Understanding Institutional-based Trust Building Processes in Inter-organizational Relationships

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Abstract

This paper deals with the role of institutions in the development of trust in relationships between organizations. We review various strands of literature on organizational trust and examine the assumptions made about how trust building processes are influenced by institutional arrangements. Following this conceptual analysis, we discuss four mechanisms that are pivotal in the development of institutional-based trust. We also examine four situations where the influence of institutions can be particularly conducive to building trust. Finally, we argue that each of the situations calls for specific mechanisms to be predominantly employed in order to effectively create trust in inter-organizational relationships.

Keywords: trust, trust building, institutions, institutional-based trust, inter-organizational relationships

Introduction

Trust has become a central concept in explaining business behaviour in organizational contexts. The ability to create trust has widely been recognized as hugely valuable because it can significantly reduce transaction costs and lead to the creation of new ideas, for example when knowledge is pooled in inter-organizational relationships. In recent years, many studies have examined the conditions and variables that influence the creation of organizational trust (e.g. Nooteboom 2002; Möllering 2006, to name just two monographs which dig into these issues). Meanwhile, there is a growing collective understanding of what are to be seen as the key areas within trust research. These areas, among others, include trust and innovation, trust and contracts, trust and competitiveness, and trust and institutions (Bachmann and Zaheer 2006). However, the role of trust in (vertical and horizontal) business relationships seems to be, conceptually as well as in empirical terms, so complex that many questions still need to be asked and answers pieced together before we can speak of a fully consolidated research field within management studies.

In this paper we seek to deepen our understanding of the relationship between trust and institutions in that we specifically examine *how* and *when* institutions matter with regard to trust building. Arguably, this is one of the least understood areas within trust research. At the same time, however, it seems most urgent to gain profound insights into the building of institutional-based trust in the current global financial crisis. Institutional-based trust is badly needed when strategies are developed to re-build individuals' and organizations' trust in banks and other firms which have recently massively failed to live up to their business partners' as well as other stakeholders' expectations. The enduring global financial crisis is above all a trust crisis and demands solutions for repairing trust in business relationships by employing macro-level approaches. Clearly, the problem has not emerged in that trust has broken down at the micro-level, i.e. in relationships where individuals know each other face-to-face. The trust crisis is essentially due to a breakdown of macro-level trust, i.e. trust in (large) organizations. This is why we urgently need to know more about the development, repair, reach and potential of institutional-based trust. Some lessons may be learned from micro-level efforts to repair trust which is meanwhile a fairly well understood area (e.g. Kim et al. 2004; Kim et al. 2006). However, these insights have only a limited capacity to capture the core of the problem. Thus, a macro-level approach is needed and the concept of institutional-based trust seems key to developing viable strategies to overcome the current trust crisis.

The reason why we have not yet progressed further in analyzing the role of institutions in trust building processes may have to do with the fact that the phenomenon of institutional-based trust does not enjoy undivided interest in the research community. Substantial parts of the trust literature assume that the development of trust is essentially a micro-level phenomenon based on frequent contacts between individual actors (i.e. trustors and trustees) and that institutions, if at all, play no significant role in trust building processes. These approaches conceptualize trust as a psychological phenomenon. Trust is described as an attitude, or 'state of mind', that an individual develops over time in the face of experiences with other relevant individual actors (see e.g. Rousseau et al.'s influential definition (1998), or Mayer, Davis and Schoormann's well known conceptualizations of trust (1995)). When a psychological perspective is employed, however, macro-level factors such as institutions are usually not recognized as important to the development and the quality of the relationships between two actors (see e.g. many contributions in Kramer and Tyler (1996)) or in the trust-targeting special issues of several management journals in recent years, including *Academy of Management Review* in 1998 and 2009). In these predominantly micro-level contributions to trust research, institutions, if mentioned at all, tend to be seen merely as *external* factors that perhaps have the capacity to disturb individuals' relations, for example between a sales and a purchasing manager in a supplier relationship, but not as a constitutive part of the relationship and thus only of limited relevance with regard to trust building processes. In this perspective, the analysis of institutions appears as an issue that is to be separated from the concept of trust and as a mechanism which might even be understood as an alternative way to manage uncertainty in inter-organizational relationships.

In our view, this approach is far too narrow. We think that macro-level analyses are important in trust research and that institutional-based trust deserves more attention in business contexts as advanced socio-economic systems can hardly rely on interaction-based forms of trust creation alone. The latter requires repeated face-to-face contacts and is thus usually very time-consuming and – economically speaking – not always very efficient. In contrast, where institutional trust exists, both parties refer to institutional safeguards in their decisions and actions and can thus develop trust without having any prior personal experience in dealing with one another. Zucker (1986) has shown in her historical studies in the US-American socio-economic system of the 19th and early 20th centuries that institutional forms of behavioural coordination and control, such as institutional-based trust, are essential if the function of trust in inter-organizational relationships in differentiated modern business systems is to be understood. In Zucker's as well as in our view, institutional-based trust is a very important distinct form of trust (development) which necessarily involves macro-level arrangements and can only to some extent be captured by insights transferred from interaction-based trust, i.e. trust built on the basis of repeated face-to-face contacts.

Zucker's work is by no means the only important research contribution on the macro aspects of trust. A number of other scholars' efforts, typically oriented around sociological theory, should not be overlooked. Even if they are not representing the mainstream of trust research they build the basis for our subsequent discussion (see Child and Möllering 2003; Hagen and Choe 1998; Misztal 1996; a number of contributions in Lane and Bachmann 1998; and in the 2001 special issue of *Organization Studies* on trust). Concepts such as 'system trust' (Giddens 1990; Luhmann 1979), which are in essence very similar to the notion of institutional-based trust, are referred to in this strand of the literature and a number of scholars confirm that institutions do have a very crucial influence on trust building processes in inter-organizational relationships. From their point of view, trust is conceptualized as an 'organizing principle' (McEvily et al. 2003) or an efficient means to coordinate expectations and interaction (Bachmann 2001) in relationships between individual actors (i.e. managers) and/or collective actors (i.e. organizations), and not as an attitude or state of mind of an individual. The characteristics of the institutional environment in which interactions are embedded are viewed as *constitutive* elements in trust development processes in inter-organizational relationships.

The latter perspective, in our view, is very important and fruitful in terms of theory building and the development of practically relevant management knowledge, not least with regard to trust building and trust repair strategies. However, this perspective has by far not been exploited in its explanatory potential yet. Our argument developed in this article takes on the challenge to fill this gap. It builds on this more sociologically grounded approach to inter-organizational trust and, in so doing, aims to considerably deepen existing insights in the role of institutions in trust building processes. This, in our view, is crucial in the context of building and repairing trust in business partners after numerous examples of large-scale fraud (Enron, Worldcom, Parmalat etc.) and irresponsible behaviours (by many bankers and governments) that have shaken the business world so dramatically in recent years. In order to restore trust, which is vital for the functioning of differentiated modern socio-economic systems, approaches which only target the micro-level and call for ethical behaviour by individual managers seem not sufficient. Rather, institutional-level interventions appear necessary to overcome the current trust crisis. This is why we urgently need to understand how exactly institutions do their job in the context of trust building, and when they matter the most.

In this paper we analyse the relationship between institutions and trust creation by investigating two key issues. First, we examine the mechanisms through which institutions produce trust. Second, we discuss common managerial situations in which strong and reliable institutions are particularly relevant to trust development. In more detail, our paper is organized as follows: after the introduction, our understanding of (institutional-based) trust in organizational research is recapitulated. We then look at the approaches that are offered by general sociological theory to understanding the nature and function of institutions. A brief review of two literatures specifically dealing with institutional impacts on business relationships, namely the neo-institutionalist and the national business systems approaches, follows. We examine what these two approaches contribute to answering the question of how and when institutions matter with regard to trust building and trust repair (the latter being seen as a specific subtype of trust building processes). We then discuss the basic social mechanisms through which institutions produce trust and the situations in which institutions are specifically important. The following section suggests that a specific type of situation requires (a) specific dominant mechanism(s) to effectively produce institutional-based trust in business relationships. A summary of the key points of our argument and some suggestions for how to successfully steer through the rough waters of the current trust crisis are presented in the conclusion of this article.

What do Organizational Scholars Mean by (Institutional-based) Trust?

Trust between individual and/or collective actors is based on the decision of one party to rely on another party under conditions of risk. The trustor permits his or her fate to be determined by the trustee and risks that he or she will experience negative outcomes, i.e. injury or loss, if the trustee proves untrustworthy (March and Shapira 1987; Sitkin and Pablo 1992). Although attitudes and dispositions are often viewed as the essential substrate of trust in the psychologically, i.e. micro-level oriented literature, it is – from our point view – the *action* taken which follows the trustor's decision to *invest* trust in a relationship that actually shows the existence of trust between two actors. Through a 'leap of faith' (Möllering 2006) trust transforms fuzzy uncertainty (where anything is possible) into the specific assessable risk (of betrayal) that a trustor is prepared to accept (Bachmann 2001) and thus creates opportunities for interaction which might otherwise not exist.

Trust in the form of interaction-based trust develops on the basis of personal face-to-face experience between two (or more) individuals without references made or being necessary to make to institutional arrangements. The psychological view emphasizes this mode of trust production. By contrast, institutional-based trust is a form of individual or collective action that is constitutively embedded in the institutional environment in which a relationship is placed, building on favourable assumptions about the trustee's future behaviour *vis-à-vis such conditions*. This is what the sociological view on trust highlights and what we refer to when we say 'institutional-based trust'.

In this context, it is important to note that in some parts of the literature institutional-based trust denotes trust *in* institutions (where institutions, like for example the law, are the object of trust) but more often, and this is also our view, the concept of institutional-based trust refers to the phenomenon that individuals or collective actors develop trust *in the face of* specific institutional arrangements in the business environment. Here, we agree with the notion that trust *in* institutions, which is sometimes also referred to as societal trust (Barber 1983; Fukuyama 1995; Sztompka 1999), is not seldom a vital precondition of trust developed between firms and/or managers *vis-à-vis* powerful and reliable institutions (Child and Möllering 2003).

Trusting someone builds on a decision which is based on an assessment of the other party's competence, integrity and benevolence (Currall 1992; Sako 1992; Mayer et al. 1995), as well as a rough and quick semi-conscious assessment of the unrecoverable costs that would occur if the other party turned out to be untrustworthy (Bachmann 2001). These assessments can, in the case of interaction-based trust, build on experiences made with a potential trustee in repeated face-to-face encounters. However, such first-hand personal experiences are not always possible or desirable. In the case that the trustor and the trustee do not know each other, a third actor known to and trusted by the first two actors may function as a 'third-party guarantor' and thus play an essential role in trust development (Coleman 1990; Shapiro 1987). The third-party guarantor does his or her job in that he or she provides an overlap of both parties', i.e. the trustor's and the trustee's, explicit and tacit knowledge domains, and allows for judgments on part of the (potential) trustor that would not be possible otherwise.

Within the concept of institutional-based trust, institutions can be reconstructed as being functionally equivalent to a personal third party guarantor (Bachmann and Zaheer 2008). However, rather than interaction-based trust drawing on a third party as a person, institutional-based trust constitutively draws on impersonal arrangements Zucker 1986). Similar to a personal guarantor in the case of interaction-based trust, institutions help to establish a ‘world-in-common’ (Garfinkel), i.e. shared explicit and tacit knowledge between the trustor and the trustee. In these circumstances, an individual or collective actor finds good reasons to trust another actor, individual or collective, because institutional arrangements are, like a personal third party guarantor, capable of *reducing* – which is not the same as eliminating! – the risk that a trustee will behave untrustworthily, allowing the trustor to actually make a leap of faith and invest trust in a relationship.

Institutional structures that can reduce the risk of misplaced trust may include, for example, legal regulations, professional codes of conduct that are or are not legally binding, corporate reputation, standards of employment contracts, and other formal and informal norms of behaviour. Institutions sometimes convey norms of behaviour that are deeply rooted in ancient traditions. For example, in the continental European business environment, and especially in Germany, the existence of active and powerful industry associations and the role they play in defining formal and informal norms of business behaviour have roots back into the Middle Ages and have been identified as being very conducive to developing institutional-based trust in inter-organizational relationships (Lane and Bachmann 1996; Bachmann 2001). Institutional-based trust may generally be seen as a weaker form of trust compared to interaction-based trust, i.e. trust generated on the basis of intensive face-to-face contacts. However, it has considerable advantages with regard to the costs to generate it while, in a basic sense, institutional-based trust works quite similar to interaction-based trust. The elements of the institutional framework of a business system do their job in that they create shared explicit and tacit knowledge between the (potential) business partners, just as repeated face-to-face contacts would do.

What do (Organizational) Sociology Scholars Mean by Institutions?

General Sociological Theory

According to Giddens (1984), institutions are structural arrangements represented by rules of behaviour to which individual and collective action is oriented. Institutions create social order by providing patterns of behaviour used by actors to lend meaning and legitimacy to their behaviour. They can occur in the form of explicit rules and as implicit routines and practices. Institutions appear as formal institutional arrangements if they are based on explicit rules of behaviour. But they also include more context-specific informal rules, implied for example in the routines and practices of applying legal rules, teaching and learning styles, practices of financing investments, the use of industry associations' resources by their members, or the usual forms of treating vulnerable and not so vulnerable suppliers. Informal routines and practices represent, like formal rules, very important institutional arrangements, especially when they acquire stability over a longer period of time and attain legitimacy through common acknowledgement.

Institutions often appear detached from individual social actors' preferences and intentions. This detachment makes them sometimes look like unalterable forces ('faits sociaux' in Durkheim's (1895/1982) terminology) or natural laws. This can make them appear neutral with regard to single individuals' socio-political interests and thus hard to challenge. However, neither formal institutional rules nor informal routines and practices are set in stone, as many critical social scientists have often pointed out (e.g. Hall 1986). Institutions represent the views of a large number of social actors that permanently confirm the validity and acceptability of these rules or routines and practices by the very concrete patterns of their interactions (Giddens 1984). Thus, institutions can be changed by social actors, although this is a relatively rare phenomenon. To take an example from outside the sphere of business, marriage can be seen as a good example of an important societal institution. Although it is possible that marriage could vanish as a form of long-term partnership between two individuals who establish a specific emotional bond and usually have children together, this could happen only if a large number of individuals continuously and radically question its legitimacy and/or usefulness.

Institutions are relatively stable bundles of commonly accepted explicit or implicit rules of behaviour to which most people orient their behaviour. Irrespective of what a single actor may think about a specific institution, institutions create guidelines of behaviour that may occasionally be violated but cannot be ignored. Social order of any kind manifests itself in institutions (Parsons 1951) and even where old institutions are overthrown, new ones will emerge soon. At the same time, the strength of institutions can vary greatly between socio-economic systems and the degree of the embeddeness of interactions in the given institutional arrangements (Granovetter 1985) is a variable that matters when specific empirical contexts are under review. Both the power of institutional arrangements and the depth of the embeddedness of inter-organizational exchanges are crucial with regard to the predictability and trustworthiness of individual or collective actors who envisage or build a business relationship.

The Neo-institutionalist View

The neo-intuitionalist approach in the socio-economic analysis of business relationships, which has flourished since the early 1990s, emphasizes institutional arrangements that both enable and restrict actors' behaviour (Powell and DiMaggio 1991; Scott 1995; Meyer and Rowan 1977). After about two decades of focusing on social change and individuals' capabilities to express their needs and desires in the 1970s and 1980s, sociological theory in general and organization theory in particular became more interested (again) in social structures and institutional order. Since then, many scholars have slightly re-balanced their perspectives and tend to place more weight (again) on institutional analyses that are geared to understanding not only the restrictions of social action but also the formative elements in social rules, routines and practices (Reed 2001). Among neo-institutionalists' key notions is what they call 'institutional isomorphism'. This concept relates to the observation that organizational actors tend to exhibit very similar behaviours when being exposed to the same institutional environment (Di Maggio and Powell 1983). Institutions, in their perspective, are generalized rules and patterns of behaviour that are engrained in all kinds of social interaction (Berger and Luckmann 1966). Similar to Giddens' structuration theory, neo-institutionalists conceptualize trust as developed through the formal and informal patterns of behaviour. It can never exist in separation from them. Thus, any form of trust is essentially seen as institutional-based, following from collectively accepted norms and not from socially disembedded individuals' rational (or indeed irrational) decisions. With respect to inter-organizational relationships, business environments are thus viewed as constitutive conditions of firms' behaviour.

In our view, the neo-institutionalist approach provides important insights into the role of institutional-based trust in advanced socio-economic systems. However, we would maintain that there is also a way to develop trust by way of face-to-face contacts, the latter being not much, if at all, dependent on references made to the institutional arrangements that surround the interaction between trustor and trustee. Nonetheless, we share the neo-institutionalist view on institutional-based trust as a very important and basic form of trust (development).

The National Business Systems Approach

The literature on national business systems (Hall and Soskice 2001; Lane 1995; Sorge 1996; Whitley 1999; Haake 2002) shows less interest in abstract theoretical conceptualizations when analyzing institutional arrangements. In this body of literature, which largely also emerged in the

1990s, institutions are not just understood as general forms of social behaviour. Instead, a number of elements of the institutional framework of business systems are empirically identified (e.g. Whitley 1999) and different countries' business systems are characterized by attributing country-specific variables to these categories. The quality of industrial relations, the system of vocational training and education, the legal system, and corporate governance practices are among those elements of the institutional frameworks of national business that are studied in detail in various countries. In this context, for example, the research on intellectual property rights (Andersen 2006) finds significant practical consequences of different national regulations and the literature on alternative firm ownership structures (e.g. La Porta et al. 1999) analyzes corporate and legal practices that explain differences in this respect across developed and developing countries.

Looking at trust, the national business systems literature discerns high trust business systems and low trust business systems (Fukuyama 1995). Fox (1974), who focused on British and German industrial relations, was one of the first scholars to suggest such a conceptualization. In contrast to studies that see the differences between socio-economic systems predominantly rooted in culture, such as Triandis (1972), Hofstede (1991) or Trompenaars and Hamden-Turner (1997), the national business systems literature analyses institutional arrangements and the fit between institutional characteristics of business systems and organizational configurations. Different from many neo-institutionalist contributions to the debate, the national business systems literature provides strong empirical data, especially from a comparative perspective (e.g. Geppert, Matten and Williams 2002, or Casper and Whitley 2004 on the biotech industry). Through this approach valuable insights have been produced into the varieties of capitalism (Hall and Soskice 2001) and the forms and country-specific conditions of trust development in inter-organizational relationships (Lane and Bachmann 1996).

No doubt: Institutions can be Important and Efficient Facilitators of Trust …

Institutions can play a key role as facilitators of trust in that they produce shared 'taken-for-granted' knowledge. Different from the utilitarian approaches to understanding trust, structuration theory, neo-institutionalist theory and the national business systems approach view trust as an embedded quality of social relationships. Institutions create common orientations and are capable of channeling interactions between two (or more) actors into foreseeable patterns, both by providing explicit rules incorporated in institutional arrangements and tacit knowledge embodied in routines and practices (Seligman 1997). Institutions bridge across knowledge domains and the decisions of individuals and organizations that otherwise would often not find any reason to trust a potential transaction partner. Institutional arrangements create familiarity and can lead to the suspension of critical questions about the actual trustworthiness of trustees. Both neo-institutionalist theory, with its roots in phenomenological philosophy (Husserl 1929/1969), and the empirically based analyses of national business systems share this view.

… but how do Institutions do Their Job Precisely?

While the existing literature makes a very convincing case for the importance of institutions in the process of trust building in relationships between individual and collective actors, there is no clear understanding of how institutional arrangements precisely find their way into the decisions and actions of (potential) trustors and trustees. In other words, it is unclear what it precisely means when we say that institutional arrangements are a constitutive part of a relationship based on institutional trust and that trust is developed by references made to strong and reliable institutional arrangements in which a relationship is embedded.

To answer this question it is helpful to distinguish between three possibilities that exist with regard to how institutional arrangements might do their job. *First*, institutions may find access into potential trustors' behaviour in that they lend meaning to the circumstances in which the actors are embedded before any relationship is built. This is to say that the actors' behavioural antecedents can be influenced and thus lead to a (potential) trustor's decision to invest trust in a relationship. For example, if a job applicant signals a strong background of professional education and institutions in the form of a reliable system of professional education can underpin this signal and thus attach credibility, meaning and relevance to such a signal, this can encourage a (potential) trustor, i.e. the (potential) employer, to suspend doubts and develop trust in the applicant's professional competence. *Second*, the antecedent behaviour as observed from a potential trustor's point of view might not be the direct target of institutional influences. Rather, institutions influence the patterns of how trustors and trustees interact when they start to actively establish a business relationship. If this is the case, institutions creep into the relationship in that they channel the behaviours of both parties and the patterns of their interaction. Institutions shape actors' behaviours along the lines of institutionally provided templates. To use the same example again, a job interview might be done according to certain common routines created and underpinned by institutional arrangements, which could be guidelines issued by an industry association or recommendations and requirements that originate in the political and/or legal spheres. Then, it is not the antecedent behaviour but the actual patterns of building a specific relationship which are the target of the institutional influences. *Third*, a trustor has faith in the institutional arrangements themselves, making them the object of trust and by-passing the trustee as a free-willed actor who might or might not orient his or her behaviour towards a certain institutional order. This third possibility is, in our view, limited in its theoretical capacity and less realistic, at least where business relationships are concerned. Above, we have already indicated that trust *in* institutions is not what we see as essential when we look at institutional-based trust in inter-organizational relationships. Thus, in the following we will only take two possibilities into account: institutions as targeting the behavioural antecedents to a (potential) trustor's decision to either invest trust in a relationship or refrain from so doing (i); and institutions providing templates for interaction which either lead to a trust-based relationship or not (ii).

Whether possibility (i) or possibility (ii) holds true is theoretically difficult to decide. However, as our examples illustrate, there is no reason to assume mutual exclusiveness of both possibilities. Rather, it seems that institutions can and often do work both ways. Which of the two possibilities is more prominent in a certain situation is analytically important but can only be decided by way of empirical observation. Thus we want to move a bit closer to the empirical world now and see what are the concrete social mechanisms through which institutions do their job and the situations in which they matter the most with regard to building inter-organizational trust.

Key Mechanism Through Which Institutions Foster the Development of Trust

All social relationships involving trust are accompanied by an inherent risk: the trustor can never completely rule out the possibility of untrustworthy behaviour on part of the trustee. A central question associated with institutional-based trust is: what are the concrete mechanisms through which institutions do their job, allowing trusting managers and firms to deal with the risk of betrayal that unavoidably comes with the decision to invest trust in a relationship? In this section we systematically consider four concrete mechanisms through which institutions can specifically reduce risk and foster trust building processes in inter-organizational relationships. These mechanisms are frequently named when (institutional) trust is referred to, for instance in the colourfully presented and already classic empirical examples which Coleman (1990: 91 ff) discusses. They explicitly or implicitly refer to all four mechanisms which we have selected here. What Coleman – like others – does not deliver, however, is a deeper understanding of how exactly institutions do their job. Viewing them simply as parameters in a mathematical equation, as Coleman does, is in our view certainly not a very enlightening approach.

Legal Provision

Everyday knowledge seems to suggest trust and legal provisions do not fit together very well. Equally, the tradition of socio-legal studies (going back to Macaulay 1963, and Beale and Dugdale 1975) puts this notion forward within an academic context. However, newer comparative empirical research shows that the existence of reliable contract law can actually be very conducive to developing trust in business relationships as relationships firmly based on legal rules can significantly lower the inherent risk of trust (Arrighetti et al. 1997). Law can be an effective risk reducing institution because it aligns actors' expectations and behaviours long before any serious disagreement arises. It can also provide the possibility that the trustee faces serious sanctions if he or she does not live up to the trustor's expectations. The latter, however, is only the *ultima ratio* which should normally not become relevant when law fulfils its function properly (Luhmann 1979).

Consider the case of two organizations that have entered into a contractual relationship. There are no guarantees that these organizations will comply with the law. However, in socio-economic systems with effective legal systems there is a high probability that the two parties will orient their behaviours to the existing formal legal rules. Usually, the relationship will function without the trustor having to directly and explicitly resort to contract law or to threaten to mobilize the sanctions attached to law. If the trustor did this, these actions would surely get in the way of a productive business relationship. Law as a formal institution providing explicit rules of appropriate behaviour does its job best when it remains latent and both parties only vaguely consider the formal sanctions available if one side violates the agreement (Luhmann 1979). When disagreements result in legal action the law has failed to do its job efficiently because the sanctioning process is often costly, time consuming and it usually precludes the two parties from doing business with one another again in the future.

In this context, it is interesting to note that some scholars see legal recourse via contracts rather than the law underpinning contract clauses as the pivotal institution in contractual relationships (Poppo and Zenger 2002). With regard to our understanding of institutions, which draws on sociological rather than economic theory, we do not agree with this argument. Only when the existence of a contract leads to behaviours outside the specific bonds of the contract, or a contract represents the existing legal norms, are contractual documents to be viewed as evidence of an institutional impact on the quality of the relationship. In this case, the legal contract is a tool that can be used to refer to the law, which in turn provides structural assurance that the other party will in all likelihood not behave opportunistically (unless there are strong external incentives to do so).

Arrighetti et al. (1997) suggest that a contract can serve as a reassuring device that merely confirms what contract law requires from the contractors in a business situation. Admittedly, this is typically the case in business systems that build on the tradition of civil law, rather than common law, which means that the legal system builds on a powerful rule-based legal code. Regulation by means of legal norms features strongly in this type of business environment, which is common in continental Europe and large parts of Asia. By contrast, common law, which is widespread in English-speaking countries, is based on sometimes difficult to find precedents and not on a set of clearly stated rules. It is thus relatively weak as an institution and contractors understandably fall back on their own – individually available – means to enforce or protect their interests whereby the contract (as such) can be an important tool. Common law systems usually leave more freedom as well as burden to the contractors to specify the nature of their relationship through their idiosyncratic contracts. The latter, however, is not necessarily very conducive to trust building, especially if the stronger side of two unequal partners is determined to maximize its interests.

Civil law fosters the development of institutional-based trust as, if in doubt, the legal code has priority over idiosyncratic contract clauses, and thus often leads to inter-organizational relationships that are much more standardized and stable than under common law. Clearly, the effect on trust building can be stronger than in the common law system. However, even a common law system provides a significant level of commonly known and respected orientations as to what is acceptable business behaviour and what is not. Although to a lesser extent than civil law, common law – like any reliable legal system – makes actors' behaviour more predictable and is thus an important mechanism to coordinate and control mutual expectations and to foster the development of trust, i.e. institutional-based trust, in business relationships.

Legal provision in the form of contract law targets primarily the behavioural antecedents of trust building between a trustor and a trustee in that it aligns their expectations and behaviours before they actually engage in business transactions. (Long) before it actually comes to the process of shaping the specific relationship the law has – as a trust encouraging institution – already done most of its job in that it has oriented the antecedent expectations and behaviours of both the (potential) trustor and the (potential) trustee to a common understanding of what are the basic premises of their relationship.

Corporate Reputation

Institutions can also have an informal character and incorporate social, rather than legal sanctioning power. Corporate reputation is an example of a mechanism that conveys informal behavioural norms. Similar to formal rules of business behaviour, such as those implied in legal regulation, an organization's reputation channels behaviours of and towards the organization in certain directions, which in fact makes the future behaviour of the organization and their (potential) business partners more predictable. A firm's reputation will influence the degree of attraction one has to affiliating with such an organization. Firms that value their reputation as social capital (Coleman 1990; Putnam 2002) will be unlikely to engage in practices that have the potential to damage that reputation and will thus be more predictable and trustworthy.

What both legal arrangements (as a formal institutional mechanism) and reputation (as an informal institutional mechanism) have in common is that they can involve sanctions that might, even though this is only the exception, be activated against a cheating actor within the business community in which these institutions exist. In the case of reputation the sanction is its own erosion and subsequently the loss of business. Coleman (1988) discusses this deterrent possibility with regard to the Antwerp-based community of Jewish diamond dealers. Many more locally concentrated business communities could be found, and in fact, as bad and good news travel faster today than ever before in history, the reputation of large and small firms can quickly be ruined on a global scale.

The mere fact that business partners know, often only very vaguely, that there might be some form of sanctions in the case of unaccepted behaviour, is the key to understanding the sanctioning power of formal and informal institutions. They provide orientation and stability rather than explicit threats and deterrence, with not much difference between legal and informal sanctions in this respect. This is an important insight as to how these institutional mechanisms function with regard to building trust. They reduce the risk that a (potential) trustor misplaces trust and thus encourage him or her to actually invest trust in a relationship.

Reputation can channel the meaning and interpretation of the behavioural patterns of trust building processes between two business partners. Different from legal provision, corporate reputation does not so much influence the antecedent behaviours of both parties but the routines and practices of relationship building activities. When one of the contractors signals a certain understanding or expectation in the contractual negotiations these signals gain their meaning in the light of the presence or absence of reputation. If, for example, a supplier firm with a reputation for high quality products or services signals to be flexible in terms of prices, this is likely to be contributing much more to establishing a long-term trust-based relationship than if a firm with a low reputation sends this signal. In the latter case this could easily be interpreted as a sign that the quality of products might be even lower than what one would normally expect from this firm, thus leaving the buyer firm in doubt about whether at all the product might be usable for his or her purposes. In these circumstances, the buyer may well refrain from trusting the seller.

Certification of Exchange Partners

The formal certification of an exchange partner is also a way through which institutions may do their job. Consider the guidelines and norms of good business practices created by societies of doctors, lawyers, accountants and other professionals, or indeed those of industry associations. Professional organizations, among other things, seek to promote behavioural norms among their members that ensure compliance within a set of established rules. When, for example, an accountant is hired to perform an audit, access to financial data is required, the exposure of which could be harmful to a firm should it fall into a competitor's hands. Clearly, trust is a vital issue in this context. Thus it is important to many clients that auditors who are CPAs (in the U.S.) or Chartered Accountants (in Canada and the U.K.) will have undergone extensive training and be certified by a governing body.

Also, ISO 9000 certifications which are acknowledged worldwide, are a tool to standardize procedures of industrial and services sector firms in the interest of safety and quality of products and thus create institutional-based trust (Casper and Hancke 1999). Furthermore, national technical norms in the engineering sector (e.g. DIN-norms in Germany and BS-norms in the U.K.) ensure the comparability of parts that are outsourced (Lane 1997). All these standardization efforts are highly conducive to managing risk and to building trust among business partners. They make potential trustees' behaviour more predictable as even if firms do not like specific technical standards, they are quite likely to comply with them. This is both because this behavioural option reduces complexity, simply making life and business easier, and because there might ultimately be severe sanctions, for example a serious decline of business on part of those ignoring industry-wide (technical) norms and standards.

In the case of certifications the direct target of the institutional arrangements appears to be the antecedent behaviour of both parties to the business transaction. Similar to law, certifications do not gain so much relevance in the actual negotiation process which may lead to a trust-based relationship. Rather, they are influencing the antecedent expectations and behaviour of the trustor and the trustee (long) before decisions to trust or not to trust are made.

Community Norms, Structures and Procedures

An institution establishes behavioural norms that exchange parties usually will orient their behaviour to, especially if they have limited knowledge about each other and long-winded face-to-face trust building is not a desirable option. Within internet communities, for example eBay, users form opinions about whether and to what degree multiple buyers and sellers can be trusted and in doing so, make judgements about the community itself (Pavlou and Gefen 2004). Collecting information about many individual sellers who appear with multiple identities serves as a proxy for the overall trustworthiness of the seller community. Trust in such virtual communities is essentially impersonal and fairly informally based as it relates to generalized perceptions of the community and its ability to function in a manner that is consistent with members' expectations. Such a community will build norms, structures and procedures regarding the behaviour of their members and thus make it function without any personal contacts.

Online auctions and e-commerce in general have become an enormous business and the level of cheating is very low, both between individuals and organizations. The reason is that community norms, structures and procedures, such as those incorporated in systems to rate the reliability of potential business partners, provide a third-party guarantor function in the relationship between the trustor and the trustee. This allows for collective, i.e. legitimized, control of actors' behaviours. Although rather informal and with no legal protection, norms, structures and procedures that are created internally in a business community make individual as well as collective behaviours more predictable and thus lower the inherent risk of trust. Actors, thus, are considerably more inclined to invest trust in a relationship than if such norms, structures and procedures were not in place.

Here again, behavioural patterns that occur in the process of establishing a specific relationship rather than behavioural antecedents of decisions to invest trust in a relationship are influenced by this mechanism. Within a business community behaviours of individuals are monitored, interpreted and sometimes, especially if the community is large, formally assessed in a quantified manner. Community norms, structures and procedures lend meaning to certain behaviours involving the interaction between trustors and trustees. If, for example, sellers on eBay are rated in terms of reliability, this is part of the routines and practices through which community norms, structure and procedures contribute to trust building processes. Thus, the primary target of these institutional forms is not the antecedent behaviour of sellers and customers but the patterns of interaction between the (potential) trustor and the (potential) trustee. Table 1 summarizes our argument with regard to the question of which mechanism primarily targets either the behavioural antecedents of a relationship or the patterns of interaction which evolve in the relationship in which trust is developed. Generally speaking, we find that *formal* institutions tend to influence the behavioural antecedents of relationships whereas *informal* institutions target the patterns of exchange-specific processes that are instrumental in building a trust-based relationship.

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Insert Table 1 about here

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Common Management Situations: When do Institutions Matter most?

As we have shown, institutions are often a vital source of trust in complex socio-economic systems. As indicated earlier, we do not assume that interaction-based trust, i.e. trust produced by face-to-face contacts, is negligible in differentiated modern socio-economic systems or that there are, besides trust, no other means to coordinate and control inter-organizational relationships. We believe, however, that there are specific situations where the influence of institutions targeting either the behavioural antecedents of trust development or the patterns of interaction between the (potential) trustor and (potential) trustee can be particularly conducive to efficiently building trust in business relationships.

After having examined the key mechanisms through which formal and informal institutions can help establish trust in business relationships, in this section we will now analyse situations where institutions matter most in the process of building trust in inter-organizational relationships. Typically, this is the case where interaction-based trust development is not a favourable option. At least four such situations can be clearly identified: in the early stages of the development of a trust-based relationship; when trust needs to be established swiftly; when the transaction involves a low level of asset specificity; and when transactions in mature industries are concerned. These situations are very common in the business world and thus frequently referred to but not analysed in depth anywhere in the literature. We do not claim that they are exhaustive or mutually exclusive. Despite the fact that there are many over-lapping cases in the empirical world it is, however, possible and useful to distinguish between these four situations.

Trust in the Early Stages of a Relationship

Institutions can be a specifically important factor in processes of trust creation where limited or no previous interaction exists between the (potential) trustor and the (potential) trustee. Consider what happens when a new joint venture is formed. At the formation stage, information about the partner firm and the managers involved in joint venture management will often be fuzzy and/or incomplete. Even if the partner firm and their managers are generally perceived as friendly and reliable, trust may be tentative between the involved managers as will be the relationship at the firm level. In this situation, institutional safeguards, such as those we have discussed above, e.g.

legal regulation can be very useful to encourage the boundary spanners in both firms to build a relationship on the basis of trust (Gulati 1995).

Trust, as we argue throughout the paper, is not just a function of the idiosyncratic interests of actors; it is in many cases and in a fundamental sense a function of the nature of the institutional context in which relationships are embedded (Nooteboom 2002; Sheppard and Sherman 1998). A familiar context, as we have seen above, produces 'taken-for granted' assumptions and perceptions of safety, which can lead actors to place themselves at risk with other actors. Without these safeguards, managers and organizations would often be more focused on self-protection than mutual task performance (Sitkin 1995). Over time, when information about counterpart firms and managers becomes available, commonly shared knowledge embodied in the relevant institutional environment may have less influence on trusting behaviour whereas trust building on face-to-face experiences, i.e. interaction-based trust, may play a more pronounced role. Especially in the initial stages of the relationship, however, managers will be more likely to trust business partners when they know that reliable structural safeguards such as external legal arrangements or certification systems exist.

This view is also confirmed by Mayer and Argyres (2004) who argue that in the early stages of a relationship contracts as such are often not a sufficient basis for trust building processes. Contracts have often limited detail because the parties have limited knowledge about each other and about the future dynamics of the exchange relationship. In this situation external safeguards are very important as they can reliably encourage a (potential) trustor's willingness to engage in a trust-based relationship where not much is known about the exchange partner him- or herself. In the early stages of a business relationship the existence of such safeguarding institutions that do not require as much individual effort as this would be the case with interaction-based trust building efforts playing a crucial role. Admittedly, establishing and maintaining institutional arrangements such as, for example, legal provision, the standardization of technical and behavioural norms or certification schemes etc., comes with costs that need to be paid for collectively and over time. However, at the point in time when they are needed institutional safeguards are costless for the parties involved in a specific situation and thus can be a very efficient way to produce trust, especially at the early stages of a relationship.

In the early stages of a relationship it seems particularly important that those mechanisms which target the behavioural antecedents of trust come to the fore. Certification and legal regulation are most effective here. Reputation may also play some role in the early stages of a relationship. Less important are community norms, structures and procedures which only become relevant when business communities are small and relatively stable in terms of size. Thus we can say that simple and reliable safeguards which are highly generalized and exist independently from the individual relationship are most efficient when the initial stages of trust-based relationship are concerned. This is also in line with Lewicki and Bunker (1996) who suggest that a (potential) trustor takes a relatively calculative approach in the early stages of relationship. Legal regulation and certification are perfect tools to influence a (potential) trustor’s relatively calculative antecedent assessment of the trustee’s trustworthiness.

Swift Trust

Where decisions need to be taken swiftly, which is not necessarily case in all early stages of business relationships, institutional-based trust is often indispensable. Business partners do not always have the time and energy to build trust-based relationships by way of repeated face-to-face contacts, especially where one-off transactions are concerned (Barney and Hansen 1994) or special reasons for swift decisions exist, such as when a business chance is to be seized before rivals become aware of it or where ‘hastily formed networks’ (Denning 2006) are unavoidable, for example in the case of health or safety related emergencies. Meyerson et al. (1996) are thus right to point out that ‘swift trust’ is frequently of the essence in business relationships.

Often a quick assessment of the situation and the business partner with some minimal amount of swiftly generated trust is a precondition of any (further leading) exchange taking place between two actors. If this basic form of trust rather than stronger forms of trust such as, for example, ‘identity-based trust’ (Lewicki and Bunker 1996) is to be created between the trustor and trustee, stable and commonly accepted institutional arrangements can often do a very efficient job. Without having to make lengthy checks and explicit considerations of whether to invest trust or not in a particular relationship, actors can fall back on institutional risk absorption provided, for example, through the certification of exchange partners, which in many situations is completely sufficient, especially where no close and long-term partnership is envisaged.

In cases where swift trust is needed, corporate reputation, even if not substantiated and confirmed by one’s own knowledge or experiences, can also make the difference between trusting and not trusting a (potential) business partner. Certification and reputation are most easy to grasp in such situations. A potential business partner is either certified or not and has a good or a bad reputation. The legal situation is a bit more difficult to swiftly assess in sufficient detail although it is here in principle also helpful to know that there are legal safeguards in place.

Transactions Involving a Low Level of Asset Specificity

The type of product or service exchanged in a business transaction also has an influence on the value of institutional-based trust. Barney and Hansen (1994) argue that trust is specifically important where sophisticated and customized products and services are concerned. The underlying assumption is that a relatively low level of asset specificity (Williamson 1985) requires only a low level of trust and that developing high levels of trust developed on the basis of face-to-face contacts, i.e. interaction-based trust, might in such cases often be a waste of resources. In the case of a low degree of asset specificity, the value and quality of the assets relevant to a transaction can usually be easily assessed. Short and simple agreements are possible and a strong form of trust is often not needed in such cases.

Institutional-based trust can, however, greatly enhance the efficiency of transactions involving low level asset specificity. Zucker's (1986) argument that advanced socio-economic systems are highly dependent on institutional-based trust and cannot work solely on the basis of personal experiences (and ascribed group characteristics, for example the ethnic origin of business partners), is consistent with this part of our own argument. Too often transactions would simply not take place if strong but time-consuming forms of interaction-based trust developed in long-winded face-to-face interactions were always needed before any exchange is considered. Advanced complex business systems have to establish a form of trust production which can avoid hold-ups and excessive situational costs on part of the actors involved in a specific relationship. Institutional-based trust seems to be a tailor-made solution for markets on which products and services characterized by a low degree of asset specificity are exchanged. It may generally be a weaker form of trust but it comes with no, or at least no immediate or individually claimable, costs for the actors involved in a specific relationship while its quality may often be just good enough.

In these circumstances, the reputation of a large and/or well-known player in the market can encourage a transaction partner to enter into a relationship with this firm without much hesitation. For transactions involving more sophisticated and difficult-to-evaluate assets, by contrast, a high degree of uncertainty tends to prevail and the establishment of relatively costly interaction-based trust, i.e. trust developed in face-to-face contacts, may be worthwhile, especially where a longer-term relationship is envisaged between the two parties. But where this is not the case a good corporate reputation of the (potentially) trusted organization may well be sufficient to facilitate a mutually beneficial transaction.

Legal safeguards and certification are also useful in such situations but these are not the primary mechanisms to establish institutional-based trust, especially where the trustees are large global players, which is often the case when a low level of asset specificity is characteristic of the exchanged product or service. If, for example, a specialist petrochemical firm uses Exxon or Shell as their supplier of a mass-produced input such as, for example glycols or polymers, this firm would usually simply rely on the reputation of the large multinational firm, rather than any form of certification or legal safeguards.

Mature Industries

The question of why particular industries are strongly developed in some countries and less so in others has, among other things, to do with the way trust is developed in specific business environments (Bachmann 2001). For example, continental Europe is not overly successful when it comes to high tech industries that require high levels of risk-taking on part of ambitious individuals. Where the latter is needed, strong forms of trust, i.e. interaction-based trust developed by repeated face-to-face contacts, can be much more effective than institutional-based trust, which, as we have seen in the case of transactions involving a low level of asset specificity, usually has a lower quality. High tech industries and the often knowledge intensive services sector, which are typically well developed in English-speaking countries, profit from an environment that supports high levels of interaction-based trust. By contrast, mature industries, which are more strongly developed in continental Europe, rely more on an environment where institutional-based forms of trust flourish and are most efficient in absorbing an, on average, lower level of risk in relationships between individual and organizational actors.

It might be argued that the latter two situations are strongly overlapping as where mature industries are dominant one would often also expect low levels of asset specificity. However, we maintain that both situations are by no means congruent. Numerous cases exist where highly asset specific investments occur in relatively mature industries. This, for example, holds for many supplier relationships in the automobile industry, where costs are to be reduced by means of close and exclusive partnerships.

In the case of mature industries, community norms, structures and procedures are the primary institutional mechanisms to establish trust-based relationships. To a lesser extent, reputation and legal regulation also play a role. In large-scale mature industries the players are few and the markets tend to be relatively transparent. The in-group norms, structures and procedures are thus relatively strong. Certification, by contrast, is not an effective means to build trust in the large mature industries of continental Europe. Where this has been tried, adverse effects have been observed and certification can then actually be a source of distrust rather than trust (Walgenbach 2001).

Mechanisms and Organizational Situations Combined: an Integrated Model

The previous sections of this paper discussed four mechanisms by which formal and informal institutions specifically impact trust building processes and four organizational situations where the influence of institutions are most conducive to trust building in inter-organizational relationships. The following table now summarizes which of the four mechanisms feature(s) specifically strongly in which of the four situations. In viewing table 2 it is important to note that each of the four mechanisms is associated with more than one of the four situations. On the basis of this insight, table 2 indicates one or two primary mechanisms per situation which reflect the most characteristic combinations, and one or two secondary mechanisms per situation which may also play a non-negligible role.

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Insert Table 2 about here

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As depicted in this table, formal institutions, i.e. law and certification, are most important in the early stages of a business relationship and when swift trust is in demand. In both situations there is usually little knowledge available and a weaker form of trust would normally suffice for a (potential) trustor to take the first step. Here it is the antecedent expectations and behaviours that are formed by potential business partners vis-à-vis such conditions that matter. Reputation, as one form of an informal institutional structure, matters most with regard to swift trust development and situations where the products or services exchanged are characterized by a relatively low level of asset specificity. Community norms, structures and procedures are institutional arrangements which matter specifically in mature industries where the players are few, large and well-known. In this sector, for example in the steel or oil industries, key players tend to establish their own unwritten rules to organize their business. Both in the case of reputation and where community norms, structures and procedures are concerned, the primary target of these institutional facilitators of trust are the concrete patterns of interaction between a (potential) trustor and a (potential) trustee which channel the actors' behaviours in certain forms, rather than antecedent expectations and behaviour which are relevant already before a specific relationship between two business partners is established.

Conclusion

While the present paper presents a conceptual framework for research on institutional-based trust, we admit that the role of institutions in trust development is as yet not sufficiently researched, especially in empirical terms. Much effort is still needed to unravel the subtleties of empirical cases where institutional-based trust can make all the difference. For our future research, we believe that institutional-based trust should be seen as form of trust (development) which, in analytical terms, is different from interaction-based trust. We do not follow those scholars, such as Shapiro (1987), who may have an interest in impersonal forms of trust but are essentially very skeptical about the influence of institutions such as practice standards, and regulatory statutes on the behaviour of managers. In Shapiro's view, the temptations to lie and steal continue to exist where strong institutions are in place. She concludes that 'in complex societies in which agency relationships are indispensable, opportunities for agent abuse are sometimes irresistible and the ability to specify and enforce substantive norms governing the outcomes of agency is nearly impossible, a spiraling evolution of procedural norms, structural constraints, and insurance-like arrangements seems inevitable' (Shapiro 1987: 649). In other words, in her view institutions alone are insufficient for the existence of trustworthy transactions and must at least be supplemented by a host of additional controls. Our view is that depending on the situation in which trust is required, institutions can matter a great deal. Although these may produce a form of trust which is weaker than interaction-based trust, i.e. trust developed over a period of time by face-to-face contacts, institutions shape and channel actors' expectations so as to allow for trust building in many situations where otherwise there would be none.

In this article, we discussed four mechanisms through which institutions particularly influence trust development processes. We also discerned four specific situations where the influence of institutions can be particularly conducive to building trust in business relationships. In examining these mechanisms and situations, we believe we have made a persuasive case as to why institutions should play a more prominent role in the study of inter-organizational trust. Not least with regard to the urgent issue of trust repair we think that institutional arrangements will have to play an essential role as trust based face-to-face contacts alone would not necessarily lead the way out of the current trust crisis and are also in many cases not feasible and often far too costly.

The primary target of institutional influences is, in our view, key to understanding institutional-based trust. Future research should thus seek to understand and, on the basis of empirical studies, differentiate situations where institutions directly influence actors to develop trust in inter-organizational collaborations from those where institutions only vaguely encourage or discourage actors to consider institutional-based trust, and those where actors deliberately make their decisions primarily on the basis of other organizing principles, for example, power. To address these issues, empirical research will need to isolate specific managerial situations and examine the very concrete circumstances around transactions, relationships, and institutions. For example, the propensity to use joint ventures versus acquisitions could provide insights into the strength of institutions. Wang and Zajac (2007) examined the costs and benefits of alliances and acquisitions and suggested that organizations with previous alliance experience may have developed a trusting relationship and might be more likely to prefer a long-term partnership over an acquisition in the future. To test for the role of institutions researchers could look at the attractiveness of alliances in the light of experiences that both parties made with one another in prior relationships. The question could be examined using cross-border data from countries with strong and weak institutional frameworks. According to our view the chance that alliances are formed in the absence of prior experiences in close inter-firm relationships should be higher in the country with stronger legal and social institutions. Acquisitions would likely be more prevalent when institutions are weak, given that future interactions in an acquisition occurs under one owner and eliminate the threat of partner opportunistic behaviour. Experimental scenarios could provide interesting avenues for the examination of contracting behaviour and situations, for example, where trust is developed in initial stages of relationships or where the level of the asset specificity of exchanged products or services is specifically low or specifically high. Extensive empirical research is needed to show whether our conceptual framework helps to fully understand why and how institutions matter, where institutional-trust can stand in for interaction-based trust and vice versa. Especially in times when trust is a scarce resource while needed more than ever, these questions are urgent. As we are moving out of the global financial crisis into a new era of post-liberal capitalism, this will be one of the most important fields in management research. The repair of trust will to large extent build on institutional measures and involve a substantial degree of re-regulation after almost three decades of de-regulation. That moralistic appeals will do the job and contribute much to overcoming the trust crisis seems a quite unrealistic hope.

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Table 1
Mechanisms and their Primary Targets

Mechanism	Target
Legal Regulation	Antecedents of Relationship
Reputation	Practices of Interaction
Certification	Antecedents of Relationship
Community Norms, Structures and Procedures	Practices of Interaction

Table 2
Mechanisms and Situations

	Legal Regulation	Reputation	Certification of Exchange Partners	Community Norms, Structures and Procedures
Early Stages of A Relationship	x	(x)	x	
Swift Trust	(x)	x	x	
Low Asset Specificity	(x)	x	(x)	
Mature Industries	(x)	(x)		x

x – primary relationship
(x) – secondary relationship