
TRUST & RELATIONAL CONTRACTING

EXTRACT FROM MDL PAPER ON RELATIONAL CONTRACTING

1.0 THE RELEVANCE OF TRUST IN CONTRACTING

- 1.1 The role of trust in building relationships is fast gaining ground in the theory and practice of purchase and supply and the formation of partnerships, in business and, overseas, between public agencies and community services. This is not to do with "feeling good". There is a growing body of experience in the commercial world showing that trust-based relationships between buyers and sellers produce significant economic and strategic benefits in the form of sustainably lower costs of doing business and greater ability to meet strategic goals. The shift in business practice is towards managing relationships, from managing contracts.
- 1.2 The application of trust to public administration is complicated by the high levels of accountability required in the use of public money. It does however carry practical fiscal benefits (there is a growing recognition that there are fiscal risks associated with an absence of trust). Furthermore, high levels of trust will be important to Government if it wishes to rely in the future on the commitment voluntary organisations bring to the services they provide end users/clients, to fulfil Government policy objectives.
- 1.3 As reasoned in literature on the economics of trust, cost and trust are inversely related: the absence of trust requires resort to rules and compliance to regulate relationships, in turn incurring higher costs in the specification, negotiation, management and monitoring of contracts. A trust-based approach is inherently lower in transaction and compliance costs.

From business experience: "For relationships to bloom and achieve their full potential, they must have a degree of flexibility and informality. Long, detailed contracts are inconsistent with building relationships based on trust and simply tend to get in the way. Companies that base their relationships on trust either have minimal contracts or do away with contracts altogether. What holds these relationships together is not legal force but mutual obligations and opportunities rather than legal force."¹

1.4 *A definition of trust*

¹ The Power of Trust in Manufacturer-Retailer Relationships", Nirmalya Kumar, Harvard Business Review, Nov-Dec 1996, p 105.

The essence of a trust-based approach to contracting is that it rests on an understanding that each party should benefit from the relationship.

Trust can be seen as a rational form of cooperation which recognises risk - it is based on a hypothesis or prediction of how the other party will act, adding to that a judgement about how that action will affect the 'trustees' interests, weighing up likely benefits and costs. Finally, it rests on repeated tests of the trust invested in the other party. If those experiences support the trust invested, for example if cooperation is met with cooperation, trust becomes self-reinforcing (which is why trust is seen in the literature as fundamental to building social capital).

- 1.5 A trust-based approach does however need to be seen as requiring a longer term focus than the short-term funding contract, since by its very nature trust is the result of repeated experiences that either build trust or undermine it. It is a process of trial and error.

2.0 TRUST-BASED (RELATIONAL) CONTRACTING

2.1 The Relational Contract Model

2.1.1 The central premise of relational contracting is that it is trust-based, while still allowing for a legal core. A relational contracting approach implies:

- Moving towards commitment to common goals (outcomes).
- Recognition of and respect for the roles and expertise each has independently of the other.
- Risk allocation that involves agreed risk-sharing (including policy risks) between the parties, and, conversely, mutual acknowledgement of the gains from the relationship.
- Each party well-informed about the other, with appropriately open communication.
- Each party motivated to maintain credibility and reputation with the other, and ultimately with the client group the service is designed to serve.

2.1.2 The rationale of relational contracting is the value that accrues through taking a multi-year, holistic approach to the contracting relationship, rather than focusing solely on exchanges taking place at any one point of time. The contract contemplates a future relationship, rather than being conducted separately from that possibility.

2.1.3 Relational contracting has equal relevance to achieving desired policy outcomes, because it creates an environment that implicitly and explicitly promotes qualitative, or process, 'outcomes' such as co-operation and collaboration.

2.1.4 Over time, a relational contracting approach can potentially allow formal specification to be replaced, to a degree, by flexibility in the terms of the relationship and how it is managed by each party.

2.1.5 Relational contracting is of most relevance when Government funding has an 'investment' purpose, ie:

- When the funding is meant to achieve something more than defined outputs;
- When the service being funded is expected or intended to give rise to positive benefits in the wider community in which the outputs are being delivered;
- When the Government expects to want to "re-purchase" and there is a need for the funder and the provider to be focusing not just on the supply of outputs, but on acquiring an understanding of each other's objectives;
- Where collaboration rather than contestability or competition is the best way to reduce risk and promote innovation.

2.1.6 There are quite challenging conditions required of **both parties** to make relational contracting work in practice. The range of critical success factors includes the requirements that:

- Each party relinquish some of its independence, ie becomes more inter-dependent on the other (literature suggests that an organisation cannot build trust while seeking to maintain leverage over another);
- Both parties believe they will gain by becoming a more valuable resource to the other;
- Both parties acknowledge that the other will prize its self-sufficiency, and that inter-dependence does not equate with loss of this;
- The relationship involves sharing sensitive information, investing effort in understanding each other's business and customising systems to serve the mutual interests in the contract better.

2.2 Benefits

2.2.1 The benefits of relational contracting are very significant in terms both of efficiency and effectiveness.

2.2.2 Efficiency

Efficiency benefits arise from:

- Reduced transaction (informational) costs in the short term: relationship contracting relies on complementary expertise and information rather than each party inventing its own, or buying in, expertise and information the other party can bring;

- Reduced transaction (uncertainty) costs in the medium to longer term: more reliance on trust reduces the impact of uncertainty on achieving objectives desired from the contract, since trust reduces friction and opportunistic behaviour;
- Reduced compliance costs: cost savings are generated by reducing the need for close specification and monitoring;
- Less reliance on regulation: lighter control;
- Generally, easing working relationships.

2.2.3 Effectiveness

The funder's interest is not simply a least cost one. Relationship contracting enhances the likelihood of achieving policy objectives through:

- Encouraging collaboration over the use of scarce resources;
- Making it easier to adapt the contract to changing circumstances and priorities, without loss of focus on outcomes;
- Supporting the development of networks;
- The potential for the funder to be an important element in assisting the service organisation to develop ongoing capacity and capability;
- Helping create conditions favourable to the engagement of third parties such as employers, other community groups and local authorities;
- Creating a reservoir of goodwill that helps 'weather the situation' when one party fails in some way, as can happen.

2.3 Limits

2.3.1 It is necessary to recognise the limits on trust as the basis of contracting by Government, both to ensure expectations are realistic, and, paradoxically, to make it work:

- Regardless of the degree of trust between the contracting parties, there will always be areas of difference because the two parties will inevitably have some goals that are different.
- Any element of contestability will always carry some tension between the contracting parties.
- Trust is rarely all-encompassing: each party will trust the other on some things and not others; and there will be legitimate reasons for holding back on such things as the provision of information.

2.3.2 Perhaps most of all, there will be challenges for both parties in adopting a trust-based approach. For reasons of accountability, for example, both parties will need to recognise that the other may wish to monitor their trust of the other's actions, including checking on areas of distrust.

2.4 Steps Towards Relational Contracting

2.4.1 A shift towards relational contracting can be supported by a number of practical measures.

2.4.2 *A Longer Time Horizon*

As noted above, one characteristic of relational contracting is that it has a longer term focus than is typical of conventional contracting. It therefore requires integrating a longer time horizon into contracting systems and into individual contracts.

It is quite possible that this can be achieved within a system of annual contracting, and even single year contracts if those are approached with a direct understanding of the kinds of outcomes the contract is intended to create. There does however need to be an expectation of future contracts to sustain the focus on outcomes.

2.4.3 *Outcomes Focus*

For a whole variety of reasons² budgeting and contracting on outcomes has taken time to develop in Government and most contracts are still written in output terms.

There is however scope to adopt "intelligent" output-based contracting that builds in some of the strengths of relationship contracting. This would for example involve the contracting agency knowing, in advance of going to contract, what it wishes to achieve over time through the contract, even if outputs are specified and funded short-term. Another example would be to recognise, when renewing a contract or re-tendering for outputs, that the existing provider will have some of the institutional knowledge the contracting agency requires and to factor this explicitly into the next contract decision.

2.4.4 *The Status of the Parties in the Contract*

As has been discussed earlier in this paper, most contracting relationships in practice are unbalanced and favour the funder.

A key to breaking through this barrier is for the contracting agency to treat the service organisation fairly - in terms both of fairness of outcome for the parties (how the benefits and loads are divided) and fairness of procedure (the process for managing the contract).

Both forms of fairness are important in establishing trust, but procedural fairness may in fact be considerably more important because the contractor will be seen as being always in control of its own policies and practices, whereas outcomes will often be influenced by factors external to both parties.

² Set out for example in OAG reports.

Practical steps to consider in achieving these two kinds of fairness are:

Fairness of outcome - having the funder accept some responsibility for the health and viability of the service organisation, such as by paying a value that allows the service organisation to invest in improving services to the client group.

Fairness of procedure - adopting as matters of practice bilateral (rather than unilateral) communication including frankness by the funder of its own shortcomings, and encouraging the service organisation to disclose problems with meeting the terms of the contract when they arise; having ways to air concerns and appeal decisions; taking care to explain the rationale for decisions; being familiar with the local conditions under which the service provider operates; acting with respect for the service organisation and the people in it.

Both forms of fairness obviously carry a cost to the funder in direct costs and in the effort, energy, change in organisation culture and perhaps re-organisation they call for. But fairness may be less transaction-costly in the medium and longer term because of better results and efficiency from improved services, and more productive relationships.

2.4.5 *Providing Evidence of Trustworthiness*

As with reputation, in any organisation, building trustworthiness takes time. It can be demonstrated on a number of fronts:

- By consistency and predictability so that the other party knows what to expect.
- By transparent and clear actions which the other party can 'read'.
- By clear expression of intent.
- By acknowledgement of funding constraints on both sides.
- By being open to the likelihood that either side will pursue sectional interests, without necessarily being in conflict with the funding contract.

2.4.6 *Internal operational conditions*

These will include:

- Good internal communication and delegation.
- Clearly expressed outcome statements and strategies.
- Consistency in the application of rules.

2.4.7 *Personnel management*

When trust-based approaches have been adopted in business, it has been found necessary to allow time and opportunity for trust to evolve through the staff at various levels on both sides. This means low staff turnover, or alternatively a team approach so that the contracting relationship is less dependent on one person.

3.0 RELATIONAL CONTRACTING AND IMPLEMENTATION

- 3.1 Full relational contracting clearly involves a philosophical shift as well as significant changes in systems and procedures.
- 3.2 It is more demanding of contract design and management and would put stronger disciplines on the contractor. For example, establishing a trust relationship would require the funder/purchaser, who is usually in a monopoly position, to take the first step.
- 3.3 Specific changes are possible however that would represent an achievable shift in the direction of relational contracting, not necessarily its wholesale adoption. The suggestion above of "intelligent output-contracting" is one avenue that should be explored.
- 3.4 Much that characterises relational contracting is true of effective relationships generally.
- 3.5 Ideally, methods of contracting should be evaluated against the benchmark of trust and relational contracting, as well as against immediate changes sought in current contracting practice.