Chapter 1: Introduction

1.1 Problem Statement

With a heated discussion worldwide about social capital and its powerful influence on poverty alleviation and economic development, an increasing number of researchers have emphasized the roles of trust in inter-organizational transactions. However researchers do not agree on the definition of trust. Literatures showed that trust and transaction costs are inter-related. Some researchers pointed out that trust facilitates transactions among organizations by reducing transaction costs, such as information searching, negotiation, monitoring and enforcing transactions; other researchers found that the perception of partners' trustworthiness depends on the amount and accuracy of information, the degree of cooperation and the other factors that are associated with transaction costs; still others focused on certain types of transactions and analyzed how transaction costs and trust interact.

To better utilize trust as a tool to improve organizational economic performances and to build up a healthy transaction environment, it is helpful to clarify these controversial problems: what are trust and transaction costs? What is the relationship between transaction costs and trust? And what are the influences of characters of transactions on transaction costs and trust?

1.2 Organization of the Paper

This paper tries to identify how trust, as a major component of social capital functions in transactions between organizations. An analysis is developed around the interactions between trust and transaction costs.

Chapter 2 provides a theoretical background on social capital, trust, and transaction costs. In this chapter, trust is defined in general and at the inter-organizational level. Analysis of origins is provided. Then, this chapter conceptualizes transaction costs, and analyzes their causes and types. Finally, the function of intermediaries between organizations is studies.

Chapter 3 explicitly analyzes the linkages between trust and transaction costs, and discusses the importance of intermediaries in the growth of trust. To make it clearer, the paper analyzes ex-ante cost and ex-post cost separately. It is important to recognize that the two sets of cost elements are usually interdependent, and any attempt to change one set of transaction costs may change other set of transaction costs and the whole cost of transaction.

Using industrial districts as examples, chapter 4 further explores the relationship between trust and transaction costs in inter-organizational transactions. The case study analyzes the roles of trust in industrial districts and importance of keeping proximity to foster trust. The following sections define industrial districts, and explain the difference between industrial districts and Fordism. Then, the paper studies the origin and the

importance of trust in industrial district. After that, research is developed to explain why location matters. This chapter also identified lock-in effects as the negative impact of trust in industrial districts, and how the intermediaries help to solve this problem.

Chapter 4 discusses policy implications and suggestions. These suggestions include understanding the role of trust, building up norm and regulations, keeping information available, and encouraging the formation of intermediary systems in the targeted areas.

Chapter 5 makes three conclusions. Firstly, transaction costs and trusts are inter-related and depend on the characters of transactions; secondly, trust has positive and negative impact on inter-organizational transactions; and lastly, intermediaries of trust can help to enhance the positive effects of trust and mitigate the negative impacts of trust.

Chapter 2: Theoretical Background

2.1 An Overview of Social Capital

2.1.1 Definitions of Social Capital

The rapid rise of interest in social capital is one of the dominant trends in American social science and public policy over the past decade. Though it is unclear who first used this term, it is certain that James Coleman brought social capital into the mainstream in the American social sciences (DeFilippis, 2001). He defines social capital as sets of actions, outcomes, and relationship:

"*Social capital is defined by its function. It is not a single entity, but a variety of different entities having two characteristics in common: They all consist of some aspect of a social structure. Like other forms of capital, social capital is productive, making possible the achievement of certain ends that would not be attainable in its absence" (Coleman, 1994, pp302).*

Since 1993, Robert Putman has published several books and articles to discuss the relationship between social capital and economic development. These works include "Making Democracy Work: Civic Traditions in Modern Italy" (1993) and "Bowling Alone: America's Declining Social Capital" (1995). With this research, he thoroughly redefined social capital that is broadly accepted by the academia:

"Social capital refers to features of social organization such as networks, norms, and social trust that facilitate coordination and cooperation for mutual benefit" (Putman, 1995, pp26).

2.1.2 Components of Social Capital

Putman's definition of social capital has three major elements: trust, norms and networks. In section 2.2, I will conceptualize trust in detail. In this section, I will briefly discuss what norms and networks are.

A norm is the consensus in the social system or subsystem whose right to control is held by others. This implies that others have the authority over the action. "Authority is not voluntarily vested in them, either unilaterally or as part of an exchange, but is created by the social census that placed the right in their hands" (Coleman, 1994). A norm is not necessarily a legally defined right or a right based on a formal rule imposed by those who have authority. Norms may exist in the absence of legally defined rights, or even conflict with a law or rule.

Networks are defined as inter-personal and inter-organizational relationships, which are accumulated when people or organizations interact with each other in certain geographic locations or in social groups. Networks describe the patterns of informal ties within organizations, and work as a form of governance as social glue that binds individuals together into a coherent system (Powell, 1990).

2.1.3 Types of Social Capital

Two types of social capital have been distinguished by scholars: bonding capital and bridging capital. Bonding capital, which is also called "strong ties," refers to the relations among relatively homogenous individuals or groups. Bridging capital, or "weak ties," refers to the relations and connectedness between heterogeneous groups.

Bridging capital, "no matter how dense and no matter how important to its participants, cannot sustain social trust and cooperation" (Putman, 1995). Information obtained through weak ties is often less reliable than that from strong ties. More important, the norms of reciprocity against the threat of opportunism are less likely to be imposed upwards and less likely to be acceded to, if imposed. Despite of this weakness, bridging capital is more outward looking and encompasses people across different social divides. Weak ties allow parties to access new information. It is good at exploring emergent innovations and other significant changes in environments.

Bonding capital is different. Bonding capital is more inward looking and has a tendency to reinforce exclusive identities in homogeneous groups. Strong ties are associated with exchanges of high quality information and tacit knowledge. Bonding capital serves as a mechanism of social control that governs the interdependencies in partnerships (Uzzi, 1996). Bonding capital is more efficient at exploring existent technologies, capabilities and information (Xavier. etc, 2002). Since networks maintained by bonding capital are more likely to consist of members who are engaged in long-term

economic relationships, these relationships are kept by observing social norms. For good in the long run, members are willing to act less opportunistically and more cooperatively. In this case, trust is easier to maintain and enhance.

2.2 Trust

2.2.1 Conceptualization of Organizations and Transactions

Before defining trust at the inter-organizational transaction level, it is helpful to conceptualize organizations and transactions.

2.2.1.1 Definition of Organizations

In this paper, organizations are simply defined as "goal-directed, boundary-maintaining and socially constructed systems of human activity" (Aldrich, 1979). Actions in organizations are deliberately designed to move the organizations closer to their desired targets. Boundary maintaining means that the establishment of an organization implies a distinction between members and non-members, thus setting organizations off from their environments. Organizations have activity systems to accomplish work. These systems consist of bounded sets of interdependent social behaviors. In this sense, an organization can be a company, corporation, firm, enterprise or institution, or part or combination thereof, whether incorporated or not, public or private, that has its own functions and administration.

2.2.1.2 Transactions

Transactions can be organized within an organization (hierarchically) or between autonomous organizations (across a market). In this paper, transactions refer to the latter, and should equal the whole process of "contracting" in transaction cost economics. A transaction is an agreement between two or more parties in terms of exchange. The transaction should include the agreement, the actions of carrying out the agreement, and all situations that cause any change in the agreement and further enforcement behaviors. The transactions are defined by quantity, quality and duration (Williams, 1994).

2.2.2 Definition of Trust

2.2.2.1 General Definition of Trust

Trust is defined in different ways in the literatures. In general, four issues are central. First is that trust is about "risk and uncertainty"; second, trust is to the willingness to accept "vulnerability"; third trust is the perception and interpretation of the other's expected dependency, and last, trust is about "share value". For example, Child (1998) defined trust as the belief or confidence that one transacts with another "under condition of some uncertainty that the other's actions will be beneficial rather than detrimental to it". Fukuyama (1996) defined trust as the expectation that arises within a community of regular, honest and cooperative behavior, based on commonly shared norms, on part of

other members of that community. Deutsch (1962) stated that trusting behavior increases one's vulnerability to another whose behavior is not under one's control in a specific type of situation.

The definition of trust is very similarly to those of cooperation and risk. But these terms are different. Cooperation sometimes is not associated with trust. It might result from continuous calculation of self-interest rather than a mutually recognized suspension (Sabel, 1992). Trust affects the trustor's calculation concerning the probability that she will be better off as a result of taking a risk (Coleman 1990). Trust is not, however, either the risk-taking behavior or the calculation about whether to take a risk; it is a belief that informs the decision on how to act.

2.2.2.2 Trust in Inter-organizational transactions

Reviewed studies also differed by the level the trust is assessed. It has been suggested that inter-organizational and inter-personal trust may not be possible to study with similar measures (Zaheer et al. 1998). The study by Zaheer et al. (1998) indicates the effects of trust in the inter-organizational context are distinct at the individual and organizational levels of analysis. Inter-organizational trust is associated strongly with lowered costs of negotiation and conflict. Interpersonal trust is not related to conflict and showed a seemingly anomalous positive association with negotiation costs.

Since businesses are abstract systems, inter-organizational trust is the trust in between two abstract systems. Researchers conceptualize the role of trust in economic

transaction by extending an inherently individual-level phenomenon to the organizational level of analysis. For instance, Zaheer (1998) defines interpersonal trust as “the trust placed by the individual boundary spanner in her individual opposite member,” and inter-organizational trust as “the extent of trust placed in the partner organization by the members of a focal organization”.

In the context of transactions, trust is the willingness to engage in a transaction in the absence of adequate safeguards (Noorderhaven, 1995). Trust would be expected to emerge in situations where the "trustworthy" party in the exchange relationship: (1) is known to reliably make good faith efforts to behave in accordance with prior commitments, (2) makes adjustments (e.g., as market conditions change) in ways perceived as "fair" by the exchange partner, and (3) does not take excessive advantage of an exchange partner even when the opportunity is available (Mayer et al, 1995). In short trust in transactions contains reliability, fairness, and goodwill/benevolence (Dyer & Chu, 2002).

2.2.3 Origins of Inter-organizational Trust

In summary there are four origins of trust: trust-building over time, trust through contacts, trust through social regulations, and ascriptive trust. The four possible origins of trust may be combined, or follow in a sequence (Lorenzen, 1998).

2.2.3.1 Trust-building Over Time

Most common inter-organizational trust is built by cooperating over time. That is because first, there is a learning perspective. Over a long period of time, organizations cooperate toward common objectives, exchange information, and get to know each other and build trust. Trust initiates the cooperation and is the by-product of cooperation.

Second, there is a sunk cost perspective, or asset specificity perspective (A more detailed description of asset specificity will be given in section 2.3). When organizations place sunk investments into transaction-specific assets, the investment will lose if the cooperation is destroyed and thus the organizations can trust each other not to behave opportunistically. This explains how trust gets maintained.

2.2.3.2 Trust through Contract

In many cases, neither is trust dependent on contracts nor are contracts the sufficient cause of trust. However, some organizations initiate trust based on formal procedures. At first, formal and written contracts are required to provide sufficient legal security to enforce the transactions.

2.2.3.3 Trust through Social Regulation

Organizations are embedded in societies and surrounded by “institutional environment”. Laws, rules and norms support the system of social regulations, which

facilitate trust among organizations. Taylor (1982) argues that social regulation is an efficient origin of trust in “closely knit communities”, in which most members would expect each other to act less opportunistically.

2.2.3.4 Ascriptive Trust

Organizations can have “cognitive function”(Lorenzen, 1998). Cognitive organizations have a common “culture” background, or common social characteristics to foster trust within the network. They can interpret and ascribe each other’s actions and motives. This type of trust is present among those in the same family, community, religion, region, and a specific profession (Fukuyama, 1995).

2.2.4 Fluctuation of Inter-organizational Trust

Placement of trust in the trustworthy trustee brings gains to the trustor and expands the trust. Overexpansion of trust, that is, placement of trust in a trustee who is not reliable, brings losses to the trustor and contracts trust. The expansion of trust increases the potential for social interactions between partners, and the contraction or withdrawal of trust has the opposite effect. On the other hand, expansion of trust tends to bring further expansion and contraction leads to further contraction (Coleman, 1994). The process of fluctuation of trust is unstable.

2.3 Transaction Cost

2.3.1 Definition of Transaction Costs

Many definitions of transaction costs offer powerful conceptual insights, but they have not been translated into widely accepted operational standards. For example, Kenneth Arrow (1974) defines transaction costs as “the costs of running the economic system.” Yoram Barzel (1997) defines transaction costs as “the costs associated with the transfer, capture, and protection of rights.” Thrainn Eggertsson (1990) observes that transaction costs are the costs that arise when individuals exchange ownership rights to economic assets and enforce their exclusive rights. The more comprehensive definition of transaction costs is brought out by North (1990), he described transaction costs as “the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements”.

2.3.2 Causes of Transaction Costs

Transaction Costs Economics (TCE) use transactions as the basic unit of analysis to analyze inter-organizational relationships. It is generally recognized that TCE is at the heart of the new institutional theory of organizations (Groenewegen, 1996).

In the model of a perfect market, transactions are both costless and instantaneous. Transaction costs tend to be zero if information is perfect and symmetrical among parties

(North, 1990). North stated that

"The costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreement"(North, 1990, pp220).

Time asymmetries in delivery introduce risk into a unilateral action or transaction for the party or parties who must invest resources before receiving a return (Coleman, 1994). In some cases, delivery of goods or services by one party occurs only after the other party has made delivery. In other cases, delivery by both parties occurs in degrees over a period of time. In still others, the return to both parties is some product of their actions, so both must invest resources but neither receives a return until some later time.

As we know, in the real world transactions occur only over a period of time and information is never perfect. That incurs three main factors: bounded rationality, opportunism and asset specificity that lead to the existence of transaction costs (Williamson, 1985, Rao, 2003).

2.3.3.1 Bounded Rationality

Bounded rationality means behavior that is intended to be rational, but only in a limited way. It involves cognitive and perceptive limitations on the one hand and language limitations on the other.

"The physiological limits take the form of rate and storage limitations on the powers of individuals to receive, store, retrieve and process information without error. Language

limits refer to the inability of individuals to articulate their knowledge or feelings by the use of words, numbers, or graphics in ways that permit them to be understood by others. Demonstrations, learning-by-doing, and the like may be the only means of achieving understanding when such language difficulties develop." (Williamson 1975, pp95).

2.3.3.2 Opportunistic Behaviors

Opportunism includes guile in pursuit of one's own interests. It refers to incomplete or distorted disclosure of information, especially calculated efforts to mislead, distorts, disguise, obfuscate, or otherwise confuse transacting parties (Williamson, 1994). A mitigation of opportunism plays a central role in transaction cost economics.

The transaction costs economics use "adverse selection" and "moral hazard" to describe "the behavioral traits in the presence of asymmetric information among parties to an agreement or other transactions" (Rao, 2003, pp14). Adverse selection is the phenomenon of misdirecting other organizations based on an organization's private information that is not shared with other organizations in the transactions. Moral hazard is post-contractual opportunism in the presence of unobservable asymmetric information. Since information asymmetry more or less happens in every transaction, organizations are more likely to cooperate with long-term partners with whom information is more available.

Theoretically, because of the behavior uncertainty such as adverse selection and

moral hazard, a rational organization, will always expect that other organizations act opportunistic in the transactions. Some organizations even forego opportunism when transacting with other organizations. Transaction cost economics takes the view that "contractual man" is self-interest seeking and opportunistic. However, the reality is, as Williamson (1994) implied that not all organizations are continuously opportunistic. Though, generally, organizations seek self-interest, it does not necessarily mean all organizations are opportunistic. In most cases, organizations are just simply self-interest seeking. Their bargains are struck on terms that reflect original positions, which are fully or candidly disclosed upon inquiry. Their perception of world is accurate and execution of oath or rule bound in the manner described above.

2.3.3.3 Asset Specificity

Asset specificity refers to the extent to which non-fungible assets are tied to particular transactions specified by contracts or other commitments. Assets are specific to a particular use if the "returns" they provide are much more highly valuable only in that use. As the paper mentioned before, when organizations invest assets specific to a transaction to a certain amount, they are less likely to behave opportunistically, which will destroy the cooperative relationship and will waste investment.

2.3.4 Types of Transaction Costs

Transactions that are subject to post-contractual (ex-post) opportunism will benefit if appropriate safeguards can be devised in the pre-contractual (ex-ante) phase. Associated with ex-ante opportunism and ex-post opportunism, are ex-ante costs and ex-post costs respectively. Ex-ante costs are the costs incurred before a contract is signed or an agreement is reached. Ex-post costs are the costs incurred after the contract has been made but before the entire transaction has been completed.

Learning is the process that runs through the ex-ante phase and the ex-post phase. It includes the sharing of information and the interpretation and use of information. Through learning, organizations form a common goal, or mutual understanding, which constitutes the basis for trust.

2.3.4.1 Ex-ante Costs

Ex-ante costs include searching costs (information) and negotiation costs:

Information costs may include brokers' fees, charges for information services, costs of advertising the willingness to engage in a transaction, and delays experienced while seeking a suitable partner (Dudek & Wienar 1996). They are incurred when organizations seek partners for mutually advantageous projects and survey a range of alternatives prior to making a decision. The potential trustor decides at any point whether or not to engage in a further information searching. Once the information searching is finished, decision

on whether or not placing trust on the potential transacting party will be made.

Then negotiation phase begins. During negotiation, conflict, misunderstanding and changing expectation may finally be solved or result in new rounds of negation and transaction or lead to termination of the transactions.

Negotiation costs are the costs of interested partners takes to reach an agreement (Cacho etc, 2002). They include the costs of deciding the details of project design, the responsibilities of each partner, assignment of benefits, method of payment, and the schedule over which benefits will be paid. Legal costs may also be incurred in specifying the terms of the contract. Delays caused by negotiations can also be costly. They also include the cost of writing contracts when literacy is limited, and legitimization of contracts through authority.

2.3.4.2 Ex-post Costs

Ex-post costs include verification and certification costs, implementation costs, monitoring costs, enforcement costs, and insurance costs.

Verification and certification costs occur when the negotiated exchange must be approved by a government agency. These costs involve generating and compiling the information required in an application for approval. They also include costs experiencing delay and uncertainty.

Implementation costs are defined as the costs of negotiating refinements to the

projects as new knowledge becomes available indicating that such refinements are advisable. They are associated with the resources expended in administering the translation of a project design into practice.

Monitoring costs are the costs the partners make to observe the transaction as it unfolds, and to verify the compliance with the agreed terms.

Enforcement costs are the expenses of insisting on compliance if monitoring detects divergences from the agreed terms of the transaction. They may be incurred in the form of litigation or administrative proceedings (Dudek and Wienar 1996).

2.4 Intermediaries of Trust

As long as social life is possible, the realm of trusting behavior can always be enlarged, by extending to new realms. Intermediaries of trust act as the bridge of communication. They are essential to the growth of trust, either in homogeneous groups or among heterogeneous groups.

Intermediaries of trust can be described as advisors, guarantors, or entrepreneurs (Coleman, 1994). The amount of trust placed in each of the three kinds of intermediaries differs. When advisory intermediary is used, the trustor trusts the advisor's judgment, leading him to place trust in the ability and integrity of the trustee. When the guarantor or entrepreneur intermediary is used, the trustor places trust in the performance capability and integrity of the intermediary, as the intermediary does in that of the trustee. The

intermediary must trust highly his own judgment if he is to be able to act as intermediary. He must in fact have good judgment if he wants to act as intermediary in the future.

One important aspects of trust is its “transferability”. Trust between individuals can become trust between strangers and trust of a broad fabric of social institutions by one party or all parties acting as intermediaries (Coleman, 1994). The intermediating process operates as a widespread basis for trust: if A trusts the judgment of B; B trusts the performance capability of T, the final trustee, this leads to A’s trusting on T’s performance capability. The process is circular and does not stop. C trusts the judgment of A and thus comes to trust the performance capability of T, and then B, who trusts the judgment of C…if the process is undisturbed, which is determined by depth of trust developed between trustor and trustee, trust will be built up in the whole system.

Another way of approaching the problem is to introduce the concept of the "radius of trust." All groups embodying social capital have a certain radius of trust, that is, the circle of organizations among whom cooperative norms are operative. If a group's social capital produces positive externalities, the radius of trust can be larger than the group itself. It is also possible for the radius of trust to be smaller than the membership of the group, as in large organizations that foster cooperative norms only among the group's leadership or permanent staff. A modern society may be thought of as a series of concentric and overlapping radii of trust.

Some organizations that are in more than one radius of trust can act intermediaries to

help others to cross the radius. The usage of intermediaries provides a channel or the possibility to share information across radius, and functions as a bridge between two strangers and thus builds up trust across heterogeneous groups.

Chapter 3: Transaction Costs and Trust

Pervasive evidence from numerous researches supports the inclusion of trust as a critical factor in the investigations of transactions. Trust plays two roles in transactions: first, through norms and sanctions, trust may act as a substitute for the formal control system in governing transactions. Secondly, there is evidence that trust can facilitate the formation of ongoing networks governing economic transactions.

However, trust must place on reliable trustees in order to benefit the organizations. Over-expansion of trust might save an organization's transaction costs in one phase of a transaction or in the short long. In the long run, the organization has to put more transaction costs to implement and enforce the transaction, or lose all the investment in the transaction.

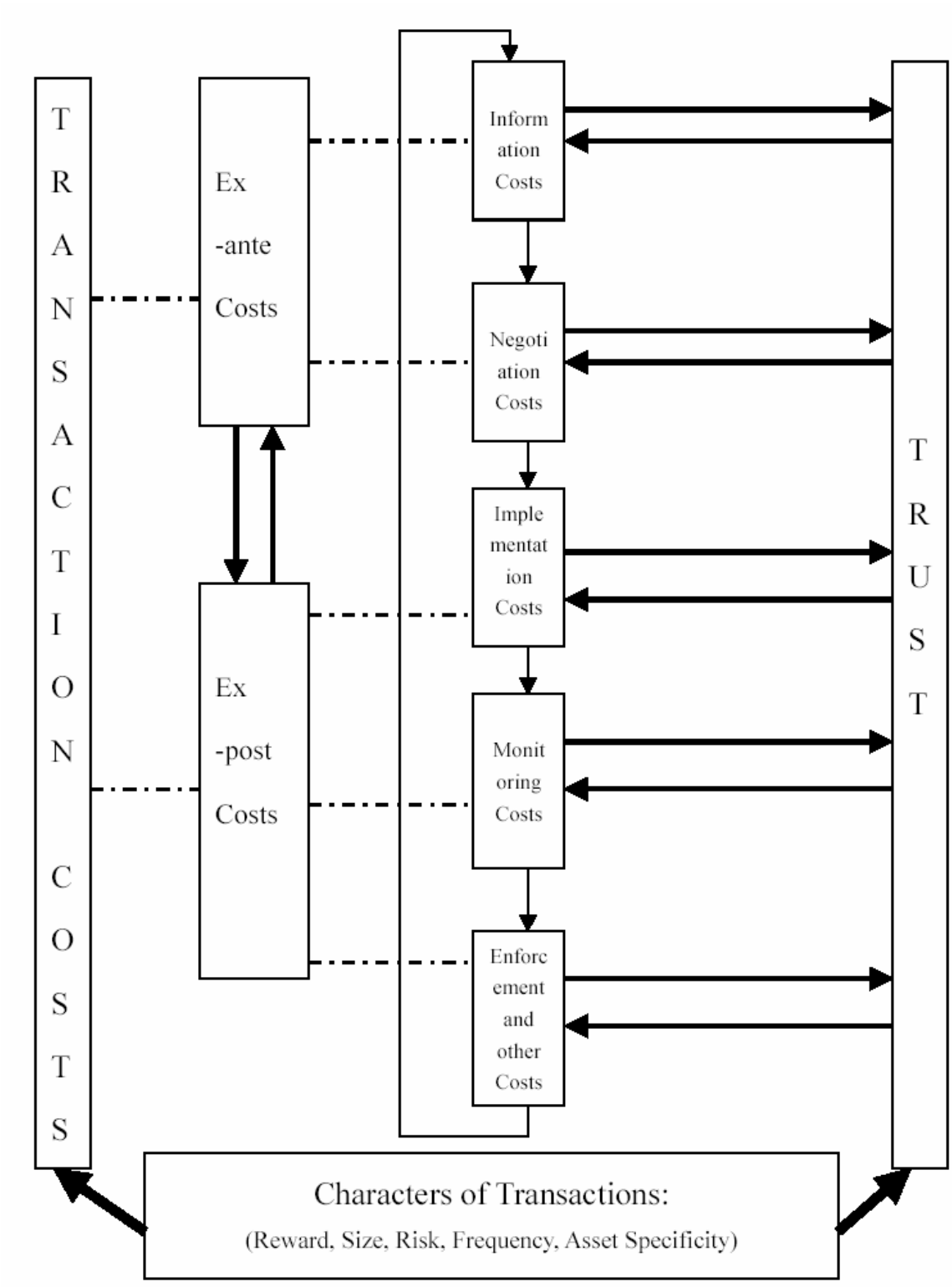
On one hand, trust can impact on transaction costs; on the other hand, transaction costs also have influence on the type and depth of trust. It might be hard to say that high investment in transaction costs will incur high trust. However, it is agreed that, to build up trust, investment in transaction costs is necessary. Particularly, in a transaction, interactions between organizations in one phase will impact or even determine the next phase of the transaction.

Besides the interactions between transaction costs and trust, the characters of the transactions determine the nature of transaction costs and trust. These characters include the size and reward of transactions, risk involved, frequency of the transactions, asset

specificity and so on.

In order to be clear, below is a chart to illustrate the content of this chapter. The dashed lines mean the item(s) at the left end contains the item(s) at the right end. The directions of arrows refer to the direction of impacts.

The Relationship between Trust and Transaction Costs:
In the Content of Inter-organizational Transactions



3.1 Trust and Transaction Cost-Relevant or Not?

Researchers didn't agree what the role of trust plays in transaction. They even didn't agree whether trust have a relationship with transaction costs.

Oliver Williamson is one of the researchers who claim that trust is irrelevant to transaction. He (1993) claims that,

"…Because opportunistic agents will not self-enforce open-ended promises to behave responsibly, efficient exchange will be realized only if dependencies are supported by credible commitments. Wherein trust is implicated if parties to an exchange are farsighted and reflect the relevant hazards in terms of the exchange? I maintain that trust is irrelevant to commercial exchange and that reference to trust in this connection promotes confusion."(Williamson, 1994, pp114)

Williamson is right that the term is used too broadly and facilely. However, he goes too far in denying any role to trust in transactions. Multiple assertions of the importance of trust by eminent scholars can be found in literatures (e.g. Fukuyama, 1996, and Coleman 1994).

In general, it is proposed that a certain amount of trust is needed as a threshold condition for inter-organizational transaction to evolve. A high level of trust permits a wide variety of social relationship to emerge. By contrast, widespread distrust in a society imposes a kind of "tax" on all forms of economic activity (Fukuyama, 1996). People or organizations who do not trust one another will end up cooperating only under a system

in which every detail has to be negotiated, agreed to, litigated and enforced, sometimes even by coercive means. This legal apparatus, serving as a substitute for trust, entails what economists call “transaction costs”.

To some degree, trust and contractual safeguards are substitutes of each other. Trust is not only a substitute for rules and contracts in the absence of formal economic regulations (Arrow, 1971), but also is the facilitation of complex transactions in the case that a well-functioning institutional system cannot be fully ‘arranged’ in terms of contracts (Sjoerd & Ton, 2001). In a society lack of trust, the transactions must be ensured by rule and regulations.

3.2 Trust and Ex-ante Costs

As mentioned above, ex-ante costs are costs incurred before a transaction takes place. This set of costs includes information searching costs (or information costs) and negotiation costs.

The accumulation of trust is based upon available information in hand or the perception of past transaction with potential partners. Through continuous interaction and information sharing, former suspicions are gradually eliminated or proved. When a trust relation is built up, it will generate a system of expectations and obligations, allowing group members to draw on favors, circulate privileged information, and gain better access to opportunities and resources.

3.2.1 Trust and Information costs

There are three essentially different sources of information that effect the placement of trust in a single trustee: (a) the trustee's performance itself, (b) others who have the position similar to the trustor's and similar interest in the placement of trust and (c) others who have the position different from the trustor's and lack similar interest (Coleman, 1994).

Information from these three sources characteristically differs. Information from source (b) often leads to the same decision about placement of trust as that made by the individuals or organizations whose judgment was trusted. Information from source (c) often provides more independent evidence for the decision. Information source (b) and (c) providers are called intermediaries in trust. In the content of inter-organizational transactions, information often comes from inter-organizational relations, including suppliers, key customers, members of relevant regulatory agencies and the like (Walter and Smith 1994). Organizations always rely on the information from trustworthy intermediaries.

Information from source (a), which is accumulated from past communications or transactions, passes through no intermediary at all, and most likely leads to correct assessments. This kind of information possesses the following features (Williamson, 1994).

(1) It is cheap, relatively less additional costs;

(2) One trusts one own information best, it contains more detail, and is accurate;

(3) Individual with whom that has a continuing relation has an economic motivation to be trustworthy, so as not to discourage future transaction;

(4) Departing from pure economic motives, continuing economic relations often become overlaid with social content that carries strong expectations of trust and abstention from opportunism.

In a supplier-buyer relationship buyers are strongly attracted to well known or existing suppliers since current suppliers are perceived as being less risky (Batt, 2001).

Trust may expand from dyads to encompass a growing number of partners. By utilizing investments in the already existing relationships as channels to reach new partners (your-friend-is-my-friend), organizations can successfully minimize their search costs for a transaction. This information even can be acquired through trustworthy relationships that are maintained for other purposes (Coleman, 1994).

Trust enables information sharing between trustors and trustees. In a supplier-buyer relationship, if the supplier can trust the buyer not to behave opportunistically, it will be more willing to share confidential information, such as information on production costs, product design, and process innovations (Dyer & Chu, 2002). However, this voluntary information sharing happens only if the transacting organizations trust their partners not to steal their ideas, not to share the information with competitors, and not to "squeeze" the supplier's profit margins. In the absence of trust, information sharing on costs, new

ideas, and technologies is unlikely because this information could be "poached" or used opportunistically. Trust also enables buyers to adopt schemas which leave them free to act without trying to process more information than they are capable of handling or where it proves difficult or impossible to acquire information about future events (Batt, 2001).

However, high trust relationships are always bonded by strong norms and mutual identification. Thus trust and reciprocated trust always help to foster a cohesive group identity. They always exhibit the disparaging of people outside the group and often come with a strong in-group identity. As Fukuyama (1995) said, there is an inverse proportion between the solidarity of those inside the community and the hostility, indifference, or intolerance shown to those on the outside.

This exclusion feature of trust often cause an unhealthy homogeneity among network members, which creates a rigidity or staleness by restricting access to diverse sources of ideas, knowledge and information. A form of collective blindness is formed that actually hinders development (Erridge & Greer, 2002). Thus, highly specialized organizations in a “radius of trust” might not be able to use intermediaries in the same radius to expand their business to other radius.

3.2.1 Trust and Negotiation Costs

During negotiation, organizations that have developed strong trust in each other may be more likely to work out their disagreements amicably. They are more willing to accept

some level of conflict as more or less routine (Nelson, 1996). Organizations that distrust each other tend to discuss each terms and clause in the contract, which costs time and money. On the other hand, Negotiation process might change the perception of an organization's trustworthiness. Through negotiation, organizations may reach the same objective or compromise on objective or form a common understanding, enhance inter-trust between them and facilitate transaction in the next-step; or they might enhance previous suspiciousness and distrust, and thus terminate negotiation.

Researches found that the desire of cooperation and the level of trust are closely related. Low trust stimulates less favorable attitudes and lowers the level of communication in the negotiation process. High-risk coordinative behaviors are more likely to occur with a trusted partner. These behaviors include making concessions, compromising, tension-reducing actions and expressions of candor. In a transaction relationship, direct experiences of these kinds are going to be the principal basis for judging the trustworthiness of a partner.

The process and the content of negotiation are impacted by factors such as frequency of their prior transactions, the technical reputation for the partners, their presence in the market, intention to keep long-term relationships, risk of the transaction, and reward of the transaction. Trustors use the information collected in the former phase to score the factors and to estimate the trustworthiness of trustee. When the trustees can contribute to achieve the objectives of the transactions and are trustworthy, the transactions are

probable. Otherwise, the organizations will argue, persuade, and haggle over the appropriateness and interdependence of their individual and collective goals of the transactions. These processes may be conducted through written communications, telephone, face-to-face meeting, e-mail, and combinations of these media. Negotiation process also permits the parties to determine whether the prior breaches of trust are serious enough, and to reconsider whether they should continue to rely on trust to govern the transactions.

In negotiation process, organizations need to decide whether they are willing to rely on trust to govern their transactions in the next phase or future transactions. If they have had extensive transactions with each other in the past, if they have relied on trust in these deals, and if the expectations of the parties generally have been met, then they are more likely to use trust to govern the current transaction than these conditions were not present. In addition, the existence of these kinds of conditions permits the same parties with an opportunity to determine whether they can all agree that these kinds of conditions exist.

Trust promotes negotiating efficiency by enabling each party to be more flexible in granting concessions because of the expectation that the exchange partner will reciprocate in the future. If trust has already existed during the negotiation process, organizations are confident that payoffs will be fairly divided. As a result, they might not have to plan for all future contingencies because they are confident that equitable adjustments will be made as market conditions change. Trust allows transaction actors to

achieve "serial equity" (equity over a longer period of time) rather than to require immediate or "spot equity"(Dyer, 1997). Consequently, it reduces the need for partners to invest heavily in bargaining.

It is perhaps easier to appreciate the economic value of trust if we consider negotiation between organizations devoid of trust look like:

"If we had to approach every contract with the assumption that our partners would try to cheat us if they could, then we would have to spend a considerable amount of time bulletproofing the document to make sure that there were no legal loopholes by which we could be taken advantage of. Contracts would be endlessly long and detailed, spelling out every possible contingency and defining every conceivable obligation. We would never offer to do more than we were legally obligated to in a joint venture, for fear of being exploited, and we would regard new and possibly innovative proposals from our partners as tricks designed to get the better of us. Moreover, we would expect that, despite our best efforts in the negotiation, a certain number of people would succeed in cheating us or defaulting on their obligation. We would not be able to resort to arbitration, because we would not trust third-party arbitrators sufficiently. Everything would have to be referred to the legal system for resolution, with all of its cumbersome rules and methods, or potentially even to the criminal courts."(Fukuyama, 1996, pp151-152)

3.3 Trust and Ex-post Costs

Theoretically, if organizations spend enough time in searching information and negotiation, it is possible to reduce ex-post costs because all of the expectations and obligations will have been clearly specified during the contracting phase. However, in reality, due to bonded rationality, contractual specifications are inevitably incomplete in relating to various known or unknown contingencies (Rao, 2003). A contract is incomplete in the sense that it does not specify unambiguously, or spell out all the requirements and obligations of the parties in every possible future situation. As events unfold during contract execution, the full requirements and obligations of the parties become known, and appropriate adjustments and adaptations are required. The incomplete contracts (written or oral, formal or informal) lay the ground for the prevalence of opportunism in ex-post phase.

Trust on reliable trustee is believed to have an inverse relationship with ex-post costs. When trust is present, requirement for enforcement and monitoring is reduced (Paldam and Svendsen, 1998; Butter and Mosch, 2003).

First, under conditions of high trust, transacting partners will spend less time and resources on monitoring to see if the other party is shirking or fulfilling the "spirit" of the agreement. If each exchange partner is confident that the other party will not be opportunistic, then both parties can devote fewer resources to monitoring. Contrarily, partners who rely only on contracts and regulations might need to invest resources in both

monitoring and enforcing to ensure the compliance with the contracts. Monitoring costs would lower the total value of the relationship to both parties.

Second, trust may reduce transaction costs by reducing the amount of time and resources that transacting parties spend on ex-post bargaining and haggling over problems that arise in the execution of transacting. If trust level is high, each party will assume that the other party is acting in good faith and will interpret behaviors more positively (Uzzi, 1997). Consequently, transacting organizations with high trust is associated with lower ex-post costs due to mutual confidence that inequities will be fairly addressed and remedied.

Third, a lack of trust may cause suppliers to suppress potentially relevant information that would be useful for problem solving. For example, suppliers may be unwilling to share information on production or design problems if they do not trust the buyer to work cooperatively in joint problem solving. In particular, suppliers may be reluctant to share any information that exposes weaknesses in their operations or their cost structure, even though sharing of such information could result in valuable suggestions for problem solving from the buyer.

In most informal market, there may be limited legal recourse to enforce contracts due to the slowness of court proceedings and the difficulty in recovering debts. In these circumstances, the reputation of buyers and sellers, as a measurement of trustworthiness, can be an enforcement mechanism for not legally enforceable agreements. Short-term

gains from opportunism can be offset by long-term losses from a damaged reputation in the industry community if others refuse to deal with parties who have bad reputations.

3.4 Transaction Characters, Trust, and Transaction Costs

It is important to notice that the accumulation of trust does not necessarily lead to its successful exploitation. Rather, the development or elimination of trust depends on the quantity and quality of continuous interactions. Misused trust might cause negative or destructive consequences in transactions.

The following part in this section examines the impact of the transaction's characters on transaction costs and trust. The analysis is developed at four dimension of transaction: the size and reward, risk, frequency, and degree of asset specificity. In a transaction, the four dimensions actually are overlapped and co-related.

3.4.1 Size and Reward

In general, the size and reward of a transaction have a positive relationship with the willingness of transacting partners to invest in transaction costs. High rewarded transactions are often associated with high risk. A rational organization will weight the potential gain (if the partner is trustworthy) and the potential loss (if the partner is untrustworthy), and base on utilities under respective risk to choose between placing trust

and not. When considering the reward of a transaction, organizations compare long-run reward with short-run benefit.

3.4.2 Risk

Generally speaking, trust-sensitive transactions include those in which goods and services are provided in exchange for future payment, employment contracts in which managers rely on employees to accomplish tasks that are difficult to monitor, and investments and savings decisions that rely on assurances by governments or banks that they will not expropriate these assets (Knack & Keefer, 1997).

No risk, no reward. In high-risk transactions, on one hand, high risk is associated with high transaction costs; on the other hand, transacting partners are more willing to do business with those who are perceived trustworthy to avoid additional risk.

3.4.3 Frequency

As mentioned previously, trust building is a continuous process. Sometimes, trust is not built up in a single transaction, but built up through a series of transactions. That is, the trust built in past transactions might be used in future transactions. The past interactions become first-hand experiences, which is more accurate and cheaper. When the frequency of transactions increases, organizations become familiar with each other's norm, culture or background, and build up trust. If trust is built up, organizations can

spend less time on information, negotiation, and implementation, and are more willing to use “trust” as the governance of transactions.

3.4.4 Asset specificity

In situations where investments in relation-specific assets are low, trust may be unnecessary. Trust is necessary when organizations have made specific investments that cannot be used other transactions. Greater asset specificity increases the need for information sharing, because idiosyncratic transactions tend to require greater coordination than standardized exchanges. In addition, asset specificity is a good for reduce opportunism because both parties will lose if they destroy the relationship (Dyer and Chu, 2002). High asset specificity also means that the transaction is critical to organization. As importance of a transaction to an organization increases, it is probable that the process of sense making, understanding, and committing required in negotiation and transaction phase will be sufficiently complex and time-consuming (Smith 1997)

Chapter 4: Case Study-Industrial Districts

Industrial districts are nearly the only example that Putnam provides of social capital in action at the micro-level (Farrell & Knight, 2003). Putman (1993) argued that,

"What are crucial about these small-firm industrial districts, conclude most observers, is mutual trust, social cooperation, and a well-developed sense of civic community—in short, the hallmarks of the civic community" (Putman, 1993, pp56).

Thus, research on industrial districts will provide an important test case for arguments about social capital and its effects. They provide a setting in which casual factors underlying trust can be observed more closely. Research on industrial districts will also provide an insight into the interaction between transaction costs and trust in a physical geographic setting.

The case study analyzes the roles of trust in industrial districts and importance of keeping proximity to foster trust. The following sections first define industrial districts, explain the difference between industrial districts and Fordism, and then, study the origin and importance of trust in industrial district. Third, research is developed to explain why location matters. Fourth, the paper will analyze lock-in effects in industrial districts as negative effects of trust; and last, I will discuss the role of local institutions as intermediaries.

4.1 The Rise and characters of Industrial Districts

From the mid-1970s, Italian scholars called attention to the different development model in the Northeast-center of their country. The model is called “Third Italy” and is characterized by flexible specialization. Generalizing from Italy to other cases (notably German), the success of such forms of production is based on macroeconomic and historic context. Nowadays, scholars call the areas characterized by this productive model “industrial districts”.

Industrial districts comprise a large number of small, geographically concentrated firms, small producers with flexible and skilled workforces cooperating with their customers (Harrison, 1992). The role of individual firms played is a mixture of competitor and cooperator. Such systems are flexible and meet the needs of markets that were both fragmented and changing fast. With communication, transportation and production technology improved, this radical decentralization pattern of production is found in quite different sectors of production. It is in not only more “traditional” sectors such as textiles, clothing, footwear, and jewelry but also more advanced ones such as mechanical engineering and medical equipment.

Industrial districts is a competitive organizational forms compared to fordism. Fordism is characterized by mass production and of the vertically integrated firm. Fordism was based on the systematic separation of conception and execution throughout all parts of production and management. Separation of design and production applied to within large

firm and its relations with subcontractors. Hierarchy, vertical integration and the rigid fragmentation of knowledge worked for large firms when there was little competition in markets and when the rate of product and technological change was relatively slow. When markets became competitive and product and technological change more rapid, as they did beginning in the 1970s, Fordism is proved to be very uncompetitive.

"Industrial districts" provides an alternative to the mass production by trading on "economics of scope" instead of "economics of scale" (Sabel, 1982). As markets become more volatile and fragmented, technology changes more rapid, and product life correspondingly becomes shorter (Sabel, 1992), firms have to respond to the market quickly. Industrial districts, is much more competitive than conventional cluster in Fordism by using subcontracting and flexible specialization rather than standardization and low costs. More specifically, "subcontracting" refers to total or partial transfer of services owed by the titular of the main contract drawn up with the buyer by separate contract, to a third company. "Flexible specialization" is a Production model customarily denoting production activities that are decentralized and flexible, or based on multi-purpose machinery and skilled workers. The flexible forms of organization in the industrial districts that captured attention as alternatives to Fordism in the 1980s, gained their advantage by integrating conception and execution in production and management. The flexible system incorporates an extra conversation into problem solving deliberations. The system also provides more choices for commodity and adaptability to the changing

economic environment.

An industrial district is normally discussed as a historically bounded area, reflecting local traditions and entrenched relationships. Industrial districts are embedded in local institutional structures that support a dynamic mix of cooperation and competition. They represent a system with emergent properties, evolving not necessarily linearly and uniformly, and reflecting relations of power, status, and reputation. Its current structure and performance are seen as the result of long-term developments that can last decades. The much-celebrated Emilia-Romagna district in Italy, for example, took three to four decades to reach a stage where one can reasonably speak of economic success (Murray, 1987).

4.2 The Formation and Importance of Trust in Industrial Districts

In Section 4.1, I analyze that through subcontracting and flexible specialization, industrial districts can promptly respond to the rapid market change. Those two mechanisms require a firm in industrial districts to cooperate closely with and to rely more on its partners than a Fordist firm that works on everything themselves. The logic of the industrial district is self-reinforcing (Powell & Smith-Doerr, 1994). The more distinctive each firm is, the more it depends on the success of other firms' products to complement its own.

In industrial districts, subcontractors have to trust the subcontractees to meet agreed-upon quality and price targets, and to deliver promptly. Subcontractees might need to accept short-run low price and trust subcontractors to provide enough transactions in the long run to avoid loss of asset specificity. At the same time, most small firms in industrial districts are constantly renegotiating formal and informal arrangement with one another to bid new projects, this also put a strain on the need of trust. Thus, trust seems to be crucial both when decisions to redesign inter-firm linkage are made and once a link has been forge (Harrison, 1992).

Researchers on industrial districts agreed that trust in districts is built over a time through learning. Sabel (1992) argued that it is the past experience and reflection that trust be founded. The experience and reflection cannot be reproduced precisely in other locations. When exchanges happen frequently, and transacting partners expect long-run return, firms are less likely to act opportunistically. More important, firms might value their appearance as a member in an industrial district. The members are rooted in a common history. This history might include religion, politics, ethnics or culture. Interestingly, trust is not built up as a goal intentionally but as a byproduct of long period interaction. Over time, organizations invest sunk costs into transaction-specific assets, which they will lose if they destroy the cooperation, they can trust each other not to act opportunistically. In the same organization cooperatively move towards a common goal, exchange information, and get to know each other, and they built trust. Cognitive

organizations can interpret each other's actions and motives, ascribing honesty to each other on some social identities.

As discussed in Chapter 2, trust building constitutes transaction costs. In industrial districts, new firms are often founded by those who worked in other firms in the past, or are family members of other firm owners (Lorenz, 1998). All firms accept and understand the existing norms and informal rules. The norms and rules are built and kept by the firms in these districts through innumerous transactions and communication. Any evolvement of norms due to technology change, political change or economic changes will soon be known by all firms in the same districts. The norms and rules give firms the platform of shared understanding, communicating and are used to monitor and enforce the transactions. Along with the generally accepted norms and rules, information in the districts is relatively accurate and easily available, which also enhance the practice of norms and rules. It is more important that flexible specialization and subcontracting is associated with highly asset specificity. This means once the relationship is destroyed, firms have to change the production system in order to transact with other firms. In this sense, firms, even newly founded firms in the industrial districts enjoy the high-trust environment, and can invest relatively less than firms outsiders to initiate trust between members. However, firms still need constantly formal and informal contacting to keep the information and norm circulating and consume transaction costs.

The trust environment enables firms to trust every other firm in the industrial district.

Depending on assignments designated, the firms can easily find their subcontractees in short time. They don't have to spend lots of time and money to investigate the trustworthiness of their partners. The trust environment helps to organize and reorganize relatively flexible productive teams constantly to accept various assignments. To some degree, trust is the basis for flexible specialization in the industrial districts.

4.3 Proximity and Trust

Trust can built through learning about the idiosyncrasies of firms through repeated interactions. These interactions can be facilitated by personal contacts, which are enhanced by geographic proximity.

4.3.1 Norm and Proximity

The ability to judge the trustworthiness of others is important in industrial districts, not only because of the possibility that outsiders may be impervious to the methods of social control used in the communities, but also because of the inevitable scope for opportunism caused by incompleteness of contracts. The factors influencing the perception of trustworthiness depend on kinship, religion, politics, social ties and constant contacts. All these factors seem easily to be shared and identified when it is spatially clustered (Powell & Smith-Doerr, 1994).

The concept of path-dependence offers some useful insights for the study of the origin

of ascriptive trust in industrial districts (Engstrand & Stam, 2002). Path-dependence refers to the effects of past commitments or acquired knowledge on subsequent actions and decisions. It is recognized that "history matters" for a future course of action or development, such as past commitments or learning activities could entail previous investments in transaction-specific assets, such as contracts, research and development, or the pool of learned behaviors and organizational routines or norms which constrain future activities. Through interaction, a whole set of code is form to explain information. Ascriptive trust is built and not reserved for particular firms, which encompasses whole group of firms (Lorenzen, 1998).

There is also a profound geographical dimension to the ascriptive trust. This is because firstly the guild, which is the pivot of information sharing, has a limited geographical hinterland. Secondly, even within the group of firms in the guild, the ones which are localized closest together allegedly have a closer relationship with each other than with those that are not physically close. In generally, firms in industrial districts prefer cooperation with local firms. Being "a local firm" thus is a ground in itself for ascribing trust.

4.3.2 Information Sharing and Proximity

Local firms are more easily trusted is that it is easier to access information about them. The geographical roundedness increases the probabilities of social interaction and

communication, reduces the problem of bounded rationality, and engenders trusts (Grabher 1993).

To lower costs of searching and co-coordinating knowledge, it has been suggested that mutual experiences along with long-termed inter-organizational contracts are crucial features, as they entail practices and trust. Long-term inter-organizational contracts require stability, which is important for two reasons. The first is to induce subcontractors to accept the risk inherent in narrow specialization in skills and equipment, and second it permits continuing cooperation between those who concern the development of specifications, processes and designs.

The cognitive limitations of firms cause trouble to the absorptive capacity of firms. However, the limitations can be eased through prior knowledge in the firm, because it is easier for organizations to apply additional knowledge to already existing knowledge.

Information sharing in industrial districts takes place through a combination of long-term and short-term vertical relations (shorter or longer specialization subcontracting arrangements) as well as through horizontal relations (between producers of similar products). Interestingly, even entrepreneurs that are competing on products consider themselves as colleagues rather than competitors.

Information exchanging usually takes place between firms within the guild's catchments area. Thus there is a geographical dimension to the information availability. Hence, each and every firm does not have to go through a trial-and-error process of

personal experience with co-operative behavior. Instead, it can take advantage of local information sharing through both cooperation and second hand information about the experiences of the other firms.

Geographical agglomeration (proximity) of firms, are beneficial to sharing of tacit information. The geographical proximity amongst business firms may also give rise to "information environment" of communication. The availability of information amongst co-localized firms may lower their searching and communication costs as well as absorbing information signals (Arrow 1973). Thus, the low information cost within information environments significantly lowers.

4.3.3 Cooperation and Proximity

Unlike the standard vertically integrated firm, where all stages of the production process are hierarchically organized within a single organization, the basis for industrials districts' success appears to be diffuse patterns of cooperation. Particular phases of the production process are put out to specialized firms who cooperate with each other in making the product. In the ideal-typical industrial district, production is organized by certain firms, which are engaged with customers on the final market. They take orders, and draw up plans or specifications. They then subcontract out the actual process of production to a host of smaller subcontractors, each of whom may specialize in only one phase of production, and then assemble the finished product and bring it to market.

Obviously, the form of production seen in the industrial districts requires a high degree of trust between firms. Subcontractor may need to respond quickly to shifts of market. On the face of it, both subcontractors and final firms can act opportunistically. Subcontractors could hold final firms to ransom, using the threat of "holdup" to renegotiate informal agreements in their own interest. At the same time, the production of bespoke machinery requires a very high degree of flexibility from subcontractors, both in terms of their willingness to accept changes in specifications and their willingness to work long hours and weekends at short notice to complete a commission. In the short term, this may involve substantial costs for a subcontractor, costs outweighing the price that a subcontractor receives for a particular order. These costs may be compensated for by future orders in a long-term relationship.

Because of physical proximity of the firms, clients and competitors would immediately be informed of the cheating behaviors and thus firms are less likely to act opportunistically. Put more explicitly, Reputation plays a highly important role in relations among firms in industrial districts. Dishonest actors could expect their malfeasance to become quickly known in the community. In cases of repeated malfeasance, they could expect to be shunned. The informal rules and sanctions exist in the districts so that dishonest behaviors are unprofitable in the long run.

Thus, the informal agreements are negotiated on the basis of these norms involved benefits for both final firms and subcontractors. Subcontractors typically refrained from

opportunism; they knew that if they were caught cheating, they would not only endanger their current business relationship but also have difficulties in finding new ones. They also were prepared to provide a high degree of flexibility in circumstances in excitation of normal agreement. Such flexibility might be expensive; subcontractors firms may have had to refit components at short notice or pay their employees overtime or have them work over the weekend to complete an order. However, it will be rewarded with long-term commitments from final firms. Thus, smaller subcontractors had a reasonable guarantee of income over the longer run.

4.4 The Lock-in Effects in Industrial Districts

Industrial Districts was successful up to the 1970s (Easton & Araujo, 1992). It is meeting new problems in more recent times. Large firms equipped with flexible manufacturing system offered small firms intense competitions (Sabel, 1989). At the same time, the social and political context supporting the emergence of industrial districts has changed (Harrison, 1994).

Social embeddedness or lock-in effects of inter-firm networks is generally perceived as a major reason for industrial districts' uncontested responsiveness and ability to generate incremental innovations. However, the lock-in effects also are responsible for the decline of economies in industrial districts.

To sum up, there are three types of lock-in effects (Grabher, 1993): functional

lock-in effects, cognitive lock-in effects and political lock-in effects. Functional lock-in effects refer to the close and stable linkages between the regional core firms and the supplier sector that are favored by the long-term stability and predictability of demand. Transaction costs might be reduced by these stable relationships. But the interaction in the area might result in serious problems: lack of diversity, or so-called boundary-spanning function. This makes certain types of external information relevant to the firm difficult to obtain.

Cognitive lock-in effects refer to personal ties of long standing that result in mutual orientation involving a common language regarding technology, contracts, and information. The social process of "group thinking" limits the perception of innovation opportunities and leaves no room for bridging relationship. This effect further reinforces the block effect of information from different sources.

Finally, political lock-in effects refer to the cooperative relations between industry, the government, unions, and professional associations. The politically administrative system obstructs a timely organization of a region and paralyses political innovation. The vested interests in this economic and political setting might actively oppose the required changes when their positions are threatened.

4.5 Local Institutions as Intermediaries

Industrial districts benefit from rapid and tacit knowledge exchanges and from norms and values. Consequently, these characteristics benefit individual firms for the exploitation of existent technologies and opportunities. However, based on the same logic, these characteristics might not be suitable for exploring new technologies and opportunities (Molina. etc, 2002).

Fortunately, proximity can facilitate the creation of third-party relationships, which provide individual firms in the district with indirect links to sources of knowledge form outside of the districts, as well as from inside it. Intermediaries, who are always acted by local institutions, create third-party relationships. The local institutions are locally orientated organizations that provide a host of collective supports to firms in the district. The local institutions include a range of institutions: universities, research and other academic institutions, regional policy agents and trade or professional associations. Some of local institutions can act as intermediaries linking outside networks with the internal networks of industrial districts. The new linkage can provide industrial districts with new ideas, concepts and technologies and reducing their searching costs (Molina. etc, 2002). Because these institutions interact with a large number of firms in the district, they are exposed to a wide variety of problems and organizational challenges. Based on experience and by observing solving of similar problems, local institutions summarize particular capabilities and routines and disseminate them. Local institutions can act as

go-betweens for potential exchange partners with complementary interests, who would otherwise remain unconnected.

In summary, local institutions can play the role of intermediaries for individual firms and act as a repository of knowledge and a source of searching economies. Hence, local institutions benefit firms by facilitating the exchange and combination or acquisition of new knowledge, and consequently by helping them out of lock-in effects.

Chapter 5: Implications

In industrial districts, trust is generally nurtured through repeated contacts with third parties (Harrison, 1992). This trust is based on a common history and highly restricted to certain geographic area. The case study of industrial districts clearly shows that trust is very important in transactions, specifically in industrial districts, the characters of flexible specifications and subcontracting requires high trust among firms. The cases study also illustrated that transaction costs, including information searching and sharing, negotiation, implementation and enforcement, interact with trust. Though high trust in the districts facilitates transactions and reduces transactions costs, the maintenance the basis of trust (information sharing, norm and constant contacts) constitutes transaction costs. It is also illustrated that the strong trust seems only to exist in the districts itself and the members tends to transact with members in the same group and exclude outsiders. It is important that trust development in industrial districts is long time learning process. It is path-dependent and unique, thus hard to reproduce in other area.

Based on the theoretical analysis and case study, a few suggestions are made to policy makers and economic developers.

5.1 Find the Role of Trust

Before using trust as a tool to promote economic development, local governments or developers should realize whether or not trust is critical to their inter-organizational

relationships. Generally speaking, trust-sensitive transactions include those in which goods and services are provided in exchange for future payment, employment contracts in which managers rely on employees to accomplish tasks that are difficult to monitor, and investments and savings decisions that rely on assurances by governments or banks that they will not expropriate these assets.

5.2 Build Norms and Regulations

It should point out where theory (or concepts) illuminates the practices presented in the case study, where it was inadequate and needs to be modified (or jettisoned), and where new concepts are needed based on commonly shared norms, on the part of other members of that community (Abegglen & Stalk, 1985). Building inter-organizational trust requires habitation to the common norm like honesty, dependability. This norm should increase the costs of defection, fosters robust norms of reciprocity, facilitates communication and improve information flows, and embodies past success at collaboration and provides a blueprint for future cooperation. In the case of lack of available commonly accepted norms, enforceable regulations should provide general-purpose safeguards to relieve the need for additional transaction-specific supports.

5.3 Enhance Information availability

Risk and opportunism are associated with information asymmetry. Information sharing helps to mutual understanding and cooperation among organizations, which is the important step to build up trust. Accurate information help organization more precisely estimate the trustworthiness of potential partners, avoid blackmail in negotiation, and decrease investment in monitoring and enforcing, eventually, reduce transaction costs. Government, guild or other possible NGOs can make information about supply and demand, misbehaviors and high performance firms available to its targeted organizations and area through meetings, internet, paper, or posters.

5.4 Build Intermediary Systems

Intermediaries play major role to build up new trust relationship and expand the "radius of trust". Intermediaries are important to encourage entrance and growth of new firms and to enhance the existing network. Local government, Chamber of Commerce, large organizations in the areas or NGOs can play formal intermediaries. Local institutions, acting as intermediaries, can provide firms with new information collected through their structure of external contacts, rich in structural holes. More important, just like every firm in districts, acting as intermediaries to spread and transfer trust, every member in the areas itself can be a intermediary. When acting as key intermediaries and gatekeeper in the transaction, government or NGOs should keep good reputation.

Organizations should be encouraged to enroll local guild or other associations. Without such association, local government should provide other form of communication platform. By using network, organizations can use others as intermediaries or act as intermediary themselves.

Chapter 6: Conclusion

With the growing importance of social capital in promoting economic development, trust, as a major component of social capital is often believed to be a catalyst for transaction. Many literatures hold that trust can reduce the transaction costs including information searching, negotiating, monitoring and enforcing a transaction or agreement. This paper analyzes the impact of trust on these transaction costs and also, researches how these transaction costs changes the perception of trustworthiness and studies how the characters of transactions influence both transaction costs and trust.

The paper concludes that transaction costs in different phase in transaction are jointly determined, are affect by factors such as intention of keep long-term relationship (frequency of transactions), importance of the transaction (asset specification), and physical relationship. In general, trust helps reduce these transaction costs and the input of transaction costs will in turn, changes the perception of trustee's trustworthiness.

More important, the paper pointes out that trust might have some negative effects including functional lock-in effects, cognitive lock-in effects and political lock-in effects. The paper suggests using local institutions as intermediaries to build up communication channels connecting insiders and outsiders, and thus to mitigates the negative effects.

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