A CALCULATED TAKE ON TRUST

DOES NOBEL ECONOMIST **OLIVER WILLIAMSON** REALLY BELIEVE THAT TRUST HAS NO PLACE IN BUSINESS?

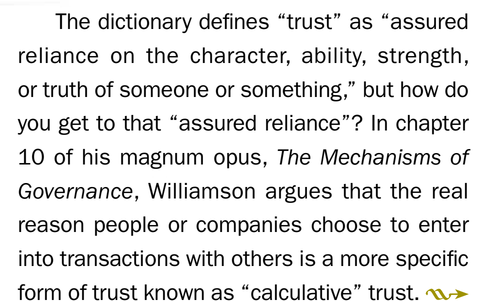
BY HEATHER MCGREGOR

"A common word but without a common meaning." Oliver Williamson, joint winner of the 2009 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel (more commonly known as the Nobel Prize for Economics), pronounced his view on the word "trust" to the *Brunswick Review* while perched on a chair in the foyer of a building at the University of Stirling, Scotland.

To be fair, we had not expected anything different. An e-mail request for an interview on the subject had been met by an unequivocal answer. "I am a great skeptic of employing 'user friendly' words (of which trust is one) in a commercial context."

Does Williamson really believe trust has no place in a commercial context? After all, it is a subject much studied and written about by academics, many of whom have shown that trust encourages people to enter economic transactions (such as buying items from a website), reduces the time spent deciding on those transactions (which website to buy from), influences how institutions deal with each other (is there really a need for a lot of paperwork for every contract if two firms have dealt with each other often?) and encourages the exchange of information between companies. Trust, it would appear, lowers transaction costs.

The dictionary defines "trust" as "assured reliance on the character, ability, strength, or truth of someone or something," but how do you get to that "assured reliance"? In chapter 10 of his magnum opus, *The Mechanisms of Governance*, Williamson argues that the real reason people or companies choose to enter into transactions with others is a more specific form of trust known as "calculative" trust.



WHAT DO YOU GET FOR FIVE MILLION SWEDISH KRONOR? (ABOUT $750,000)

Oliver Williamson is the Edgar F. Kaiser Professor Emeritus at the Haas School of Business, the University of California, Berkeley. The announcement of his Nobel Prize was exciting news for everyone at Haas, especially its Dean, Richard Lyons. A few days later, he had a meeting with Williamson in his office at the Nobel Laureate's request.

The MBA blog at Haas takes up the story: "I'm sure the Dean expected a request for more research assistance, perhaps a larger office or, the perk of perks that is granted to all Berkeley Nobel Laureates, an assigned parking space. Instead, Williamson and his wife had been talking about what they would like to do with the prize money. [Williamson had shared the 10m Swedish kronor prize with fellow winner Elinor Ostrom.] They decided to give most of it to the Haas School, to establish an additional faculty position in economics.

"And for the record, Williamson did get his parking spot."

The concept of calculative trust is simple. People come to believe that they can rely on another party, based on the rational calculation of the payoffs and costs of doing business with that party. I buy my meat from my local store because I have done so many times before and know the bacon I purchase is of a better quality and a lower price than I would find at the supermarket. That is "calculative trust," a concept Williamson has rightly described as "a contradiction in terms."

The University of Stirling is based on a campus noted more for its site (310 acres, complete with loch and 18th century castle) than its architecture, which is relentlessly modern. In June it became, briefly, a mecca for economists from all over the world when the International Society for New Institutional Economics held its 2010 meeting there. Heading the lineup of speakers were Williamson and his fellow ISNIE member and joint Nobel Laureate, Elinor Ostrom.

Their audience in windswept Scotland was far more familiar with them than most business leaders will be, but that does not mean they have not been influential in how companies have developed.

"Williamson has not been writing to a management audience; but that's not to say that he hasn't influenced management thinking," David Teece writes in his tribute to Williamson in a special edition of *The California Management Review* honoring his Nobel Prize. In the same issue, Steven Tadelis says Williamson's work offers clear guidance for at least three practical areas. One is the way in which business strategy can evaluate the costs and benefits of outsourcing; the second is the way in which local and federal governments should decide what to privatize; and the third is to help regulators decide when to intervene with antitrust policy.

When asked to expand on his reservations about the word trust, Williamson points to what the "governance" (for which read "the management") of a company is designed to achieve: "The means by which you can infuse order, mitigate conflict and realize mutual gain." Inside a company, therefore, people do business with each other in such a way as to maximize the end result for everyone – and there probably will not be a quantifiable cost of doing that business. Surely, trust helps firms transact business both inside and out? What Williamson, who is, after all, a classically Carnegie-trained economist, seems to object to is the woolly language. He has said: "Diffuse terms, of which trust is one, that have mixed meanings should be avoided when possible." And it is true when you examine situations that seem to involve trust: there really is no risk involved.

Take the case of the Takeover Panel, a body that operates in the City of London to regulate conduct in public takeover bids. Investment banks in London appear to "trust" each other in the way they do business, but the reality is that the Panel will come down hard on firms that infringe their common rules of behavior. So, no "trust" is involved because firms rely on the Panel to keep them honest.

We could continue – and Williamson patiently did so, in the way only a 78-year-old Nobel Laureate could when confronted with an eager student – to show that every time it looks like economic transactions are based on "trust," there turns out to be a calculative decision involved, rather than an emotion.

Use of the word, as Williamson has suggested, should probably be reserved "for very special relations between family, friends, and lovers. Such trust is also the stuff of which tragedy is made. It goes to the essence of the human condition."

TRANSACTION COST ECONOMICS FOR DUMMIES

By Heather McGregor

Who invented the theory?
The term "transaction cost" is thought to have been coined by Ronald Coase, whose famous 1937 paper *The Nature of the Firm* included a theoretical framework for predicting when certain economic tasks would be performed within companies and when they would be performed through the market. Coase, who will be 100 in December and is still the Clifton R. Musser Professor Emeritus of Economics at the University of Chicago Law School, was awarded the Nobel Prize for Economics in 1991.

However, the arguments surrounding transaction costs became more widely known through Oliver Williamson's *Transaction Cost Economics*. Williamson himself also acknowledges the work of John Commons (1862-1945), although he describes it as "not an easy read."

What is the main argument?
Transaction cost economists look at the transaction as the unit of analysis, rather than the firm. They argue that there are lots of costs involved in making an economic exchange; for example, the costs incurred in searching for the best supplier/partner/customer, the cost of establishing a robust contract, and the costs of monitoring and enforcing the implementation of that contract.

The natural consequence of the existence of those costs is that their size and nature will affect the decision about where any economic exchange should take place: outside the firm, with markets setting the price and policing the transaction, or inside the firm, with the firm's own internal governance mechanisms – its hierarchy – performing that function instead.

Explain?
OK, I know it sounds complicated. But it's not difficult to grasp the basic concept. If your company makes and sells a product, then you have to choose between buying the constituent parts of that product from suppliers on the open market or making them yourself. Transaction cost economics makes it easier to work out which you should do.

Examples of companies which have been reviewing their transaction costs recently include BP. After it announced the restructuring of its exploration and production unit in September, the *Financial Times* reported: "The company also plans to review its use of third-party contractors, a move that could see it bring much of the work it has previously outsourced in-house. One person familiar with BP's thinking says: 'If you are ultimately held responsible for your operations, then it makes sense to have 100 per cent control over them.'"

By bringing economic transactions within the company, Williamson points out, you lose some of the benefit of markets, but you gain other benefits. This is well illustrated by Johnstons of Elgin, a manufacturer of quality knitwear and clothing based in Scotland, which has described its current business strategy as "a relentless pursuit of verticalization" – taking control of as many parts of its production chain as it can. Johnstons says this gives the company a competitive advantage because it can create new colors and styles more quickly than if everything was outsourced. In other words, the cost of outsourcing includes the loss of the ability to respond swiftly to customer demand.

Is there anything else I should read?
Williamson's *The Economic Institutions of Capitalism* (1985) reviews the whole spectrum of possible governance mechanisms, from commodity markets (deep and liquid) to full vertical integration.

Oliver Eaton Williamson is a US economist specializing in transaction cost economics. He was born on September 27 1932 and is the Edgar F. Kaiser Professor Emeritus at the University of California at Berkeley Haas School of Business. Williamson received his BS in management from the MIT Sloan School of Management in 1955, his MBA from Stanford University in 1960, and his Ph.D. from Carnegie Mellon University in 1963. In 2009, he was awarded the Nobel Prize in Economics for his "analysis of economic governance, especially the boundaries of the firm," sharing it with Elinor Ostrom.

Heather McGregor cited Oliver Williamson more than any other author in her Ph.D. thesis for the University of Hong Kong in 2003. A headhunter, *Financial Times* columnist and visiting professor at Cass Business School in London, she recently qualified as a pilot and flew herself to Scotland to interview the Nobel Laureate, whom she met for the first time.