Making Capitalism Work: Fair Institutions and Trust

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Abstract
In the field of political science researchers have shown empirically that the perception of relevant political institutions as fair may produce political (vertical), as well as interpersonal (horizontal) trust. By making use of these overlapping but separate theoretical frameworks, we formulated three hypotheses that we tested on data from a survey conducted in Sweden in 2006. First, we investigated whether the extent to which an employee perceives formal institutions as fair and duly enforced lower the probability that he/she will behave opportunistically. Second, we tested whether an employee’s trust in the opposite party had equivalent effects. Third, we examined whether an employee’s perception of formal institutions as fair and duly enforced increased his/her trust in the opposite party. All three hypotheses were supported by the data. Our interpretation is that that there is indeed an effect on cooperative behavior and willingness to enter into flexible contracts from perceptions of fair and enforced institutions, but it is indirect. Trust, however, has direct effects and, consequently, mediates the effects of institutions as well.

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Making Capitalism Work: Fair Institutions and Trust

*If the rulebook of capitalism is fixed and fair and enforced, perhaps energetic self-interest will find the path of accelerated development.*
(Roll and Talbott 2003, 17)

A Brief Outline of the Argument

If there ever was a debate within social sciences whether institutions matter at all, it is now obsolete. It is well established within political science (Shepsle 1989) and economics (North 1990), but also in related research on individual choice and new institutionalism (Granovetter 1985; Koelble 1995) that institutions can influence individuals’ behaviour. A more fruitful discussion about what kind of institutions that matter (Rothstein 1998), how (Elster 1989) and under which conditions (Przeworski 2004), is now prevalent.

Furthermore, the emphasis on institutions and individual behaviour has fostered an even closer relationship between research on politics and economy (Hall 1986; Persson & Tabellini 2003; Swedberg 2003). It has been shown that politically constructed and contended institutional arrangements are closely associated with different “production regimes” or alternative models of capitalism (Hall & Soskice 2001; Thelen 2004; Streek & Thelen 2005). However, the actual mechanisms of pivotal institutions of the political economy remain to be fully understood. Considering the attention given to political institutions over the last decades, scholars may still be “struck by how little robust, reliable knowledge we have about the impact of institutions” (Przeworski 2004, 528). In this article we would like to contribute to a better understanding of how politically constructed institutions matter in modern capitalism.

Capitalism is based on exchange of goods and services on free markets. Such transactions, however, do not come without costs, which vary independently of the competitive market price of the goods or services exchanged. In real life, actors are
not fully informed, goods and services are complex, and their quality is hard to determine. The risk of opportunism and need for extensive contracts increase costs considerably and may even hinder exchange. Consequently, transaction costs and the handling of such transaction costs are crucial for production and, in the end, economic growth. In this article we focus on the labor market and the mechanisms that can reduce these transaction costs.

Thus, creating an environment in which incomplete contracts are entered into and cooperative behavior thrives despite uncertainty of the behavior of others is essential to make market economies work. It has been argued that formal and informal institutions are the keys to the creation of such a low-cost transaction environment. But the existence of institutional constraints is not enough. Their (perceived) quality and performance are equally crucial. We argue that the essential mechanisms are the extent to which third party enforcement mechanisms (the formal institutions or the rules of the game) are considered both duly enforced and fair, and the extent to which the involved parties trust each other to stick to broadly accepted norms (informal institutions). These two factors may have direct effects on incomplete contracting and cooperative behavior. But in relation to recent research on institutions and trust, we argue that we should understand this as a chain of mechanisms. More precisely, we argue that the perception of duly enforced and fair rules and regulations leads to higher trust, which in turn influence the willingness to enter into incomplete, effective contracts, and engage in cooperative behavior.

In this article we try to make use of theoretical and empirical knowledge from the study of both politics and economics with the intention of formulating and testing hypotheses on the effects of institutions on the behavior of economic actors. We take the aggregated effects of institutional constraints on economic growth for granted and focus on the labor market and the mechanisms at the micro-level. We use cross-sectional data from a Swedish survey conducted in 2006 directed to employees and posing questions about conditions of and perceptions about their workplaces. Above all we investigate employees’ perceptions and attitudes about institutions, trust, and cooperative behavior. As expected, and in accordance with earlier research, the analysis shows a positive effect of trust on cooperative behavior and the readiness to enter into flexible contracts. More novel is that perceptions of institutional constraints also have a positive influence on the two outcomes. Furthermore, and more importantly, the analysis confirms our hypothesis that the positive effects on
cooperative behavior and willingness to less formalized contracts of perceptions of the implementation and fairness of institutions are indirect and mediated by the employees’ trust toward their superiors.

Obviously, these results have important implications for labour market and social politics. In order to create a workplace environment that fosters trust, and by doing so lower transaction costs, it seems crucial to design institutions that are perceived as fair.

Institutions and Transaction Costs – Three Hypotheses

Ever since Douglass North stated that institutions are the “underlying determinant of long-run performance of economies” (1990, 107), the relationship between institutions and growth has been a central theme, not only in economics, but also in the field of social science research at large. A burgeoning literature has set out to determine the extent to which the existence and quality of formal and informal institutions can explain differing growth patterns around the world.

So far, the ample empirical evidence suggests that a wide range of institutional factors are related to measures of economic prosperity and growth. It has been shown that the existence of property rights, civil liberties, political rights, and freedom of the press positively affect growth, whereas black market activity, trade barriers, and excessive regulation hamper economic development (Bockstette et al. 2002; Dreher and Herzfeld 2005; Henisz 2000; Persson and Tabellini 2006; Rodrik et al. 2004; Hall and Jones 1999). Regarding more informal institutional constraints, cross-country studies support the hypothesis that nations characterized by trusting and civic-minded citizens fair better in economic terms (Knack and Keefer 1997, Zak and Knack 2001, Beugelsdijk et.al. 2004).

But the institutional explanations of growth have not escaped criticism. Above all, the definitions, measurements, and methods used in the empirical studies supporting a positive effect of well-functioning institutions on growth are highly contested: “The growth literature does not subscribe to one overarching definition of economic, political, and social institutions, their process of change, and their likely channels of influence on economic outcome”. A central problem is that the literature has obscured different channels through which institutions operate and, hence, has impoverished the interpretation of the role of institutions in growth (Aron 2000).
Furthermore, the causal order of the factors has been questioned. Do institutions cause growth or is economic growth a prerequisite of the existence of certain institutions? To get a better grip of the causal direction is of course critical, both from a scientific and a policy perspective. But in spite of the impressive amount of studies showing significant relationships between institutional factors and measures of economic development most researchers seem reluctant when it comes to taking the leap from correlation to causation (Aron 2000; Roll and Talbott 2003).

A common suggestion in this instance is to collect more and better data to enable more elaborate statistical modeling to solve the problems (Aron 2000; Roll and Talbott 2003). Important as this may be, such an approach misses a fundamental point. Although empirical tests of the economic effects of institutions have focused on the macro-level relationship between institutions and growth, mainstream institutional economics has not jettisoned the conventional assumption of methodological individualism (Arvanitidis 2004; Williamson 2000). Thus, to better support the causal link between institutions and growth at the macro-level it is critical to understand and test in what way institutions affect individual actors (King, Keohane, and Verba 1994; Torsvik 2000). Therefore, we argue that more emphasis must be put on precisely sorting out and empirically testing the assumed individual-level mechanisms underpinning the macro-level relationship between institutions and economic growth. Specifically, what is needed is a clear idea of which institutions matter and for what reason (Elster 1989; Rothstein 1998; Przeworski 2004).

The natural starting point here is to pinpoint exactly what processes institutions are supposed to affect. What is the assumed mechanism between institutions and growth? At the center of institutional analysis is the concept of transactions – joint actions between individuals in which terms of performance are agreed upon (Martinez and Dacin 1999). The fundamental problem to solve in order to produce growth is to create an environment in which (economic) actors can get involved in successful exchange and transactions. But such exchange of goods, services, and sanctioned rights does not come without costs. These transaction costs follow (among other things) from “uncertainties that arise from incomplete information with respect to the behavior of other individuals in the process of human interaction” (North 1990, 25). In other words, you don’t enter into a transaction if you feel uncertain about whether the other actors will stick to it. If you do, you would
prefer a very detailed contract in order to try to anticipate all kinds of possible
unfriendly behavior from the opposite party.

For the purposes of this study, transaction costs are defined as the costs of
establishing and maintaining property rights, where the latter implies the ability to
freely exercise a choice over a good or service (Allen 1999). More concretely, these
costs involve

the costs of deciding, planning, arranging and negotiating the actions to
be taken and the terms of exchange when two or more parties do
business; the costs of changing plans, renegotiating terms, and
resolving disputes as changing circumstances may require; and the
costs of ensuring that parties perform as agreed. Transactions costs also
include any losses resulting from inefficient group decisions, plans,
arrangements or agreements; inefficient responses to changing
circumstances; and imperfect enforcement of agreements. (Milgrom
and Roberts 1990, cited in Husted and Folger 2004, 720)

When is it costly to establish and maintain property rights? Put differently, when will
actors successfully make complex exchanges and transactions? Transaction cost
analysis is closely connected with the work of Oliver Williamson (1975 and 2000).
Briefly, the basic idea holds that the cost of transacting is a function of the interplay
between two assumptions about human behavior – bounded rationality and
opportunism – and two properties of the underlying transaction – asset specificity and
uncertainty (David and Han 2004; Rindfleisch and Heide 1997; Shelanski and Klein
1995; John 1984; Crocker and Masten 1996). Given that actors have limits on their
rationality and constraints on their cognitive capabilities (bounded rationality) and a
propensity to, when given the chance, unscrupulously seek their self-interest
(opportunism), transaction costs will rise as asset specificity increases, the
circumstances surrounding the exchange become more uncertain ex ante, and
performance is harder to verify ex post. The interplay between these factors will, in
the end, determine whether there will be any successful exchange between the actors.
Also, it will determine the efficient form of organization for a given economic
relationship – market or hierarchy.

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1 Asset specificity includes relation-specific investments in physical and human capital, such as firm-
specific training of employees. In addition to asset specificity and uncertainty, the literature on
transaction costs has suggested, but given less attention to, two more dimensions of transactions –
frequency and complexity (Rindfleisch and Heide 1997).
However, the Williamsonian approach has been criticized for putting too much emphasis on the efficiency aspects of transaction costs.

Where organizational economists are interested in economizing transaction costs, justice theorists are interested in optimizing the perceptions of fairness, whether of the outcome of an exchange or of the process by which the outcome is evaluated. (Husted and Folger 2004, 721)

When people perceive the allocation of the outcomes of an exchange (distributive justice) or the procedures for determining those allocations (procedural justice) as unfair they will respond by shirking, breaching, and pilfering (Ouchi 1980; Husted and Folger 2004). When the allocation, instead, is seen as fair and just, individuals will cooperate in spite of tragedy-of-the-commons situations (Ostrom 1990; 2000). That is, perceptions of fairness will facilitate cooperative behavior whereas perceptions of unfairness will lead to opportunistic behavior, increasing transaction costs, and less efficient (or lack of) exchanges.

How do these insights help us understand the role of institutions in explaining economic growth? The basic premise of institutional analysis is that institutions will structure human exchange by changing actors’ incentives, reducing their uncertainty about the behavior of others and making credible commitments possible (Hall and Soskice 2001; North 1990). Connecting this assumption to the discussion on transaction costs, we should expect the importance of a well-functioning institutional framework to lie first and foremost in its possible effects on the actors’ propensity to behave opportunistically. Institutional constraints determine the returns on cooperative behavior (Ostrom 1990; 2000). Given a proper institutional framework, actors will be less inclined to behave opportunistically. Consequently, proper institutions will lower transaction costs and enable complex and efficient economic exchanges.

But what is a proper institutional framework? In this paper we adhere to North’s definition that institutions “are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (North 1990, 3). This definition is wide enough to comprise both formal and informal institutional constraints. Looking first at the formal constraints, to lower transaction costs there is a need for a formal institutional framework that acts as an impartial third party that is able to enforce agreements, thereby structuring human exchange and making credible commitments possible by changing actors’ incentives. For the
institutional framework to serve this function two conditions must be satisfied. First of all, to have an effect on actors’ choices and behavior, a constraint must be effectively enforced. Low-cost enforcement of contracts is an important source of economic growth across the world and throughout history (North 1990). Secondly, the mere existence of institutional constraints is not enough to create an environment that is conducive to economic prosperity. Comparing economic development around the world it is evident that some institutional constraints lower transaction costs while others raise them. What is important is instead the quality or performance of institutions rather than their descriptive characteristics or attributes. In line with the discussion on transactions costs above, the formal constraints governing the relationship must be perceived as fair and just by the actors to enable credible commitments and cooperative behavior (Ostrom 2000; Roll and Talbott 2003; Farrell 2004; Levi et al. 2004).

The assumption underlying this argument is that most people do not act on the basis of a single rational utility maximizing utility function. Instead individuals weight their self-interest against their commitment to adhere to moral values in a dual utility function (Levi 1991; Rothstein 2001). Thus, we should expect that effective enforcement of institutional constraints primarily influence the actors’ self-interested preferences whereas the influence of fair institutions works through the impact on the individuals’ moral stance. When institutional constraints increase the costs of opportunistic behavior individuals will be more inclined to act cooperatively. When the institutional constraints are perceived as fair and just the actors will attach greater weight to their moral convictions when deciding whether to cooperate or not (Rawls 1999, ch. 8). The discussion so far has led us to the first hypothesis to be tested in this study:

H1: the extent to which a transaction party perceives the formal constraints governing the relationship as fair and/or duly enforced will lower the probability that he/she will behave opportunistically

But even when the formal institutional constraints are perceived as fair and just and enforcement is sufficient to enable complex contracts to be entered into, uncertainty about the possibility of validating whether a contract has been fulfilled will still abound:
In particular, because contingent agreements are costly to compose and difficult for courts to interpret and enforce, contracts are inevitably incomplete. Although parties will design contracts to balance the need for adaptation with the cost of effecting adjustments, the inability to define precise obligations in response to changing events in ways that can be enforced at low cost means that contracts will, on the one hand, tend to be inflexible and, on the other, leave considerable opportunity to cheat on the agreement or to attempt to evade performance. (Crocker and Masten 1996, 9)

Thus, because of enforcement costs, most contracts will be incomplete. In other words, proper formal institutional constraints are in most circumstances not enough to enable low-cost transacting (Lorenz 1999). By filling the gaps left by incomplete contracts, informal institutional constraints also play a major role in determining transaction costs:

It should be stressed that creating an institutional environment that induces credible commitment entails the complex institutional framework of formal rules, informal constraints, and enforcement that together make possible low-cost transacting. (North 1990, 58)

Informal constraints are viewed here as “broadly accepted standards of conduct” (North 1990, 61). That is, the essence of informal constraints is norms. In this sense norms are the informal counterpart of fairly perceived formal constraints, and as was the case for formal institutional constraints, norms must be abided by to be effective. Two questions follow from this argument. First, how does an actor assess the probability that others will follow norms, however “broadly accepted”? Second, what is the essence of these broadly accepted norms? This is where trust comes into the picture as an important factor enabling low-cost transacting.

Our understanding of trust is based on the model of trust associated with Russell Hardin and his colleagues (Hardin 2002). An actor A is said to trust another actor B “when A believes that B is trustworthy with respect to the matters at hand” (Cook et al. 2005, 20). We argue that people can be trustworthy for two reasons. We say that someone is trustworthy if he/she encapsulates our interests and/or is morally committed to being so. Thus, our account of trust departs from Hardin’s conception in one important respect. As noted above, we believe that an individual’s actions can be motivated by both self-interest and moral commitment (Levi 1991). Consequently we argue that an actor’s expectation of someone else’s trustworthiness can rest on an assessment of both his/her self-interest and moral commitment.
In this sense trust can be seen as a bet on the extent to which others encapsulate our interests and/or are morally committed to act trustworthy (Rothstein 2004; Sztompka 1998). Accordingly, just as norms are the informal counterpart of fairly perceived formal constraints, trust is the counterpart of third party enforcement of formal constraints. To trust someone means to be confident (but not absolutely certain) that he/she encapsulates our interests and/or is morally committed to act trustworthy in future contingencies. That is, high-trust actors “spend less to protect themselves from being exploited in economic transactions. Written contracts are less likely to be needed, and they do not have to specify every possible contingency” (Knack and Keefer 1997, 1252). In line with this argument the second hypothesis holds that:

H2: the extent to which a transaction party trusts the opposite party will lower the probability that he/she will behave opportunistically.

Thus, institutions affect transaction costs and, in the end, economic growth through both formal and informal constraints. When actors perceive the institutional framework governing the relationship as fair, just, and properly enforced, and also trust their potential exchange partners, transaction costs decrease, the number and complexity of exchanges rise and the economy flourishes (Podsakoff et al. 2000; Miller 2001).

But what can be said about the causal order between formal constraints and trust? The earlier literature was a lot sparser on this question. But recent research on the interrelationship between welfare institutions, political confidence, and social trust argues that the institutional framework can create trust. Especially, it has been shown that citizens that perceive welfare institutions as fair and just are more supportive of the political regime and its institutions (Kumlin 2004) and more trusting towards their fellow citizens (Rothstein and Stolle 2003; Rothstein 2004; Kumlin and Rothstein 2005). Such feedback mechanisms going from formal institutions to trust might very well be valid in circumstances other than the vertical trust relationship between a citizen and the political authorities and the horizontal trust relationship between citizens.

Following our assumption about dual utility functions and the discussion on trust above we argue that institutional constraints influence actor A’s trust in actor B
in two ways. First, properly enforced institutional constraints will make it more expensive for B to break the relationship with A. Thus, A will be more likely to believe that B encapsulates his/her interests and therefore is willing to act trustworthy. Second, given that the institutional constraints are perceived as fair A will expect B to put greater weight to moral convictions when deciding whether to act trustworthy or not.

Consequently, we should expect the degree of trust in any relationship to be affected by the formal constraints governing the relationship. Thus, there is reason to state a more general hypothesis about the relationship between institutional constraints and trust and test whether:

\[ H3: \text{the extent to which a transaction party perceives the formal constraints governing the relationship as fair and/or duly enforced will increase his/her trust in the opposite party.} \]

Methods and Research Design

In order to empirically test the individual-level mechanism underpinning the macro-level relationship between institutions and economic growth, we have, first of all, to pinpoint a relevant transaction relationship with great importance for economic growth. Furthermore, this relationship should preferably be embedded in easily recognizable institutional constraints, both formal and informal. There are of course several possible situations to study. Following Williamson (1985) we argue that employment relations nicely fit the above-mentioned criteria (see also Cook et al. 2005).

First, laws and other institutions regulate employment relations in all countries, and specify for example industrial management rights, job security, and rules for conflict resolution (Traxler et al 2001; Botero et al. 2004). Thus, labor market institutions and laws regulate property rights for both employers and employees. Furthermore, since these institutions do not regulate every part of an employment relationship, employers and employees are constantly involved in exchange situations where informal institutions, e.g. norms acting trustworthy, are also important.
Second, the employment relationship is a typical situation in the sense that the actors are involved in an exchange in which transaction costs follow from uncertainties with respect to others’ behavior (Ouchi 1980; Hall and Soskice 2001). Both employers and employees have incentives to exploit or deceive the other, i.e. to behave opportunistically. Consequently, both parties also have incentives to secure themselves from being exploited or deceived, and may be tempted to engage in complicated (and costly) contracts.

Third, successful exchange and transactions between employers and employees are essential to economic growth. Not only is it important that agreements are settled; they have to be settled without too large costs arising from complicated contracts and supervising.

The Data

In order to study the effects of institutional constraints on employee behavior and attitudes we rely on an extensive survey of Swedish workplace relations. The Swedish case is a highly suitable testing ground for the three hypotheses outlined above. Most importantly, labor laws in Sweden are extensive and universal. Most employees in Sweden have equivalent job security and are affected by one distinct system of conflict resolution when involved in individual disputes.

The survey was conducted in cooperation with Statistics Sweden in late spring 2006. A random sample of 3000 respondents was selected based on a register of all Swedish citizens between 20 and 65 years of age; 1551 individuals answered the postal questionnaire after three reminders, i.e. a response rate of 52 percent. The analyses in this article are based on answers from the slightly more than 900 respondents that indicated that they had been working mainly as employees in the last month. Before we proceed to the analysis, we will explain how our basic concepts are measured.

Opportunistic Behavior and Flexible Contracts

In the survey there are no items tapping the degree of opportunistic behavior among the respondents. Repugnance to inform anyone about one’s own degree of opportunism would most likely lead to downward bias in the levels of and underestimation of the variance in opportunistic behavior among employees. Instead we asked about the opposite of opportunistic behavior, i.e. the willingness to
cooperate (Podsakoff et al. 2000). Fortunately, there is ample experience in the literature from the usage of concepts such as organizational commitment (Nyhan 2000), organizational behavior and organizational citizenship behavior (Podsakoff et al. 2000). Organizational citizenship behavior has been defined as:

Individual behaviour that is discretionary, not directly or explicitly recognized by the formal reward system, and that in the aggregate promotes the effective functioning of the organization. By discretionary, we mean that the behaviour is not an enforceable requirement of the role or the job description, that is, the clearly specifiable terms of the person’s employment contract with the organization; the behaviour is rather a matter of personal choice, such that its omission is not generally understood as punishable. (Organ 1988, cited by Podsakoff et al. 2000, 513)

Organizational citizenship behavior (OCB) has been specified and measured in several different ways. Podsakoff et al. (2000) in their review of the literature pinpoint no fewer than seven different meanings of the concept. As the most central among those they emphasize what may be called helping behavior, that “has been identified as an important form of citizen behavior by virtually everyone who has worked in this area” (Podsakoff et al. 2000, 516). In order to capture this, we asked our respondents to what extent they were willing to “work harder than they normally do” in order to help their nearest superior.

A potential objection against using OCB as an outcome variable in the models below is that in the causal chain one’s willingness to engage in helping behavior is in close proximity to one’s trust, at both the conceptual and the operational level. Therefore we will also employ an alternative measure of transaction costs as a dependent variable. In the literature individuals’ willingness to enter into flexible contracts has been highlighted an important aspect of low cost transactions. Thus, high-trust actors will “spend less to protect themselves from being exploited in economic transactions. Written contracts are less likely to be needed, and they do not have to specify every possible contingency” (Knack and Keefer 1997, 1252). Given a situation of uncertainty, low-trusting employees will prefer a very specified contract in order to avoid being exploited. To capture the willingness to enter into flexible contracts we asked the respondents what they regarded as most important, “to have considerable scope for workers as well as managers to make continuous changes in work tasks” or “to have strictly defined work assignments”.

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Perceptions of Institutions

The institutions that regulate employment relations in Sweden encompass two bodies of law: employment law and collective relations law. Job security in Sweden is regulated in special legislation dating back to 1974 and primarily stipulated in the Employment Protection Act (SFS 1982, 80; Holmlund and Storrie 2002). The law presumes that, unless otherwise stipulated, an employment contract is valid until further notice. When terminating the contract, the employer must provide a valid reason – the circumstance appealed to should constitute a “just cause” for dismissal – and advance notice. Furthermore, the Act states that the order of priority in a redundancy situation shall be determined on the basis of employee seniority. This is often referred to as the “last in–first out” principle.

Collective relations laws protect workers from employers through collective action (Botero 2004, 1355). These laws are more disparate than employment laws. A characteristic trait of Swedish collective relation laws is that they involve the organizations of the labor market to a very great extent. When a dispute between an employer and an employee arises, the first stage for the employees is to approach their workplace trade union representative. The issue is then negotiated with the employer at workplace level under the terms of the Co-Determination Act (SFS 1976:580; e.g. Levinson 2000). If the local parties are unable to resolve the conflict, negotiations will follow between the employer’s association and the trade union at national branch level. If they too are unable to come to a resolution of the conflict, the case can be taken to the tripartite Labor Court, where it can be settled through continued negotiations or arbitration, or—as a last solution—by a formal decision by the Labor Court.

In the analysis we will focus on the respondents’ perceptions of the rules for dismissals and conflict resolution. As stated above, we argue that the extent to which the institutional constraints are perceived as fair and/or duly enforced is decisive. Ideally we should have separate measures tapping perceived fairness and enforcement of dismissal and conflict resolution rules, respectively. Unfortunately, this is not the case. Instead we measure the extent to which the respondents perceive the rules for dismissals are enforced and whether they think the conflict resolution rules are fair.²

² The two items read: “To what extent do you think that disagreements between employers and employees at your workplace are solved in a fair way?”. “To what extent do you think that layoff rules
In the end this means that although we are able to test the effects of perceived fairness and perceived enforcement separately we cannot tell which effect is stronger.

**Trust**

As argued in the theory section, we consider trust to be a bet on the future contingent actions of others, based on incomplete information concerning others’ interests and moral commitment. There are two different “others” to consider in a study on trust and opportunistic behavior at the workplace. Workers’ trust and trusting behavior depend on how they assess their superiors’ (the vertical relation) as well as their workmates’ and colleagues’ trustworthiness (the horizontal relation). Even though the worker may be confident that the superior encapsulate his/her interests or will stick to the norms, it may still be safer to act “by the book” and act opportunistically as he or she conceives the workmates as untrustworthy.

Trust is measured in two different ways in this article. First by a straightforward question in which the respondents in the questionnaire are asked about the level of horizontal as well as vertical trust, i.e. to what extent they trust their colleagues/workmates and their nearest superior. The second question takes as a starting point the concrete situation after an agreement or contract has been reached, namely the extent to which the employee thinks that colleagues and superiors actually keep their word and do what they have promised to do. Together these questions cover both situations of ex-ante transaction costs (search and contracting) and ex-post transaction costs (monitoring and enforcement costs) (Dyer and Chu 2003). In the analysis to follow we have combined the two questions into a single additive index on trust.

**Analysis**

The results of the analyses are presented in Tables 1 and 2. The estimates of the seven regression models in Table 1 are intended to test the influence of institutional constraints on organizational citizenship behavior. In order to save some space we are strictly observed at your workplace?” In both cases the response alternatives run from 0 (“To no extent at all”) to 10 (“Completely”).

3 All significance tests in the models are based on robust heteroskedasticity-corrected standard errors (Huber-White).
present only the estimates of the relevant variables measuring perceptions of formal institutional constraints and trust. All variables in the table are measured using 11-point scales (0–10).

Focusing on Model 1, we can see that the first hypothesis is supported by the results. The degree to which the respondent thinks that rules for dismissal are followed at the workplace is positively related to the expressed willingness to work harder than one normally does in order to help one’s superior. In the same manner, the estimates in Model 3 strongly confirm the second hypothesis. The more the employee trusts his/her nearest superior, the more willing he/she will be to put in extra effort in order to help his/her boss. This particular result is not novel. The relationship between trust and organizational citizenship behavior is well documented in earlier research and the estimates in Model 3 confirm these findings (Dirks & Ferrin 2000; Podsakoff et al. 2000).

The results in Models 4 and 6, instead, provide us with some important, and much less well-documented, insights. When including both the measure of trust and the respondent’s perception of employment laws as predictors in Model 4 the direct effect of the latter on organizational citizenship behavior is non-existent, whereas the influence of trust remains more or less unaffected. From these results we can conclude that there is a strong correlation between the two measures of formal and informal constraints. This suspicion is confirmed by the results in Model 6 where the trust indicator is regressed on the employee’s opinion about the rules for dismissal. The estimates reveal a strong positive relationship between the two variables.

The interesting question then is how to interpret this pattern of estimated coefficients. Is the fact that the effect of the respondent’s perception of employment laws on organizational citizenship behavior vanishes when controlling for trust in the nearest superior an indication that the relationship found in Model 1 is spurious? Or should we instead interpret the relationship as causal but indirect?

Since we are dealing with cross-sectional data we cannot solve this problem empirically. Instead we have to rely on reasonable arguments. Although we cannot rule out the possibility that trust is an important precondition for the establishment and maintenance of formal institutional constraints we believe there are stronger arguments for the opposite causal ordering: that the degree of trust in any relationship will be affected by the formal constraints governing the relationship.
This is especially true of the particular case at hand. To measure the respondent’s perceptions of formal institutional constraints regulating employment relations we asked the respondents to what extent they thought that rules for dismissal were followed at their workplaces. Given the clarity and centrality of this rule for Swedish employment relations it is reasonable to assume that an employee has first-hand knowledge whether the law is conformed to or not at his/her workplace. Thus, already being informed, an employee’s trust in the superior should not affect the degree to which he/she thinks the rules for dismissal are obeyed. The opposite scenario, however, is more plausible. The degree to which the rules for dismissal are deviated from at a particular workplace will lead to lower levels of trust among the employees.

Therefore we can conclude that the results in Models 1, 3, 4, and 6 render support to all three hypotheses. Both the degree to which the respondent thinks that rules for dismissal are followed at the workplace and his/her trust toward the nearest superior are positively related to the expressed willingness to work harder than one normally does in order to help one’s superior. Furthermore, and interestingly enough, it seems as the effect of the formal institutional constraints is first and foremost indirect and channeled via the trust indicator. Thus, when the rules for dismissal are complied with at the workplace, the employees’ trust in the superior increases, which, in turn, positively influences the willingness to engage in organizational citizen behavior.

Do these results hold when turning to the relationship between the respondents’ perceptions of the fairness of the conflict resolution rules and their willingness to engage in organizational citizenship behavior? Looking at the pattern of effects presented in Models 2, 3, 5, and 7 in Table 1 one is struck by the similarity between these results and the ones presented above. The respondent’s perception of conflict resolution rules (Model 2), as well as trust towards his/her superior (Model 3), positively affects the willingness to work harder than one normally does in order to help one’s superior. We can also see that the estimated effect of the employee’s perception of conflict resolution rules decreases when controlling for trust (Model 5) and that there is a strong positive relationship between the two explanatory factors (Model 7).

Once again these results leave the door open for interpretation. This time the argument for understanding the relationship between perceptions of the fairness of
conflict resolution rules and organizational citizenship behavior as causal but indirect rather than spurious is not as obvious. Above all, it does not seem too far-fetched to think that an employee’s trust towards his/her superior could affect perceptions of how rules for conflict resolution work at the workplace. However, the results in Table 1 confirm findings from a conceptually similar but empirically different field of research stating that citizens who perceive welfare institutions as fair and just are more supportive of the political regime and its institutions (Kumlin 2004) and more trusting towards their fellow citizens (Rothstein 2004; Kumlin and Rothstein 2005). In line with this we argue that there is good reasons to believe that the results of Models 5 and 7 indicate that a large part of the effect of the respondents’ perceptions of fair rules on their willingness to engage in cooperative behavior is channeled through trusting attitudes towards the superior.
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<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
<th>Model 5</th>
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<td>Rules for dismissal</td>
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<tr>
<td>(enforcement)</td>
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<td>(.030)</td>
<td>(.031)</td>
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<tr>
<td>Rules for conflict resolution</td>
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<td>.088***</td>
<td>.477***</td>
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<tr>
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<td>(.032)</td>
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<tr>
<td>Trust in superior</td>
<td></td>
<td>.686***</td>
<td>.683***</td>
<td>.640***</td>
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</tr>
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<td></td>
<td>(.031)</td>
<td>(.034)</td>
<td>(.036)</td>
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<td>Adjusted R²</td>
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<td>.168</td>
<td>.442</td>
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<td>.261</td>
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</tbody>
</table>

Significance levels: * < .10; ** < .05; *** < .01, two-tailed tests

Note: All models are controlled for: sector of employment, occupational status, employment status, size of company/organization, company seniority, employee responsibility, educational level, gender, and age.
Proceeding now to Table 2 the models test the effects of institutional constraints and trust on the respondents’ willingness to enter into more flexible contracts. The outcome variable measures, on a threefold scale, whether the respondent prefers “to have strictly defined work assignments” (0), is indifferent (1), or prefers “to have considerable scope for workers as well as managers to make continuous changes in work tasks” (2). In order to take the ordinal character of the variable into account the estimates in Table 2 are obtained using ordered logistic regression.4

Two overall patterns emerge when comparing the results presented in Table 2 with the findings from Table 1. First of all, the effects are generally weaker and less accurately estimated. Also, the predictive capacity of the five models is not overwhelmingly impressive. But this should come as no surprise. A possible objection against the strong effects found in Table 1 is that the respondent’s willingness to engage in helping behavior is located rather close to the two hypothesized explanatory factors in the causal chain, especially so concerning the trust variable. The same could not be said about the dependent variable used in Models 8 through 12. Employee trust and perceptions about rule compliance and fairness is less obviously connected to the stated readiness to enter into flexible contracts. Thus, we should expect somewhat weaker results when changing the dependent variable from willingness to engage in helping behavior to willingness to enter into flexible contracts.

Second, and more important, it is evident that, in spite of the less obvious connection between the dependent variable and the predictors, the pattern of estimated effects in Table 2 reveals a close resemblance to the one presented in Table 1. Hence, concerning perceptions of rule compliance all three hypotheses are supported by the results in Table 2. We can see that the respondent’s perceptions of the rules for dismissal (Model 8), rules for conflict resolution (Model 9), and vertical trust (Model 10) are positively related to the readiness to enter into less formalized contracts. When including both trust and rules for dismissal in the model (Model 11) the size of the former effect is only marginally affected, whereas the impact of the latter sharply decreases. The last model indicates that the effect of perceptions of fair conflict rules decreases somewhat when controlling for trust but remains statistically significant.

4 We have also estimated the five models using a multinomial logit specification. The estimated effects from these models are very similar to those presented here. For reasons of simplicity we have therefore chosen to retain the more intuitive ordered logit results.
The interpretation carries over from the results presented in Table 1: the positive relationship between rule compliance and willingness to enter into flexible contracts is causal but indirect and channeled through the employees’ vertical trust toward their superiors (Model 3 and 11). Concerning the relationship between conflict rules and willingness to enter into flexible contracts we can see that the positive and significant impact of perceptions of fair rules on the willingness to enter into flexible contracts is somewhat smaller but still substantially and statistically significant when controlling for trust in the superior. Furthermore, the effect of trust is no longer significant. Thus, in this particular case, the third hypothesis is only marginally supported.
<table>
<thead>
<tr>
<th></th>
<th>Model 8</th>
<th>Model 9</th>
<th>Model 10</th>
<th>Model 11</th>
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<td>.060*</td>
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<tr>
<td>Trust in superior</td>
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<td>.065**</td>
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<tr>
<td>Pseudo R²</td>
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<td>.028</td>
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</table>

Significance levels: * < .10; ** < .05; *** < .01, two-tailed tests

Note: All models are controlled for: sector of employment, occupational status, employment status, size of company/organization, company seniority, employee responsibility, educational level, gender, and age.
Conclusions

Although emphasis on institutions and trust has been fundamental in both political science and economics, especially over recent decades, cross-disciplinary studies have been scant. But in line with recent studies in *Political Economy* (Persson & Tabellini 2003), we have tried to make use of theoretical and empirical knowledge from the study of both politics and economics with the intention of formulating and testing hypotheses on the effects of institutions on the behavior of economic actors.

Well-known economists Oliver Williamson and Douglass North and their followers have argued that institutional constraints and trust among people may reduce transaction costs in market economies. In the field of political science researchers have shown empirically that the perception of relevant political institutions as fair may produce political (vertical), as well as interpersonal (horizontal) trust. By making use of these overlapping but separate theoretical frameworks, we formulated three hypotheses that we tested on data from a survey conducted in Sweden in 2006. *First*, we investigated whether the extent to which an employee perceives formal institutions as fair and duly enforced lower the probability that he/she will behave opportunistically. *Second*, we tested whether an employee’s trust in the opposite party had equivalent effects. *Third*, we examined whether an employee’s perception of formal institutions as fair and duly enforced increased his/her trust in the opposite party. All three hypotheses were supported by the data.

Our interpretation is that that there is indeed an effect on cooperative behavior and willingness to enter into flexible contracts from perceptions of fair and enforced institutions, but it is indirect. Trust, however, has direct effects and, consequently, mediates the effects of institutions as well.

As always, the study is flawed with some measurement problems, and interpretations are not totally unambiguous. The perception of fair and enforced institutions should ideally be measured using two separate questions. As it is now we have information only about the extent to which employees think that rules for dismissals are followed at the workplace and rules for conflict resolution are fair. Thus, although we are able to test the effects of perceived fairness and perceived enforcement separately we cannot tell which effect is stronger. Furthermore, to empirically solve the problem of causal order between attitudinal constructs such as
trust and perceptions about institutional fairness we need panel data. Lastly, in this article, we use data from Sweden only and cross-country comparisons would provide a useful test of robustness.

In spite of these problems the interconnection between politics and the economy is obvious. In a high-trust workplace, conditions for lower transaction costs are better. Not only are employees prepared to engage in exchange situations without specifying work tasks in a complicated contract and, hence, take the risk of exposing themselves to discretionary decisions by the managers. But employees are willing to voluntarily work harder than stipulated in the incomplete contract if they regard it as important to the company. But the important lesson here is that the degree of trust is not given; relevant institutions can create it. At the workplace, institutions regulating dismissal and conflict resolution are of course essential. While others have been discussing effects of predictable (rigid) versus flexible rules, we argue that another important aspect is to have political processes that create institutions perceived as fair and duly enforced by the parties affected by them.

Lessons from research on varieties of capitalisms have taught us that economic growth may be accomplished within several different institutional environments. Hence, it may well be that trust between employers and employees is more important in coordinated market economies which “generally entails more extensive relational or incomplete contracting” (Hall and Soskice 2001). In any case, the conclusion is that fair and enforced political institutions are at least one way to make capitalism work.
References


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