THE ECONOMICS OF TRUST

Is trust a fool's game? Or is it the only game?

By Tam Thao Pham

Trust has been a cornerstone of commerce for eons. Particularly in the modern economy, where the face-to-face exchange of physical objects has become a rarity, trust is like oxygen. Credit is based on a "trust, but verify" esthetic – or more precisely, "verify, then trust." An institution hands an individual a sizable sum of money and allows them to walk out the door having written their name on a piece of paper. A credit check, FICO score, references, and interview provide the lender with confidence that this individual will return the sum in a timely manner. There are also the depositors, who put their life savings in a bank with the assurance that they will receive it back when needed. They gain this assurance through a blue-chip brand, FDIC insurance, and sometimes a personal relationship with the bank.

The recent financial crisis shook and some would say nearly shattered the trust basis at the bedrock of our economy, as well as how quickly that trust in institutions can unravel. When these institutional trust relationships break down, so does the economy.

I define trust as the extrapolation of expected future behavior based on some body of evidence, for example credit scores and patterns of behavior. Few would argue with the notion that trust is critically important as the underpinning of our economic system. In the past, it was often a matter of honesty versus dishonesty at the transaction level: would the other party skip town with your money? Would they provide substandard product to pad their margins? But, increasingly, trust has also begun to emerge as an optimal strategy for business. With the emergence of open innovation, ideas for new products and services, and incremental improvements to the existing portfolio, will increasingly come from outside the company walls. New business models will be based on the firm as a member of a broader interlocking system that includes users, customers, vendors, partners, competitors, outside talent, and stakeholders in the community. Access to knowledge flows is becoming the new competitive advantage.

The companies best positioned for success in this new environment will be the ones that are able to build trust quickly. However, the nature of how trust is built in an environment of high information visibility and velocity – the world we find ourselves in today – is changing as well. In a transparent environment, trust will be more closely correlated with trustworthiness. Trust can be a highly lucrative endeavor. However, these gains are only sustainable if grounded in reality: businesses pursuing a trust strategy need to start focusing less on their reputational veneer and more on the underlying foundation.

Trust is everywhere

Trust is the invisible underpinning of many of the systems that surround our daily lives. Property rights in a developed market economy, for instance, are trust-based. In the United States, we do not require hired thugs and prominent signage to lay claim to real estate. Transfer of property happens smoothly and relatively quickly, with the signing of scraps of paper. This is in stark contrast to India where there is often little clarity as to who owns a piece of land, resulting in red tape, corruption, and other excess transaction costs. Effective governments with low levels of organized crime earn their legitimacy by instilling trust in their constituents that they can secure their rights and property.

The economic impact of trust is often underestimated. We have already seen what happens when trust in financial institutions breaks down. A study by economist Paul Collier also found a strong correlation between GDP growth and governance mechanisms, explaining in part why some resource-rich developing nations find themselves locked in a frustrating cycle of poverty.[1] If we cannot trust other people, institutions and the capital market, we must do everything ourselves and forego the benefits of efficient specialization.

In another example, the value of brands is based on the creation of consumer trust. When a brand is well-managed, consumers will expect a certain type of experience to be associated with the brand, an expectation engendered by consistent and coherent past experience. Even the traditional engagement ring is a trust-building exercise, establishing seriousness of intention by creating a financial commitment that is hard to withdraw.

Trust can be a lucrative venture

Being trusted can be quite lucrative. All else being equal, consumers prefer to buy and use products and services from companies they trust[2]. Between two equivalent products, preference for one over the other means a customer is willing to pay some $X more for it – the actual differential depending on the product and level of preference. Trust is equivalent to a price premium. Consumers will buy more at the same price or the same volume at a higher price from companies they trust, e.g. branded Tylenol versus generic acetaminophen. Velocity of transaction is likely to be higher as well, with lower research and monitoring costs.

Consumers are also more likely to recommend products and services from companies they trust. Google built what has been called the most valuable brand in the world[3], worth $18 billion by one estimate, largely on word-of-mouth advertising. It spends very little on traditional forms of advertising, such as billboards and newspaper ads.

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[1] Chauvet, Lisa and Paul Collier, "Development Effectiveness in Fragile States: Spillovers and Turnarounds," Centre for the Study of African Economies, Department of Economics, Oxford University, 2004.

[2] 2009 Edelman Trust Barometer.

[3] "Top 100 Most Powerful Brands 08", Millward Brown Optimor, Apr 2008.

As the cycle of innovation gets shorter, however, trust becomes more than a nice-to-have. The bases of competition are shifting toward access to external knowledge flows. Consumers are more likely to participate voluntarily in the feedback cycle for companies they trust, accelerating the product development cycle and supporting the development of products and services that more people will buy. This stream of user feedback has real value, replacing expensive and not-always-helpful paid focus groups and surveys. User innovation only works when people opt to participate. In some cases, interested user feedback and innovation are the deciding factors between a company that manages to cross the technology adoption chasm[4] safely and one that falls flat on its face.

Amazon and Netflix have shown how valuable an asset access to information flows can be. They have built entire business models around reviews and ratings by unpaid users. They are now able to leverage this information, as well as the follow-on information flows from consumer purchases, for data-mining, mass personalization, and virtual pilots of planned initiatives. However, access is contingent on the willingness of consumers to use the websites and contribute reviews – the latter ensured by Amazon's willingness to relinquish control of their customers' verdicts on products the company sells. Trust begets trust, and the presence of negative reviews alleviates concerns of either a Big Brother or hard-sell environment. For both companies, stores of data depreciate over time and need to be refreshed – a strategy that demands long-term trust relationships with consumers.

Innovation will increasingly require the willing participation of users (e.g. MySQL), employees (e.g. Southwest), partners (e.g. SalesForce), and the general public (e.g. Innocentive). At an increasing pace driven by advances in the digital infrastructure, production frontiers that were industry canon for many years are being pushed out, breaking traditional value-cost tradeoffs. Industries are being affected that thought themselves immune. Companies lacking the trust capital to learn from the larger ecosystem and co-innovate may well be left in the dust.

The many flavors of trust

Generally, there are four ways a business can be trusted:

- Competence – Can you do what I need?
- Longevity – Are you going to be around later when I need you?
- Scope – Are you focused on a defined area or will you eventually encroach on what I do, if I am a business concern?
- Benevolence – Do you care about my needs even when it does not immediately pay?

Google's ascent was based largely on the trust it was able to generate. It is, at its essence, a middleman. This search engine has become the leading platform for the interchange between consumer and corporation, viewer and advertiser, individual and world, on nothing more than the willingness of all parties to use it. As the consummate broker, it brings people together, yet

[4] See Geoffrey Moore's perennially relevant *Crossing the Chasm* (Harper Paperbacks, 2002) for more on the technology adoption life cycle

contributes (arguably) relatively little value as a standalone entity. It is not a content company and its vaunted search technology, while a few ticks above the rest, is probably not 150 billion[5] ticks above the rest.

Google's investments signal to interested parties that it should be trusted:

- Competence – e.g., hiring high-powered superstar engineers and retaining them through expensive perks
- Longevity – e.g., obtaining access to capital through an IPO in 2004 and amassing billions in cash reserves[6]
- Scope – e.g., "It's best to do one thing really, really well"[7]
- Benevolence – e.g., committing one percent of Google's equity and profits to address global issues such as clean energy, global health and information access[8]

The company has invested millions of dollars in consumer trust. This goes well beyond the high-profile philanthropic investments through Google.org. Every tiny white pixel on Google's homepage, worth thousands of dollars per year, represents a commitment to making its engine as easy to use as possible. Google could increase its revenue by an estimated 15-20 percent instantly by serving ads on its homepage. Instead, when Google adds a word to its spartan homepage, it seeks to subtract a word elsewhere. These actions convey an implicit regard for the time and attention that its users are investing.

Furthermore, placement in organic search results on Google has never been sold, in contrast to other search engines, so users have confidence that the results they see are the best results that can be found.

Finally, at least twice in its history, Google has deliberately reduced its own advertising revenue by removing ads with low click-through, on the premise that ads with low clicks are negative-value clutter for the user. How often does a publicly traded company purposefully reduce its revenue? Trust is not blind faith, but a rational response to a pattern of consistent behavior.

Google is not alone in its ability to derive significant economic value from instilling trust. Netflix has tripled its revenue in the past five years[9] using a highly effective personalized video-recommendation system based on user ratings, called Cinematch. Cinematch is so accurate that a Netflix contest with a $1 million award to the team that could improve Cinematch's results by 10 percent ran for three years before the main prize was won[10]. Without users constantly providing

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[5] Difference between market capitalization for #1 search engine Google ($175B) and the #2 Yahoo ($24B), as of October 25, 2009. Rankings from ComScore, September 2009.

[6] Google 2008 Annual 10-K filing

[7] One of ten core tenets of "Our Philosophy," Google corporate website, October 25, 2009.

[8] Google.org website, "Our Structure" and "Grants and Investments," October 25, 2009

[9] Netflix 10-K filings, 2004-2009

[10] Netflix Prize website, October 25, 2009

data on new movies and high-performing employees implementing incremental innovation, this level of accuracy would be difficult to sustain. Netflix maintains this competence by offering its salaried employees exceptional autonomy, including unlimited vacation, zero face-time requirements, and allowing its employees to decide how much of their salary they want in stock options. Trust is a two-way street.

The dynamics of trust are changing

In an increasingly uncertain world, trust is a lubricant that eases risk for both sides of any partnership or transaction. However, despite its growing importance, people are trusting less of late. Increasing transparency is allowing people to see through false veneers, resulting in disillusionment within the general public. Confidence in authority is faltering, according to nearly every study, with significant declines in public trust of journalists, politicians, policemen and CEOs during the past five years[11]. Trust is falling in every sector[12]. People trust big business the least, according to the Chicago Booth-Kellogg School Financial Trust Index, which showed that only 10 percent of Americans trust large corporations. Globally, 62 percent of people trust business less than they did a year ago[2]. We are seeing how we have been duped.

Greater information visibility and velocity are a trend, not an anomaly. As consumers gain access to more information, including the true costs of the products and services they consume, businesses will need to navigate this new environment. Companies seeking to be trusted will need to think hard about how to become trustworthy.

Brand loyalty is generally on the decline, and concentrated among a very few iconic brands[13]. Switching costs are dropping as options proliferate and technology lowers transaction costs. Open innovation is rising in importance, suggesting that the big new ideas will come from people who don't carry your logo on their business cards.

All companies must adapt eventually – the question is when? A fast-following copycat may win itself survival. However, consumers being knowledgeable and often cynical, copycats are less credible and therefore less likely to earn the excess returns that a trailblazer in trust will enjoy. The new iconic brands of the future may well be the companies who led the way.

A hard-won asset

It is hard to argue with the notion that companies should invest in building trust, but the problem is that trust is hard. It is an expensive and low fault-tolerant endeavor.

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[11] "Trust me, I'm a judge," *The Economist*. May 5, 2007.
[12] 2009 Edelman Trust Barometer.
[13] "Brands bruised in a battered economy," *Orlando Sentinel*, Sept 2009.

Trust is a hard-won asset – it is not faith. In a business setting, sustainable trust is created through a pattern of consistent behavior that elicits a rational expectation of future behavior. Increasing transparency makes this truer than ever. The average individual needs to hear a piece of information three to five times, ideally through multiple channels, in order to find it credible[14]. Even a single conflicting data point can leave a residue of doubt.

In studies of negotiations, "tit-for-tat" strategies have repeatedly been shown to be the most effective way to maximize mutual gain in an extended game, i.e. you establish a pattern of behavior and punish the other party when he steps out of line by mirroring his action. Once a pattern is established, trust develops over time with continual affirmation. This "proof first" mentality does not mean that trust is at the end of the day a cynical endeavor, but rather simply an honest one. Trust is engendered by the patterns and the investments. It is not binary, but rather a matter of degree - "confidence" in the statistical sense.

This means, however, that trust is vulnerable to having the basic pattern on which it is based broken. As Warren Buffett has said, "It takes 20 years to build a reputation and five minutes to ruin it." If a company takes an action, it not only performed the action, it is now the kind of company that does that kind of thing in the eyes of the public. Once we know a friend has lied to us, we see them in a different light. We tend to extrapolate the future using the patterns in our historical data set. This is why people who lived through the Depression are forever penny-pinchers. The world as they experience it became a different place with one new data point.

The challenges of a trust strategy

There is no such thing as a permanent first-mover advantage or lock-in, even in an industry with significant network effects. Just watch the shifting fortunes and market shares of online marketplaces and social networking sites which formerly held commanding market positions. Short-term profit-maximizing actions which seem to make sense from a business standpoint could initiate a slow unraveling of the network effect and the business models on which they are dependent.

The bar is set especially high for companies from whom much is expected. Netflix was faced with a class-action lawsuit based on its relatively innocuous practice of prioritizing shipments to customers who rent fewer discs per month (on their flat-fee service). Google China's decision to abide by local censorship laws, blocking interdicted words, has drawn criticism from many quarters. Arguably, these companies incurred more damage to their reputation than their peers might have been because of the higher standard they set for themselves.

Sustaining a trust strategy is particularly challenging for companies seeking growth. Netflix had to craft a human resource policy that would scale and retain top performers by offering autonomy, even as they experienced enormous growth. Google's stated mission, to organize the world's

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[14] 2009 Edelman Trust Barometer.

information, was originally viewed as a high-flying pipe dream, but companies that are in the business of selling information are no longer smiling. Google's future growth may well be tied to the willingness of partners to cut through the red tape in negotiations and join coalitions. It remains to be seen what will happen as the company's size and scope threatens former allies.

Businesses who undertake a trust strategy incur risk, but the alternative is only a different kind of risk: market share erosion, e.g. unraveling of network effects and brand devaluation. Over a 12-month period, 77 percent of 25-to-64-year-olds in a survey had refused to buy a product or service from a distrusted company[2]. As in any trust relationship, it is difficult to recover once you are in a disadvantaged position.

Trust and risk

More broadly, companies also need to consider how to manage risk in a trust-oriented corporation. Some degree of process failure must be accepted. For instance, in one professional services firm, employees can submit any expense under $25 without receipt. Instances of dubious expenses submitted occur but are rare, despite the infrequency of audits. The firm not only saves on monitoring costs, which can be significant in a large decentralized firm, it also raises the productivity of expensive knowledge workers and signals a trust-based, talent culture.

Companies are especially reluctant to relinquish control of information, an area that has been historically centralized. Some intellectual property will always remain closely guarded. However, the desire to retain close control of company reputation and IP can be counterproductive at times, exhibiting itself in ways that actually do harm to reputation. Examples include defamation lawsuits over blog postings, monitoring of employee Facebook pages, terminations based on Twitter postings, and draconian new-employee agreements.

A framework for recovery should, however, be in place to guard against irreparable harm, as in the oft-cited Tylenol scare in 1982. Because Johnson & Johnson made a strategic decision consistent with their credo to recall 31 million bottles after a series of deaths from tampering, their brand emerged stronger than ever.

When in doubt, it would seem most sensible to err on the side of trust. However, a few types of process failures may be considered so high-impact as to be intolerable. Strictures and close monitoring should be instituted around these specific areas, keeping in mind that trust does not mean naiveté. A tiny subset of the population will seek to do harm, and a large company must be pragmatic enough to recognize that this subset may be represented in their employee and customer base.

Developing a trust strategy

A trust strategy must be implemented in the context of the overall business strategy. What distinct form of trust should a firm invest in? Should it be a trusted information broker, an information

filter, a comfort brand, a consultant? What level of trust is necessary to generate the behavior it seeks? Resources are finite and there is a cost to building trust-based relationships.

A web-based email provider, for instance, needs to focus on the first two dimensions of trust, competence and longevity. A web-based email provider that experiences daily outages will see its users leave in droves. Likewise, the suspicion that the provider may shut its doors, taking user emails with it, will result in an exodus as well. The bar is even higher when considering the conservative large-enterprise market, with cloud-provisioned email accounting for only a tiny fraction of large-enterprise seats[15]. It will take some time before large corporations are comfortable enough to adopt cloud email widely. Even the rare outages on current web-based email are too many for enterprises seeking near six-sigma uptime.

It is noteworthy that two-thirds of the population are late adopters[16]. These late adopters are represented in nearly every geographic slice and demographic segment, including managers and executives with purchasing authority. Companies selling new technology to late adopters and enterprises tend to focus solely on communicating value, and neglect the trust aspects. Yet, in online banking, for example, the value of a trust-based strategy may well be immense. These firms should complement sales efforts with strategic moves to prove rock-solid competence and signal their longevity. How to do so will vary by industry but could include, for instance, audited statistics, public offerings, and strategic partnerships.

In contrast, a company seeking to play an information broker role in a two-sided market, or own an industry-critical standard, must allay suspicions that they may act with unfair bias or enter the market themselves. Here, the last two dimensions of trust are key – scope and benevolence. A company can forestall friction with potential partners by making strategic public statements, financial commitments, or structured agreements. At the end of the day, however, trust always comes down to the long-term pattern of behavior. A company with a compromised reputation may need to do something dramatic, such as replacing the leadership team, to dig themselves out of the hole. Even then, it will take time for the company reputation to recover.

Companies will also need to think about the four dimensions of trust in relation to their stakeholder groups. The relationship with each group could be different. If you are a major consumer-health products company, how you interact with shareholders, caregivers, patients, partners, employees and local communities will probably vary depending on the group. If you are an Internet platform with multiple constituents, you have to prioritize among users, advertisers, developers, and sometimes publishers. If you are a creative talent-driven company with "category of one"-type employees, you might put your employees first. The type of relationship a company has with each of its stakeholder groups should be based on desired outcomes.

[15] "Gartner says E-mail will lead the charge into mainstream adoption of cloud computing," Gartner press release, July 2008.

[16] Solomon, Michael. Conquering Consumerspace: Marketing Strategies for a Branded World. AMACON, 2003 (48)

Lifting the veil

Enormous improvements in the digital infrastructure are altering the way we interact and do business. Wonderfully, as information flows more freely, the ability for malefactors to falsify proof with impunity will continue to decline. We are left with a world that looks more like it actually is.

Henry Hazlitt, in his classic *Economics in One Lesson*, wrote, "Credit…is something a man already has." Similarly, trust is earned through consistently trustworthy behavior, especially in an environment where behavior is harder to hide. For a business seeking to navigate an increasingly transparent environment, the best strategy is to earn trust-based relationships by embedding the underlying "first principles" into the company DNA and daily behaviors. It is an investment in the technical sense and a potentially lucrative one. It is not without risk but the few bold executives who have a long-term perspective and the incentives to undertake the venture can earn outsized rewards.

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