (1985) argued that strategies minimizing this complexity should be developed.

Another aspect that deserves mention are the "bounded (conditionally) rational" individuals mentioned in transaction cost theory. Namely, these individuals are those who wish to be rational but who can only be rational under certain conditions, leading to the term "bounded rational"[1] (Simon, 1976). If bounded rationalism and uncertainties were not to exist, it would neither be necessary to select certain governance mechanisms during the negotiation and drawing up of contracts nor would be necessary to include all possible conditions, and thus economic actors, in them. On one hand, it might not be accurate to speak about the existence of situations in which bounded rationality does not apply since people are subject to psychological cognitive restrictions (Chiles & McMackin, 1996). However, on the other hand, uncertainties are grounds for being conditionally rational, as already explained. Thus, we can assume that bounded rationalism will be minimized if uncertainties themselves are minimized. As a matter of fact, Chiles and McMackin (1996) explained that the relationship between bounded rationality and trust emerges with information, impact, and the control variables determined by Zand (1972). Thus, it can be argued that increased trust minimizes behavioral uncertainties in the process of building relationships, and thus, that bounded rationalism becomes less problematic and less apparent.

Discussion and Conclusion

Williamson contributed greatly to transaction cost theory, rendering it the most discussed economics-based organization approach. In these discussions, assumptions are based on micro formations while explaining the macro formations of transaction cost theory. The present study has discussed trust within the scope of bounded rationalism and opportunism which are the behavioral assumptions of transaction cost theory. The discussion's starting point is to depict a portrait of the economic actors effective in transaction cost theory within a more necessarian structure.

Although transaction cost theory argues that not all economic actors are opportunist, it does argue that they do include certain opportunist approaches

1 For sake of flow and grammatical correctness, the term "conditionally rational" will be used for the remainder of the article. [Editor]

and that determining who is and who is not an opportunist would be costly (Barney & Hesterly, 1996). As such, we can say that the current dominant approach is that economic actors are both unreliable and deceitful. However, as stated above, the main downfall of this approach is its disregard that organizations are, in fact, a part of a social community.

It is therefore argued that “trust” is the most important virtue within the domain of virtue ethics, especially in social relationships. This also applies to business relationships (Romar, 2004). The concept of trust is at the very heart of both social and communal contexts, including economic actors. If we are to discuss this fact on an economic or corporate level, there are also agreement/ social norms, such as cooperation, that come into play. According to many researchers, any company involved in a commercial relationship with another company is obliged to build a relation of trust if it hopes to earn a positive reputation (Romar, 2004, p. 669). Thus, a positive organizational reputation is assured when these norms are respected. As stated above, organizational reputation will contribute highly to the organization in the long run. In essence, therefore, when we consider the matter from this point of view, we are able to feel the presence of the “save the day” behavior present in transaction cost theory’s definition of the economic actor.

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