Representative Agency: The Fundamental Trust Relation of All Social Structure

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Abstract:
Representative agency is defined and illustrated as a fundamental building block of every social organization. An analytical framework emerges that is used to reformulate the normative paradigm advanced in Milton Friedman's famous (1970) essay identifying maximization stockholder profits as the sole social responsibility of corporate managers. The paper's representative agency framework clarifies moral duties for both principals and agents who are bound together in long-term trust relations. The framework renders superfluous much of the existing distinctions claimed to differentiate stakeholder from stockholder analysis of social organizations. Representative agency is simply portrayed as a resource control mechanism, constituted as a durable trust relation, capable of application to social /business/governmental institutions, but requiring investment in character development and other techniques for ultimately making it accountable and more productive than associations secured by more extensive government regulation, monitoring, enforcement effort, and private transaction costs.

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Reliance on someone else's trustworthiness is dangerous, and only potentially useful. Trust is a dangerous act because it creates vulnerabilities and exposes one to the potentially catastrophic consequences of trust violations. Trust can be extraordinarily beneficial when mutual trust between individuals is validated by reciprocal acts of cooperation. From a social perspective, mutual trust relations are capable of increasing productivity, strengthening organizational cohesion and creating individual peace of mind.

Two different usages exist for trust. The first is *unilateral* trust, expressing confidence in social procedures and institutions: "I trust the municipal court system to produce reliable results," or "I trust FDA safety regulations for guiding health decisions." Unilateral trust can not be reciprocated because social institutions and procedures are inanimate, and incapable of trusting a person. Unilateral trust expresses an individual's degree of confidence without attributing specific causes for confidence.

This paper focuses on *multilateral* trust, mutually reciprocated trust between two or more individuals. Examining mutual trust leads to better understand of the moral and policy dilemmas at the core of social organization, and thereby clarifies why historical attempts to build stable, productive societies have always struggled with questions of how trust relations ought to be promoted and regulated. Answers require better understanding of how mutual trust can be maintained, and in what ways do trust violations weaken confidence in social organization and diminish organizational efficiency and reliability.

This study is premised on my belief that if blueprints for *ideal* government and business organizations, or well-honed versions of constitutional/legal systems, were exported to populations lacking abundant mutual trust relations, nothing would work as anticipated. Existence of mutual trust relations, in the form of *representative agency,* is fundamental to building effective social organization. My thesis is that widespread breaches of trust, or diminished numbers of well-functioning trust relations in a society, must surely lead to diminished voluntary cooperation, less efficient government and businesses organizations, and more extensive reliance on police powers and forms of slavery – in general, a withering away of the foundations upon which individual freedom and social prosperity depend.

The Fundamental Trust Relation

Mutual trust between individuals, implemented in the form of representative agency, requires at least one individual in the relation to find it in his/her self-interest to act in the interests of another. In essence, being a representative agent means choosing to be a servant![1] For example, a pure form of representative agency is created when I choose to assign *power of attorney* to you, and you choose to wield that power in fulfilling my interests rather than use it to serve your own personal, private ends.[2] Power of attorney and similar arrangements that convey fiduciary duties to servers, establish potentially useful, yet dangerous, associations. The individual who agrees to act as a representative agent takes on extensive responsibilities, making that person accountable

[1] I use the word *servant* with intended effect. Social organization depends on individuals being willing to act in ways that enhance the well-being of others, but representative agents do so as a means of achieving self-satisfaction. Performing the role of trusted servant merely requires that the experience be considered personally fulfilling. That it is productive for society may or may not influence the decision to serve. Neither must individuals in trust relations feel subservience or hold attitudes of self-insignificance. Conceptually, an elected representative is the electorate's servant, yet officeholders are typically not regarded as servants, nor do they think of themselves as insignificant persons. On the contrary, trusted servants can, and regrettably often do, act with excessive pride and condescension toward those they are pledged to serve.

[2] Note that trust relations do not require altruistic motivation from participants. Although, assigning decision-making authority to representative agents *does* suggest that both assignors and assignees should exercise prudence and due care. I maintain the working assumption that altruism is neither (1) a reliable source of personal motivation, nor (2) enough of a tangible character trait for support of trust relations and consequently social organization. Since altruism cannot provide a consistent, verifiable basis for mutual trust, trust relations are typically based on extrinsic evidence of trustworthiness. Reliance on altruism for social policies is likewise problematic. Testimonials of altruistic motivation do little to reduce risk in trust relations.

to one or more principals. The standards of accountability are often set by professional associations of servers, but ultimately rest on society's legal system.[3]

When you and I initiate a trust relation through self-interested decision-making, the end result for society is that a greater sum of resources will be devoted to serving *principal interests*. There results a redirection of time, special skills, and effort on the part of the representative agent. This augmentation of decision-making authority causes the agent's acts to become the equivalent of the principal's acts – for creating liabilities, disposing of assets, making gifts, paying taxes, et cetera – and creates a bit more social organization, whether it be private, government, or mixed public/private organization.

Political Trust Relations

Incentive for creating a representative agent relation begins with a principal's desire to *extend governmental span of control* over a larger sum of resources in society. For example, to expand the scale and/or scope of governmental power regulating the actions of otherwise free agents, would-be representative agents are encouraged to entice principals to entrust their collective interests to them, and make the case that their principal self-interests will be more efficiently met when expanded governance is delegated to the group's most trusted agent.[4] In political applications, a single agent may be shared by many agents who have polled interests.

[3] Existence of accountability standards are not contradictory to trust; external standards are complements, making trust relations less risky and a more (mutually) reliable as a basis for social organization. The problem is that effective accountability and compliance requires policing and judging. If enforcement of trust violations weakens, trust relations become more risky and costly.

[4] The phrase "acting in one's own self-interest" needs clarification. Economists use this phrase in a variety of ways. First, it does *not* mean that individuals (1) never make mistakes, or (2) always aim for narrow, selfish consequences. Economists usually mean to convey that individuals show variety in how they interpret which consequences will best serve their individual sense of well-being. Therefore, acting in self-interest is a subjective assessment of what is best from an individual's own, unique point of view. Yet, despite the variety of individual conceptions of well-being, individuals hold in common a few characteristics in the way they seek to fulfill individual self-interest: (1) they do consider consequences that their actions will have on others; (2) they do consider possible reactions and return-consequences from others; (3) they try to avoid unintended consequences of their actions; (4) they consider consequences that their acts might have on their personal reputation; (5) they seem to distinguish short-run from longer-run consequences of their actions. The best discussion I can recommend on this topic is written by non-economists: Tibor R. Machan and James E. Chester, A Primer on Business Ethics, Rowman & Littlefield (2002), especially Chapter 3, "Self-Interest, Egoism, and Business," pages 59-72. A summary of growing evidence supporting this view of "acting in self-interest" is presented by Bruce Bower who characterizes the attitude as "I got mine, and I'll get yours, too, if you give me half a chance." See "Yours, Mine, and Ours," Science News, vol. 153 (March 28, 1998) p. 205-207.

Competition for the role of agent may be exceptionally limited or extensive depending on how democratic the agent selection processes is.

Since numerous principals many have to act jointly to consign governance to a shared agent's control, each individual principal faces a difficult task of maintaining personal trust with the agent. Over time, individual consent to the shared process may weaken or strengthen and trust in the assigned agent will vary. By collectively placing resource control into a shared trust relation, principals must be assured (at least implicitly) that they will gain more efficient governance than they could expect to achieve by either direct self-governance, or alternatively, by using a non-governmental (private) means of controlling their shared interests.

Likewise, agents who are *shared* in this way face the task of serving a *sum* of principal interests. Thus, shared agents find it more difficult to discern individual interests and maintain the trust relation with principals, relative to serving the interests of few or a single principal. In general, shared representative agents cannot perfectly or consistently serve all principal interests, however the criterion of performance is not perfection. They must simply be capable of better serving principals' interests than principals could do using alternative, or less, social organization.[5]

Trust Relations in Business Organization

A trust relation for business begins with a principal wanting to expand control over greater quantity of production resources. Controlling more resources generally requires additional *help*. Without a facilitating change in control technology, the principal must persuade another, or several other individuals, to rely on promises that they will realize a better future if they serve the principal's interests in expanding production capacity. Potential helpers must decide if joining the team, and learning to reliably represent the principal's interests, will be more rewarding than might be realized acting independently, or serving other business interests.

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[5] My description smacks of methodological dogma about "purposeful" and "goal seeking" behavior. But as Hodgson has written," … Armen Alchian (1950) argued that maximizing behavior by economic agents does not have to be justified in terms of their explicit objectives but by (outcomes) … and thus 'fit' firms and individuals are the ones that are most likely to survive and prosper." See Geoffrey M. Hodgson, Economics and Evolution, University of Michigan Press (1996) p. 217. Other economists have followed Alchian's lead in minimizing the specificity of the assumed "rationality" that presumably motivates principal and agent behaviors. The behavioral assumptions utilized in this paper are chosen to make examples and illustrations more plausible, not to justify any specific policy conclusions.

As a firm's principal and owner, I am responsible for building confidence and trust, assuring that each additional representative agent can commit with confidence and modest risk to serving my interests. Ultimately the goal is to establish reciprocated, mutual trust. Part of a principal's trust-building task is to establish a clear, fair plan for sharing the rewards that accrue from expanded production capacity.

Costs of Commitment and Protection

The preceding examples of representative agency differ significantly. The first (political) example allows the interests of many principals to be represented by a single agent. The second (business) example allows many representative agents to act in the interests of a single principal. Below, I describe in greater detail the fundamental trust relation of modern corporate organizations, organizations comprised of many principals and many representative agents. Yet, regardless of the number of either principals or representative agents, the crucial ingredient for success of a representative trust relation is commitment one person to serve the principal interests of another. Despite the fragile nature of maintaining interpersonal commitments and the integrity of promises, trust relations have historically facilitated huge expansions in the scale of resource control and the complexity of social organization.

There is great variety in the types of help that principals can recruit to enlarge social organization. Principals must have information about alternative types and sources of help. Over time, this need for costly information has stimulated growth of *job markets* – institutions that organize offers to supply help, facilitate advertisement, and make the quality of labor acquisition more predictable. Diagram 1 represents the spectrum of alternative helpers, simplifying helper quality to a single dimension -- the amount of relative trust associated with each category of help.

Diagram 1

LEAST TRUST	slave	employee (mercenary)	representative agent	MOST TRUST

Slave help is characterized by compulsion and minimal expectation of mutual trust or reciprocated loyalty. Principals therefore depend less on remuneration and more on coercion to gain slave services. Typically slaves are held in an organization by force of law. The most common means of getting helpers committed to a slave relation is through personal debt -- obligations to repay past credit in exchange for gaining back some job mobility. Slave relations are the most costly source of help for principals, as well as society, to maintain. A lack of trust must be addressed with costly monitoring, security devices, and extensive enforcement of rules. Users of slave help avoid the costs of developing minimal trust. However, they then lose the cost-saving benefit that trust provides for securing and maintaining reliable labor services that serve owner interests.

Employees are the most common source of business help, and they exist in wide variety – from short-term, at-will relations to shared ownership with extensive job-tenure protections. The distinguishing characteristics of employee sources of help are: emphasis on monetary compensation/benefits, legally enforceable contractual obligations, and explicitly specified accountability standards that de-emphasize reliance on mutual trust, often prohibiting helpers from making independent production decisions. Employees require vigilant, rigorous monitoring of performance, and are therefore a costly alternative to trusted agents who typically work faithfully (serving the principals' interests) without strict supervision and continuing instruction. For this reason, employers selectively engage some employees in long-term relations, developing some trust with the hope of sharing mutual gains. Rewards from long-term employment of more trusted employees take the form of marginally greater compensation to the employee and reduced employment maintenance costs to the employer.

Representative agent help also exists in great variety. A majority of representative agents share some of the characteristics of long-term employees. For example, the Governor of California technically is a state employee. However, most citizens regard the Governor as a representative agent serving the interests of all California residents -- regardless of whether one voted for the Governor in the most recent election, or for that matter, is even registered to vote. The characteristic that determines whether a manager is a representative agent is the degree to which there are trust commitments (relative to force and/or legally enforceable contract provisions) that bind the principal and agent to their relation. Clearly, residents of California do not expect force of law or personal monetary rewards to predominate as the primary motive for their Governor to serve their interests.

Implicit in Diagram 1 is the proposition that an across-the-board diminution in mutual trust will minimally affect relations on the left extreme of the trust continuum, but would maximally affect the cost and efficiency of helper relations toward the extreme right end of the continuum. This means that a decrease in mutual trust between politicians and constituents poses a much greater threat to social organization than a harsh breakout of work-rule hostilities between business employees – such as trade specialists, union leaders, and their plant managers. The later rely more on rule interpretation and contracts, whereas the former depends to a greater degree on trust commitments. A general weakening of mutual trust will not affect slave relations as much as employment relations. Workers who are heavily in debt to labor organizers, and whose labor is contracted-out to sweatshop bosses, are much more characteristic of slave help than employees who enjoy market alternatives. Although breakdowns in mutual trust will reduce efficiency in all helper relationships and cause some loss of efficiency in all social organizations, the resulting losses are proportional to the degree of trust that principals and agents rely on in their relationships.[6] To this point, I have focused on the definition of representative agency, describing the competitive environment in which principals organize help, characterized effects that this can have on social organization, and called attention to the incentives that individuals have for initiating mutual trust relations.

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[6] Trust relations have productivity implications. Improving trust, so that some force and contract enforcement activity can be diminished, can improve efficiency for those engaged in joint production and this will yield a bit more surplus for sharing. The point is that mutual trust in the adherence of commitments to others involved in production efforts may permit a revised resource allocation – one that is superior for everyone compared to any allocation reached by less cooperative actions, less-trustful relations. Yet, mutual trust strategies hold "… vast potential for damage and waste." See page 6, Edmund S. Phelps, editor, *Altruism, Morality, and Economic Theory*, Russell Sage Foundation, (1975). The relevant question becomes, which cooperative actions taken by principals and agents will promote the former and/or discourage the latter? Once initiated, how will principals and agents maintain and enhance trust and fidelity in their relations over time?

Longer-Run Considerations

Now I describe the *core functions* that representative agents are expected to perform over time for principals. Remember that representative agents are not expected to act out of charitable motives, nor possess any long-term willingness to self-sacrifice for principals, although in real world competition for livelihood, such motives can not be completely ruled out.

Prospective representative agents are assumed to have a clear sense of self, and when not committed to act in the interests of another, will act self-interestedly. However, they are not assumed be selfish, meaning that they would reject any or all offers to do work that merely furthers the interests of another, nor are they incapable of keeping prior commitments to others if an opportunity for selfish gain arises in the present. Representative agents must be able to anticipate the reactions of others in interactive competition to the point of being able to intuit the ultimate consequences of fairly complex interactions.[7] Additionally, trustworthy representative agents who are committed to serving the interests of principals are willing to search diligently for winning competitive strategies for their principals, and do so without becoming cynical toward serving the interests of others -- that is, becoming deceptive or devious. Trustworthy agents are expected act within bounds of the legal/cultural rules that govern their behavior, even in highly competitive environments, consistently adhering to a short list of shared moral values. Sadly however, not all representative agents will remain worthy of the trust they receive. Below, I expand on the theme of uncertainty and risk associated with possible trust violations.

Representative agents are expected, without exception, to be responsible and accountable to principals. That is the nature of their trust relation and commitment. Principals are expected to honor promises they make for sharing benefits produced by the trust the relation. Over time, if a trust relation is working as expected, mutual efforts will be made to deepen, and make more secure, the trust-commitments that bind principals and agents together. Because shared gains are realized over multiple time periods, principals and representative agents experience increasing

[7] In the language of game theory, representative agents can intuit outcomes by backward induction – not because they are abnormally gifted with super intelligence, but because such skill is highly beneficial and also acquirable from life experience and/or specialized training. For a summary discussion of this category of *informed rationality* – the distinction between ruthlessly narrow selfishness that cannot avoid prisoners' dilemmas for lack of any vision of cooperative behavior, versus how people actually behave when given opportunities to learn about cooperative solutions, see: Kaushik Basu, "The Traveler's Dilemma," Scientific American, (June 2007) p. 90; and David M. Levy, *The Economic Ideas of Ordinary People: From Preferences to Trade*, Routledge (1992).

incentive to maintain their cooperation so as to optimize the long-run net-benefits of their relation.[8]

The nature of a long-term trust relation between principal and representative agent can be summarized in four core functions that agents must perform, behavior guided by only minimal supervision, direction, and monitoring from principals.

1. Know whom you serve: Through practice, and diligent observation, representative agents must learn over time to effectively interpret how alternative strategies will serve the principal's interests, and continually adjust strategies to better optimize the long-run sum of gains.

Representative agents are responsible and accountable for their proficiency to serve principals – personal traits that make their services increasingly valuable to principals. However, serving principals' best long-run interests does not necessarily make representative agents more valuable from a social point of view. The social valuation of an agent's services depends in large measure on how well the principal's long-run interests are justified as a way of meeting legitimate *stakeholder* concerns within society.

Stakeholder views of principal/agent actions introduce third-party concerns into trust relations. That is, third parties are not forbidden to feel that they hold a stake in organizational decisions, but what should that mean for principals and their agents? If individuals, who are excluded from decision-making authority, nonetheless believe that they are *affected* (either positively or negatively) by decision outcomes, what influence can they impose on the decisions? This is not a novel question for social environments. When individuals closely interact in highly organized societies, the well-being of each individual is interrelated with that of others. The purpose for adopting social rules, cultural customs, and private property rights is to *regulate* externally-decided costs and benefits so that autonomous decision-making will best serve the constitutional aims of society.

[8] The goal is to best serve the joint interests they share in the anticipated consequences of their relation. Those net gains will occur in future time periods following their initiation of trust – consequences of choices they make in the present. This kind of decision-making is executed in units of *Present Value*, which is the sum of discounted future values assigned to the anticipated consequences for each future time period. To do differently, using a decision criterion of maximizing current-period net income (implying myopic behavior), would lead to profoundly inefficient choices. A decision process that repeatedly tries to optimize present value captures the essence of "serving the principal's long-run interests."

The stakeholder question might be stated this way: "In which instances do laws, social customs and legal rights provide stakeholders with insufficient protection from negative consequences, and sufficient obligation to contribute to the positive, external consequences, that result from autonomous decision-making?" Alternately, society could look at the stakeholder issue in terms of principal/agent rights being protected from external intrusions: "In what instances do laws, social customs and legal rights provide protection to principal/owners from the negative consequences that stakeholder actions might impose on them? If answers to such questions are not found in the rules and moral norms of a society, the gap between private and social valuation of organizational decisions will widen.

What kinds of stakes, if any, ought to convey stakeholder rights to directly impose change on principal/agent decisions? What constitutes a sufficient stake? Such moral inquiries are not answerable short of knowing society's uncontested valuations of autonomy, the justifications for both private and government property rights, and possessing unchallenged standards for fairness and justice. In a word, the concept of *holding a stake* generally goes undefined, and therefore, provides no meaningful measure for what would constitute a *valid stake*. Clearly, stakeholders pose potential *externalities of concern* on organizational decision-making, but concern alone conveys no obvious *controlling interests* in free society.[9]

This discussion of trust relations addresses a simpler, more resolvable question: In light of stakeholder concerns about potential principal/agent decisions, what should representative agents and principals do over time to enhance their trust relation? The last three core functions of representative agents address this question.

2. Know whom you concern. Representative agents must identify stakeholder concerns, estimating significant gains and losses, from consequences of alternative actions taken to further the principal's interests, that might concern various stakeholders.

[9] I recognize the contradiction in treating stakeholder concerns as external to organizational decisions, while at the same time allowing decision-makers to gain and internalize a clear recognition of stakeholder concerns. The essence of an externality is that it is *not internalized* in decision-making; internalization eliminates externality. What I allow in representative agency is enough recognition of stakeholder concerns *to clearly define principal interests*, and make enough accommodation of perceived, marginal stakeholder wants and desires to adequately serve the principal's long-term interests – which cannot be accomplished independently of competent recognition and accommodation of stakeholders' concerns! Stakeholder interests are instrumentally crucial to determination of principal interests.

3. Know instrumental worth: Representative agents must be accountable for trading-off marginal stakeholder consequences in pursuit of serving the principal's long-run interests, and ultimately devising actions intended to yield best long-run consequences – explicitly recognizing that the entire mix of stakeholder concerns is *instrumentally crucial* to the long-run goals of the organization.[10]

4. Be transparently engaged: Representative agents must be prudent, informing identified stakeholders about anticipated actions, sharing information of impending positive and/or negative consequences for specific stakeholders, especially those whose long-run concerns complement the principal's interests.

These four core functions reflect a truth: stakeholder concerns are nearly always *instrumentally* weighed in defining a principal's interests. Instrumentality of stakeholder concerns means that although representative agents are accountable for pursuing a principal's interests, they do so by gaining a creditable understanding of stakeholder concerns, and proactively informing stakeholders so as to avoid misunderstandings about what the principal's interests are. Without such care, the principal's long-run interests can not be effectively served. Finally, the Core Functions make clear that, if a representative agent chooses to act in favor of stakeholder concerns in ways that decrease or disregard the principal's well being, then the agent will have violated a trust commitment.

Friedman View of Corporate Responsibilities

The stage is now set for clarifying Milton Friedman's famous declaration about the preeminence of *firm profits* over any other *social responsibility* of for-profit corporations.[11] He primarily warns against a "socialist doctrine" that preaches that "… collectivist ends can be attained without collectivist means." He declares that such means are "fundamentally subversive." Corporate executives are presuming that they have a managerial duty to use corporate resources to achieve "socialist" ends. In Friedman's mind, such behavior is not "defending free enterprise." Managers are "unwittingly" undermining free society, and in fact, diverting someone else's

[10] In the case of for-profit organizations, the overall goal may be closely linked to monetary net-income or economic profit of the organization. Below, much more is said about this issue.

[11] Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *The New York Times Magazine*, September 13, 1970. p. 122-126.

private property to public uses. Much space in Friedman's essay is devoted to the idea that legitimate social responsibilities ought to be shaped by "political mechanisms" (government) and that corporate managers are not authorized, and should not feel that they can self-appoint, to "tax" stockholders and stakeholders for purposes of deciding "government expenditures." His discussion of this issue presumes that there is a well-established, sharp division for determining which functions are legitimate for government to carry out and which are legitimate private functions.

Friedman assails managers for financing charitable acts using corporate funds – rather than using their own resources. He regards such behavior as "theft," acts that cannot be justified by any *corporate social responsibility* because no such duty exists for corporations -- in either law or cultural norms. The practice is costly and lowers net corporate income, but Friedman's blanket condemnation is weakened when he acknowledges that *firm owners* may explicitly authorize or mandate such (possibly considered social purpose) expenditures – in which instance, they are spending their own money, a thing that could hardly be conceived as unethical, inefficient, or a "harm to the foundation of a free society."

The most interesting parts of Friedman's essay lurk in his assumptions about corporate roles and moral duties. He assumes that:

Stockholders: are owner/principals (presumably led by those seated on the corporate board).

Executive Managers: are employees responsible to stockholders for maximizing firm profit.

Stakeholders: (presumably) are customers, employees (other than executive managers), suppliers, firm creditors, community residents in areas that host the firm's presence, and possibly others in the broader society with major concerns about managerial actions.[12]

[12] Most often, stakeholder theorists count stockholders as merely one of many stakeholder categories, thereby minimizing the importance of stockholders as corporate owner/principals. Freeman goes so far as to also treat the corporation's managers and "competitor firms" as stakeholders! For Freeman, the sole remaining actor in the struggle for control of the corporation, the remaining entity that could qualify as a non-stakeholder/owner, is the corporation itself – a terrible misunderstanding of terms! Thus, Freeman's treatment, similar in many ways to other stakeholder theorists, makes the corporation into a free agent -- exerting its own, largely unspecified, self-interest. William R. Evan and R. Edward Freeman, "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism"

When he declares, "The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an (employee) agent serving the interests of his principal," Friedman explicitly binds managers to stockholders by contractual agreement and law, not by a trust relation (see Diagram 1). He does not assume that managers are representative agents in a trust relation with owners. When he titles his essay, "The Social Responsibility of Business Is to Increase Profit" Friedman assumes that *corporate profit* is synonymous with *owner interest.* He makes no distinction between short-run versus long-run profit. This is confusing for three reasons. First, he seems to define *social purposes* as what "government ordains" them to be; *social responsibilities* are the domain of authorized government agents. However, should "making greater profit," to the exclusion of any motivation toward doing a "social purpose," always coincide with the long-run interests of business principals? Not so, according to the property rights that Friedman assigns to firm owners. Second, can corporate managers honestly promote corporate efficiency and profitability, as an *employment responsibility,* without infringing on any of Friedman's perceived government responsibilities? How can stakeholder concerns instrumentally shape corporate profit decisions without duplicating or encroaching on the rights of government agents? How can a "business owner" perceive profit potential in a social responsibility and deny his/her representative agent authority to act on that profit potential? Third, by declaring that a business entity does not have the capacity to act morally or make choices, *firm actions* become the exclusive domain of individuals -- board members, executive officers, public relations spokespersons, operations managers, firm counsel, and the like. But the same could then be said of government. Although he attributes choices, responsibilities and actions to *government*, these must derive from authorized individuals who operate government organization.

These internal inconsistencies in Friedman's essay are related to the focus he directs to a single, unique problem: it involves executive managers who betray stockholders by misusing corporate funds. They finance a charitable (desirable to "society") consequence that is, (a) contrary to stockholder profit interests, (b) contrary to the interests of the firm's customers and employees, and (c) violates the legitimate domain of government (the responsible "public mechanism").

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and R. Edward Freeman, "The Politics of Stakeholder Theory," Business Ethics Quarterly, 4 (1994) pp. 409-421. Milton Friedman correctly warns against such conceptual confusion when he states that, "Only people can have (moral) responsibilities. … 'Business' as a whole cannot be said to have responsibilities, even in (a vague legal sense)." *Ibid*. Friedman, p. 122.

Regardless of how unique this supposed problem may be, Friedman declares the behavior results from a "conflict of interest," and asks "… how much cost is (an executive manager) justified in imposing on his stockholders, customers, and employees for … social purpose?" He then answers his question this way:

> Will not the stockholders fire him? (Either the present ones or those who take over when his actions in the name of social responsibility have reduced the corporation's profits and the price of its stock.) His customers and his employees can desert him for other producers and employers less scrupulous in exercising their social responsibilities.[13]

The answer implies any manager who imposes such costs will pay the consequence of being fired or otherwise be brought to accountability. Is this a private solution to an unusual social problem? What if the manager's intent is do some harm in the process of changing employment. The effective limit of that behavior is the amount of collateral damage that might be done to the manager's own reputation. If we conceive of the executive managers serving in a trust relation, instead of being strictly an employee of the firm, we would expect even greater reluctance to do damage to their own reputations. Suppose managers determined that only those actions that are in the long-run interests of stockholders should be executed. Then, even when outsiders criticized a manager's actions a *social responsibility,* or called the actions *profit-reducing in the short-run,* wouldn't the manager be economically and morally justified in taking the action? Ultimate control of corporate actions rests with principals -- even if principal interests are deemed socialistic and lessening to short-run profit.

Friedman's essay lacks a clear distinction between *stakeholder concerns* (like the firm's customers and employees) and concerns that intend to serve *society as a whole* (the domain of public mechanisms). In the aggregate, consumers and employees of *all organizations* constitute the totality of society. Yet, the essay implies that managers of private firms, including international corporations, should not assume they have social responsibilities. This is like saying that the US Postal Service has social responsibilities but Federal Express managers have only responsibilities for stakeholder profit, when in reality, these two organizations perform nearly identical customer services and employment. The fact that one organization is for-profit and the

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[13] *Ibid*. Friedman. p. 126.

other is not-for-profit may compensate for some of the differences in physical services and employment, but does little to explain any difference in consequences for society.

Guidance from Principals

Friedman's complaints about managerial behavior ought to have focused on how principals provide oversight and guidance to their helpers. Yet, he says almost nothing about how stockholders prevent deception and misguided actions. Stockholder guidance usually comes from two places: first a *corporation mission statement,* which typically includes owner commitments to the concerns of specific stakeholder groups as well as recognition of some society-wide concerns (e.g. international codes of human rights, areas of environmental support, substance abuse, law enforcement); and second, *board of directors* policy directives and other in-house pronouncements that characterize stockholder sentiment.[14] Friedman's essay misses this opportunity to distinguish between legitimate and illegitimate *social activities* that are carried out corporate by managers. His arbitrary demarcation between government and non-government entities leads him to reject *suspicious* actions, ones that he believes "merely cloak" managers' selfish interests in performing politically popular actions. If true, shouldn't the blame be placed on owner laxness? How can the veracity of managers' intentions be questioned if corporate owners are providing insufficient guidance to accurately interpret long-run owner interests?[15] Friedman recognizes that some owners do not understand the threat of socialist dogma as he does. He therefore opposes "misguided" principals who confuse their corporate and personal interests. He pleads for more clear-headed thinking by stockholders but neglects avenues of communication and guidance.

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[14] Friedman raises the issue of stockholders asking "… corporations to exercise social responsibility" or "… some stockholders trying to get other stockholders (or customers or employees) to contribute against their will to 'social' causes." A single stockholder can not compel a corporate director to do what the stockholder wishes. To be effective, stockholders must organize stock blocks which in turn submit requests. Friedman does not discuss the corporate board as an institution for organizing stockholder interests, establish owner policies, or to manage disputes. Corporate board members can exert influence on corporate executives (including hiring/firing executive managers and responding to proposed trade-offs among conflicting stakeholder interests). Friedman does acknowledge that "individual proprietor" firms can have social objectives. He finds this appropriate because a proprietor would be "… spending his own money, not someone else's." In other words, moral emphasis for Friedman rests in being respectful of the property rights of others and promoting accountability between principals and their agents -- especially regarding fiduciary duties.

[15] Friedman "admires … (principals) who disdain such (management) tactics as approaching fraud." *Ibid.* Friedman.

Sturdiness of Trust Relations

Historian Francis Fukuyama has marshaled extensive international data favoring his thesis that nations and cultures that possess a high degree of trust within their institutional structure can produce greater prosperity and social equality. These tangible strengths seem also to yield greater efficiency at reorganizing societies for common defense, adapting trade to new realities, recovering from disasters, and meeting other collective needs.[16] Fukuyama categorizes a society's capacity to form trust relations as a component of *human social capital* -- a quantum of that accumulates over many generations and indexes a society's ability to trust one another and cooperate in forming either larger-scale organizations, or coordinated networks of rapidly changing smaller production units and work groups. In Fukuyama's assessment, the capacity to form trust relations is equal in importance to a nation's physical capital for producing social prosperity. The portion of social capital relating to a society's ability to adapt and continually evolve social organization Fukuyama calls *spontaneous capital*.

Economists have noted a similar phenomenon (illustrated in Diagram 1): the greater the uncertainties surrounding social interactions, especially uncertainties associated with a lack of trust between the interacting parties, the more costly it is to create and carry out agreements. The costs of securing an agreement -- include planning, executing, and enforcing the agreement – are termed *transaction costs*. Building greater trust in the commitments made by parties to an agreement is a way of lowering transaction costs. As the capacity to form trust relations increases, uncertainty and risk diminish, and expensive precautions against misunderstanding and enforcement can be avoided. Other reductions in transaction costs are achievable through development of trustworthy reputations. However, building a reliable reputation takes time – repeated opportunities to verify character traits such as veracity, reliability, beneficence and integrity.[17] Greater reliance on character reputation signals a lower expected variance in the anticipated outcomes of agreements and stimulates further development of mutual trust.

[16] Francis Fukuyama, *Trust: Social Virtues and the Creation of Prosperity*, The Free Press (1995).

[17] Good character traits (or virtues) are like economic *goods,* having the unusual property that they cannot readily be purchased in a market. They must be self-developed over time by the very individual who wishes to have more. Although family/work/religious environments can provide essential motivation and resources, character traits are resistant to development by anyone other than the trait's ultimate owner.

The continuum in Diagram 1 illustrates the inverse relation between trust and transaction costs. However, since development of mutual trust requires substantial personal investment and time for reputations and virtuous character to mature, the growth rate of trust capacity – Fukuyama's social capital – may be quite low. *Game theory*, which examines and simulates strategic interactions, has contributed key insights into how incentives to build and maintain trust can be made more enticing.[18]

An Exemplary Game

Suppose two individuals enter into a game. Diagram II illustrates the payoffs they receive for alternative pairs of choices that they make. Although uncertain about the feasibility of mutual trust and cooperation, they can choose those options. Player A is a potential representative agent. Player B wants the services of a trusting helper to assist in a productive venture. The socially desirable outcome of the game is for the players to reciprocate trust, thereby realizing the payoff of a long-term trust relation (outcome (2, 2)).[19] Each player may choose whether to assume the risk of self-sacrifice toward achievement mutually beneficial pay-offs (cooperative behavior), or cheat on a trusting opponent by choosing to act selfishly (uncooperative behavior).

Diagram 2

		PLAYER B	
		Reciprocate Trust	Cheat on Promises
PLAYER A	Act in Interests of B	2, 2	0, 3
	Act in selfish Interests	1.25, 0	0.75, 0

Initially, game rules require players A and B to make *simultaneous* strategic choices, and only play a single round of the game. Both players have the same information about potential payoffs (marked (A, B)). The combined maximum (or, efficient) outcome for the game might entice both players to act in trust (resulting in payoff (2, 2)). This outcome also corresponds to a minimum

[18] This section draws heavily on demonstrations and research summaries developed by Binmore: Ken Binmore, *Natural Justice*, Oxford University Press, (2005).

[19] Mutual trust produces the greatest possible sum of payoffs and is optimal from a social point of view.

sum of transaction costs. However, given the initial game rules, the socially optimum is unlikely to be the game's outcome.

Player A sees the approximately same *expected* payoff (~1) from choosing either strategy: cooperating (acting in the interest of B) or violating trust (acting in self-interest). However, there is a decisive difference between the strategies. Player A sees greater risk (variance of possible outcome) in choosing the trust strategy. Since trusting B poses greater risk, and no greater expected payoff to Player A, and if Player A is risk-adverse, then it is likely that a strategy of choosing to be uncooperative will seem preferable. Alternatively, Player A may reason that choosing the uncooperative strategy would avoid exposure to the game's *lowest possible* payoff -- cooperating could result in a zero payoff if Player B cheats, whereas acting uncooperatively exposes Player A to a minimum payoff greater than zero, (0.75, 0). Choosing on the basis of minimum payoff exposure is called *following a min-max criterion.* This is another reason why Player A might choose to act uncooperatively.

Player B sees that a strategy of cheating dominates any payoff that could be realized from cooperating and reciprocating trust. If Player A acts cooperatively, Player B only gains 2 by reciprocating trust, but can get a payoff of 3 by choosing to be uncooperative. If Player A chooses to be uncooperative and maximize self-interest (which seems likely) Player B is equally harmed (payoff = 0) regardless of whether Player B cooperates or cheats.

If both players understand the implications of the playoff matrix, the game's outcome will be non-cooperative behavior, (0.75, 0). This type of game outcome is called a *Prisoners' Dilemma.* Although both players can see that they would be better-off if each would choose to act cooperatively, and would trust the other, both choose to be uncooperative, the game's equilibrium outcome. Neither player can find a better game strategy than non-cooperation, given that the other player continues to be uncooperative. It is clear to both players that if either should choose to *unilaterally cooperate* while the other player acts uncooperatively, unilateral cooperation will make the unselfish player worse-off.

If players recognize that uncooperative behavior and violations trust will end in mutual harm, with equilibrium payoffs far short of the socially optimum outcome, they would have incentive to explore alternative game rules. There are two avenues of change. One is to get cooperation through employment, investing in legal protections that promise to improve compliance and move outcomes closer to the social optimum outcome (2, 2). However, after netting transaction costs out of earnings, net payoffs to the players may be substantially less, e.g. (1.3, 1.3), which would be better than being trapped in a prisoner dilemma outcome (0.75, 0), but possibly not as rewarding as finding ways of promoting greater mutual trust, and thereby justify much lower protection costs.

More Realistic Games

A second avenue of change is modification of game rules that favor cooperation. Life experiences alert individuals to the futility of investing resources in situations that may not lead to significantly improved outcomes. What rules of competition for the payoffs in Diagram II would incentivize the players to invest in a trust relation? Since trust relations are long-run associations, anticipating repeated interactions and ample time to observe character traits, and establish reputations, the new game rules ought to allow *repeated rounds of play*.

Two additional preconditions ought to be mentioned. In order for principals to induce potential agents into trust relations, there needs to be some pre-existing willingness to toward cooperative behavior. There must also be some technique available for compelling short-run cooperation, a probationary method for jumpstarting trust development into a longer-term relation. The traditional technique of perform this task is called *tit-for-tat* rules – if you cheat, the harm done will (with certainty) be returned to you. This process, plus some willingness of the players to provisionally begin cooperative play, provides some reassurance that a non-optimal equilibrium of mutual harm can be avoided. Under these new rules and conditions, players must only trust that play will accurately follow the rules and minimize trust violations.

Repeated-play games, conducted under tit-for-tat counter strategies, turn a prisoners' dilemma equilibrium into mutually cooperative play.[20] This change in outcome is brought about by: representative agent (A) pledging to faithfully act in the principal's long-run interest, and principal (B) pledging to reciprocate -- honestly sharing gains produced by their implied

[20] There are other counter threat strategies that are effective substitutes for tit-for-tat rules. In repeated play games, alternative strategies are also capable of transforming single-play prisoner dilemma games into successful forms of cooperation. Binmore summarizes this general phenomenon in what he calls his *folk theorem*: "Every contract on which rational players might agree in the presence of external enforcement is available as an equilibrium outcome in an infinitely repeated game." *Ibid.* Binmore, Chapter 5, and quote p. 81.

cooperation. Pledges are exchanged according to a prior agreement. Repeated rounds of cooperative behavior causes mutual trust to further develop, allowing costs of protection from violations to decline over time. There emerges a stable equilibrium of cooperative choices. The game's cooperative equilibrium returns the efficient payoffs (2, 2). One could say that a successful trust relation has developed without *pre-existent* evidence of player character traits that would signal *a mutual trust outcome as a certainty.* However, the mutual cooperation that emerges over time is based on verified character, reputation, and not maintained by the negative motivations of counter threat avoidance. In the context of a representative agency model, tit-for-tat exemplifies a development tool, facilitating a preliminary agreement to pledge trust, and focuses present attention on longer-run benefits of a trust relation.

A belief that *repeated dealing* can turn near-term incentives to cheat into secure, long-run cooperation must confront another question: since most of the confirming research has been done with rules allowing *infinite rounds* of play, meaning that players do not endogenously determine the final round of play, what happens when players have individual rights to withdraw, thereby ending the game? Participants in real world principal-agent relations have this option. They can effectively end cooperation until a replacement relation is formed. Exercising right to voluntarily end a trust relation is an aspect of social organization that receives careful thought and preparatory planning. It stands as the most important distinction between representative agency, employment and slavery.[21] Simulations of trust relation games, under conditions of *indefinite length* of play and rights of voluntary termination, are likely to produce even more useful results for real world business applications.[22]

The Support Role of Markets

If principals and agents can voluntarily end trust relations, and if their cooperative work efforts are open to re-contracting or re-pairing with other individuals, the trust game becomes equivalent

[21] The bible story of Joseph in Egypt describes him as a man who faithfully represents the interests of his owner (principal) Potiphar, and over time he wins Potifar's trust. Thus, we could say they were in a trust relation, but since it lacked Joseph's autonomous right to withdraw from the relation, it did not constitute representative agency. Trust relations are known to arise within slavery even though the incentive structure does not ordinarily facilitate using tit-for-tat techniques for trust development.

[22] An indefinite end-of-game could result from either a violation of trust, or an amicable withdrawal that doesn't violate any conditions of the principal-agent agreement. The possibility of broken trust is always present.

to real world competition and could mimic the influence that market information has on steering principal/agent choices. Market prices signal the *external value* of labor services plied within trust relations. Extrinsic value information, combined with options to honorably withdraw from a long-term trust relation, provides representative agents and principals with additional protection against exploitation. Market prices also enhance social efficiency by directing reallocations of resources to higher-valued uses.[23] Because reputations are publicized by reference letters and other market communications that follow individuals as they move to new relations, well-functioning markets provide individuals with strong incentives to develop and maintain personal character virtues.[24]

Anticipation of shared gains provides both principals and representative agents with incentives to engage in costly search for desired character traits, ones they deem compatible with being worthy partners in long-term, reciprocal trust relations. Since potential partners in trust are armed with some pre-knowledge of search criteria being used by others, they respond by broadly casting information signals that might attract desirable re-partnering opportunities. However, those long-lasting trust relations have found techniques that stimulate efficient investments in trust maintenance, and ways to discourage destructive emotional behavior, elaborate deceptions, and short-term selfishness.

Entrepreneurial third parties can also play a role in developing stronger trust relations. They market assistance for organizational innovation, implementation of trust investments, and also services for revealing hidden character flaws. These kinds of services *come to market* as essential information, assisting decision-makers who are responsible for trust development and reallocating human resources within organizations. From a society-wide perspective, efficient

[23] Dam and Perez-Castrillo recently generalized an allocation model (assignment game) advanced by Shapley and Shubik (1972). They present an expanded confirmation of the stability and efficiency of competitive market outcomes in games involving many principals and agents engaged in 2-sided matching. The Dam/Perez-Castrillo model endogenizes all contractual terms, including game length, and demonstrates the Pareto optimality of market outcomes. They also confirm that the process assignments achieve properties of a cooperative game. Kanishka Dam and David Perez-Castrillo, "The Principal-Agent Matching Market," *Frontiers of Theoretical Economics*, V. 2, Issue 1, Article 1 (2006), www.bepress.com .

[24] While it is true that individuals self-produce personal virtues (See footnote17), this fact should not be confused with agents and principals acquiring external, third-party information and services. As emphasized earlier, depending on another individual's character is fraught with uncertainty and risk, especially when principals and agents must initially rely only on publicly available information to signal character traits. Nonetheless, trust relations can, and often do begin with quite limited first-hand information about character quality. The support role of markets in long-run trust development, and processes for lengthening trust associations, becomes all the more important.

market support provides essential services that can increase stability and growth. Absence of efficient market services that support and help sustain investment in trust relations, lessens the effectiveness of social organizations – government, business, legal, charitable, and religious.

Summary

Representative agency establishes a framework for understanding how mutual trust is related to social organization. Using this framework prompts investigators to ask productive, insightful questions. Who are the organization's principals? What are the principal's interests in the organization? How willing are individuals in a specific culture to find meaningful self-fulfillment in serving the interests of others? What is the most efficient way for principals to maintain, expand, and strengthen control over organization resources? What are the society-wide interests in the organization's successes or failures? As a society becomes less (or, more) homogeneous, how do altered cultural and ethical beliefs modify the application of trust relations to organizational control? Who are the stakeholders and how do their concerns mold principal interests? How do agents instrumentally link stakeholder concerns into decision-making criteria? How well do guidance systems of the organization promote accurate interpretation of principal interests? To what extent do ambivalent organizational aims cripple the effectiveness of trust relations? How adaptable to external changes are the various, alternative control mechanisms that principals adopt for their organizations? How important are market services and information in adaptation processes?

The representative agency framework is also shown to be a superior, more fruitful normative paradigm than the employee/managers-only-have-profit-responsibility model proposed by Milton Friedman. The concept that trust relations are the foundation of principal/agent association, in all social organizations, elevates *trust* to a crucially important role in achieving cooperative behavior between independent decision-makers, effective control over large-scale organizations, and coordinated functioning of organizations with different social missions.

The paper's concept of representative agency highlights traditional social concerns about how virtuous character formation is promoted and maintained, and the role of trust relations in organizations. However, the paper does not model trust relations in an environment of malevolent intensions, nor one of extensive malicious intent between subgroups of society. In short, many trust issues exist beyond the scope of principal/agent association.

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