The economics of residual amounts

1. Individual governance

There are some subjects that cause the eyes to glaze over when they come up. One such is undoubtedly "corporate governance", the portmanteau expression for corporate good behavior. No stock purchase recommendation, no financial analysis, no top-management meeting, no annual report is complete without the magic words – which evoke general approval. Approval for – indeed, for what exactly? Despite the fact that there is by now enough corporate governance literature to fill whole libraries, and despite a wide variety of approaches, such as, for instance, the ceremonious proclamation of behavioral principles, despite the fact that our bank too, for example, daily applies a checklist for superior or questionable management practices when performing analyses, it remains impossible to get a firm grip on the concept. It is often the case that every business situation and every operational constellation turns out to be so specific that the same behavior would be entirely unproblematic in one case but represent devious practice bordering on criminality in another. Some months ago ("Germ-free piglets", Investment Commentary No. 233), we made the point that even the practically unchallenged "transparency" does not necessarily represent the best of all possible worlds when it comes to corporate governance. For it is sadly the case that outstanding business successes are almost invariably achieved under conditions of secrecy, guile and unrestrained (objectively, possibly also excessive) risk appetite. And competences are usually massively exceeded, authorities recklessly circumvented.

This Investment Commentary takes up the topic anew. So as not to fall prey to the eyes-glazing-over syndrome, we shall stay at a very high conceptual level, and also include the issues of social governance, and "government governance" in particular. Given that the country with the world's fourth most important economy has been without a functioning government for months now, and also needs to get profoundly to grips with its "government governance", and that urgently needed corrections to unfortunate sociopolitical developments are obviously not possible under a system of democratic process, the subject of "government governance" is particularly topical. But such latent threats are certainly not confined to Germany alone.

Let us begin, though, with the entirely practical question of how we manage, organize or govern ourselves, so to speak. For the problems of corporate governance are most clearly revealed by the example of our own "individual governance" in the way we make use of the time available to us. It may seem banal enough to state that time is a scarce good, and must therefore be managed. What is less banal is that we have no idea of how scarce the good is. We have no idea how much time remains to us, today, tomorrow, in a year, in the rest of our life. Because this is so, the process of allocating this scarce good, time, becomes of great importance.

Essentially, we can distinguish three types of people by the way they deal with time. The first group attempts to manage its agenda virtually mechanistically. The result is a diary organized with minute-by-minute accuracy, largely dependent on external influences, with very little flexibility for dealing with the unexpected, and often with a similarly meticulous planning of that time which should in principle be freely disposable. Games of golf and tennis are thus also entered in the diary, as are such matters as "serious discussion with son and heir – 55 minutes".

The second group are readily identifiable to readers of *Alice in Wonderland* as "White Rabbits". They rush into meetings late, and then have to rush out early (due to "other unavoidable commitments"). They register for every possible event, only to cancel at short notice (or not even to cancel – we now have a considerable and unattractive "no-show" culture). They claim that they can manage on four hours sleep, and then can be observed dozing off from time to time, more or less inconspicuously. Their time allocation suffers under their continuously changing priorities. They invariably appear somewhat stressed, and also give the impression that they should be doing something more important than whatever it is they are doing at the moment. This is, among other things, disrespectful.

The third group might be described as "time management artists". They are the people who, despite extensive calls on their time, always seem to have enough of this scarce good. The ones who appear not stressed, but well rested, who hardly ever arrive late and leave early, who seem to have limitless time and affection for their loved ones, and who always manage to find some reserves for crisis situations. We would all obviously like to belong to this group of sovereign time managers, and from time to time, we even manage to. But as stress on a daily basis is one of the most frequently observed lifestyles, it is worth giving some consideration to the elements that distinguish an artist in time management. The more so, as consideration of these elements will lead us directly into the matter of the management of businesses and social structures.

2. "Enough time" and "leisure time"

It is clear enough what is the matter with group 1, the "Time Fetishists" and with group 2, the "White Rabbits". The first group break down their lives, from a technocratic perspective, into a series of commitments – nothing in life but commitments: what a thought! Technocratic in the sense that the criteria for individual governance, once selected, essentially become fixed rules for the allocation of time. They form a corset of priorities, within which the son and heir can be allocated exactly 55 minutes, and one's pulse rate when jogging should reach 150 within 20 minutes and remain at that level for twelve and a half minutes – otherwise the optimum training effect is not attained. From a rational perspective, the technocratic approach appears well thought out, and may even create an impression of control. But it results in uncreative bondage to a crushing degree. The second group is distinguished by the diametrical opposite to rational technocracy. Erroneous assessments of the time required abound (including in particular the systematic underestimating of journey times), and there is a complete absence of rules for determining priorities in the allocation of time. What both unhappy groups have in common is the lack of any residual time – which could also be described as "leisure time".

If "leisure time" is understood, not as so many of our contemporaries understand it – an absence from the workplace that is still crammed full of commitments – but rather as the amount of freely available time – given the prevailing situation – then it rapidly becomes clear that this is a key determinant in the allocation of time. Only those who feel sufficiently independent in the allocation of their hours and minutes can set priorities, and devote their time to those matters that are likely to create the greatest benefit. Only those whose "leisure time" contains some reserves can make additional time available in an emergency. Only those who have not entirely pre-planned their diaries are in a position to enjoy the quality of freedom of action, and indeed, to give people their time.

This may all sound rather pastoral, and that is the last thing an Investment Commentary ought to be. However, the elements of free availability and a reserve, which we shall be dealing with in a business and social context in the following sections, are so clearly revealed in the time allocation example that it is worth pursuing this line of argument a bit further. For the question obviously arises of who or what in the process of allocating this scarce good, time, represents the interests of "leisure time". Certainly not all those ready to make demands on the time of third parties. For they are the ones who are always ready to suggest that some additional task or other could also be fitted in, or who talk people into believing that some new position will really only require a few meetings a year, and so on. And now claimants are able to insert dates in other people's diaries electronically, so that the requests for appointments pile up in the e-mail, and just as with the flood of e-mails, so here too the problem of prioritization arises – a problem that cannot be delegated. Not all technological progress is a blessing.

Can one properly represent the interests of one's own leisure time? Perhaps. But the problem is that the commitments are situated in highly specific, and often also attractive or interesting areas, whereas the interest of the residual amount "leisure time" are to be found in the abstract, and often in the potential. A dinner meeting with a highly interesting contact, let's say, is up against some so far unallocated reserve time at home in an easy chair. The dinner meeting will win, and the quiet evening at home will lose, although it might have been precisely during this quiet evening that the decisive and inspired idea for the next business move occurred. And at the dinner you find yourself sitting, tired and bored, surrounded by the "usual suspects" who always turn up to such events, as the highly interesting contact repeats once again what he has already said hundreds of times before in his five books.

The residual amount "leisure time", often to be equated in the lives of busy managers with "time for the family", has a hard time. The demands are always specific and ostensibly important, indeed apparently unavoidable. The residual amount, by contrast, represents merely a general, non-specific interest. It is not a matter of necessity, and so it gets nibbled away at, and sometimes sold out entirely. There are of course strategies that can be used to protect oneself against others – and against oneself. A fixed "time out" was prescribed thousands of years ago in the form of Sunday rest. But modern lifestyles are increasingly encroaching on this weekly break, so it needs to be replaced by similar pauses. The problem with such breaks is that not all society wants to take them at the same time, if at all. Another, rather more cunning strategy consists in feigning busyness by means of a superficially apparently superhuman accumulation of specific commitments, whereas internally one has switched to inactive mode. There is however a real danger that one may stay in this mode when dealing with the son and heir, or still worse, one's significant other …

"Individual governance" stands or falls with the ability to defend the interests of general well-being against the claims of specific commitments. It is not enough, in other words, simply to optimize the management of the demand side by means of business-oriented measures. That would be the technocratic version of time management. But muddling chaotically along, in the hope that there will somehow always be enough of the residual amount time is equally pernicious. Skillful and successful "individual governance" must involve defining rules for when and to what extent the reserves are to be deployed. Residual amounts are not inexhaustible.

3. Last place in the balance sheet

Readers may well have an idea by now of where we are heading. What applies for the residual amount "leisure time" in the daily life of every one of us also applies, with a grain of salt, to the residual amount of a company – its equity. Every company is confronted with countless claimants, both internal and external. Executive boards will soon be approving the budgets for the coming year, and the picture will be the same everywhere: a variety of more or less justifiable requests will come up against the need to operate a profitable company. Being profitable can be equated with capturing what is left over at the end of a given period, after all demands have been satisfied – it is thus a residual amount. And the aggregated residual amounts of this "being profitable" are known as equity.

The "governance" problem remains the same, whether the issue is individual time management or concerns about profitability. The more or less justifiable demands present themselves as specific projects and desires; "being profitable", by contrast, is highly abstract and conjectural. The residual amount thus has few advocates and often loses out. Whatever will bring success in the next quarter, or perhaps the quarter thereafter, finds support. Less specific ideas for the future development of the company, in the areas of research or the development of interesting people within the company ("Human Resources") have a significantly harder time. And this despite the fact that these are precisely the things that would contribute most to long-term success, and to the flourishing of the residual amount. Operational hustle and bustle beats calm consideration, group-specific interests, such as those of a hungry management, for example, are more likely to find support than the generally weak voice of the investor – not least as this is often only poorly represented on boards of directors assembled by means of management cooption.

The analogy also applies for the difficult question of the appropriate scale and deployment of reserves. There is no doubt that reserves are necessary to compensate the business fluctuations that companies experience. The period from 2001 to 2003 made it very clear how devastating an inadequate amount of capital or excessive leverage could be for a company. That an excess of residual substance can also have a paralyzing effect can also be shown by analogy with an excess of leisure time – lifelong holidays, so to speak. Excess results in obesity, sluggishness and impotence, and ultimately destroys the ability to survive. But deciding when the right time has come to deploy reserves is a defining element of the fine art of company management. For there is a major problem associated with the deployment of reserves: once they're gone, they're gone. But if they are deployed too late they may no longer be able to do any good, for the company is by then already sentenced to economic death.

The analogy between individual time management and company management seems to function even in terms of the typologies. For there is undoubtedly the technocratic allocation approach – that is, a distribution approach for the scarce resource of capital that is optimized from every possible business perspective. This technocratic approach involves piles of masterplans, cost/benefit analyses, profit center structures, orgies of controlling, and suchlike. And it is also the case that little can be said against these most diligently devised and ingenious creations. Everything appears beautifully specific, minuteable, auditable and rationally feasible. But exactly as with the over-organized diary planned down to the last minute, there is no room for innovation or creativity in such an organization. Which does not mean that the technocratic approach is not extremely popular – particularly with regulatory authorities, auditors and other persons and bodies of a deterministic bent.

And of course, there is also the "White Rabbit" business. Its management is distinguished by constantly changing priorities, by the use of continually changing consultants, by continuous change in consolidation or accounting standards, by unnecessarily complex financial structures, by an information policy that appears arbitrary or driven by impulse – loquaciousness in one case, clandestine concealment in another case – by frequent staff changes, by eternal messing around with the corporate identity or the brand, and by poorly documented and thus inadequately informed management bodies.

In the ideal corporate governance situation, by contrast, the key processes in the company are driven by, and in the interest of the residual amount, the equity. Victory goes neither to the ostensibly "necessary" demands, nor to the chance ideas sparked off by the views of some hierarchically significant person. Rather, there is the often difficult and even tortuous process of seeking the maximum economic benefit for the deployment of that scarce good, capital. Tortuous because even the best management will often have to choose between short-term necessities and long-term interests, and because the meeting of both kinds of need is often mutually exclusive. This is known as a dilemma. The management of the residual amount equity represents a continuing struggle with dilemmas large and small. Any company management that does not experience this process as painful would be well advised to take a long, hard look at its corporate culture and governance. The decisions usually appear complex and equivocal, because they concern future events that are never certain, but only more or less probable. In such situations, technocratically inspired solutions appear helpful at first glance, by virtue of their high degree of specificity (business plans exact to the third decimal place …) but they can be relied upon to lead their followers astray. Equity's interests are abstract and operate in an area of conjecture. Decision-making is by definition judgmental, and is thus ultimately not susceptible to quantification. Equity's interests can only be served by bodies with freedom of action, and that are in a position to take on responsibility outside quantifiable rules.

4. The market'll fix it. Mostly.

One of the very greatest errors and omissions in the discussion about shareholder value is to overlook the interconnections between freedom of disposition, the unquantifiable nature of the decisions and the perception of responsibility and ownership entitlements. Essentially, shareholders are supposed to have a short-term, speculative interest in rising share prices, while ever new, ethic-laden justifications are found for the rightness of stakeholders' claims. This is without foundation. Shareholder value, understood as the general, tendentially conjectural interest of the residual amount equity, by no means denies the existence, and thus to a certain extent the eligibility of stakeholders' claims. But the claims are managed and met neither on a rational, technocratic and quantifiable basis, nor on an arbitrary and chaotic one, but rather by consideration of the maximum economic benefit.

And the maximization of share prices? Rising company values, reflected in higher share prices, are both a reflection of whether, in the aggregated opinion of capital market players, the interests of equity are being properly served, and also, and naturally, the goal of company owners. For herein lies the core of the capitalist economic system, that the owner's individual maximization of his economic benefit coincides with the collective interest. Representatives of stakeholder approaches in company management are thus ultimately implicitly, and sometimes explicitly, anti-capitalist and illiberal, in that they deny the coincidence between individual and collective interests.

It may freely be admitted that the market – or the aggregated opinion of market players – does not invariably apply the same criteria when setting prices. Roughly speaking, for instance, the second half of the 1990s was characterized by a clear preference for "White Rabbits". New horizons, innovation, continuous refocusing, repeated changes of strategy were announced – and for a certain time were also rewarded by the market. There was for a long while no market for solidity – for so long, indeed, that previously serious companies shifted their strategies in the direction of white rabbitry, only promptly to crash and burn on account of their hopelessly inadequate financing.

From 2001 to 2003 the pendulum swung back. The collapse in prices generated calls for transparency and solidity. And because disasters (such as Enron or Parmalat) always unleash a higher level of activity on the part of legislators, this change of mood among market players was accompanied by some sharp, and partly senseless regulatory intensification. The US Sarbanes Oxley Act is a typical product of the technocratic approach to company management. Every circumstance in the company should be able to be recorded quantitatively – that is, unambiguously –

in minutes and in auditors' attestations, and scapegoats for any unfortunate developments should be readily identifiable at any time. Scapegoats – what nonsense, when decisions have mostly to be taken under conditions of high uncertainty.

If we are right about this, there has been some normalization in approaches over the past year. That the free-for-all of the late 1990s was a mistake is still embedded deep in the consciousness of most market players. But it is also becoming increasingly clear that the subsequent technocratic approach also went in the wrong direction, namely that of a Nirvana of data dumps and a conceptual desert populated by auditors and regulators. Ultimately the market, seen over a relatively long cycle of differing valuations, appears overall to be an effective corrective for excessively chaotic or excessively technocratic company management. For the market is ultimately merciless in its demand that companies "earn money", that they are profitable. Thus, in a free economy, neither a claims mentality nor a chaotic free-for-all can win in the long run.

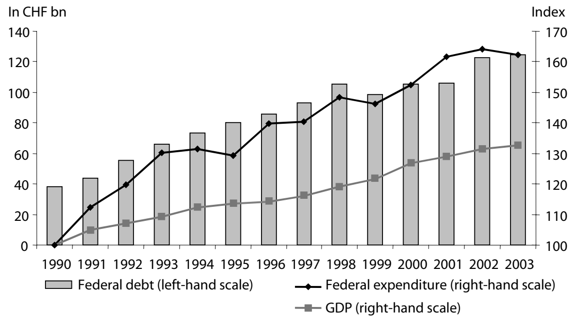
5. Social governance

Let us push the analogy between individual time management and collective governance a bit further. The crushing quantity of ever so important appointments in the personal diary corresponds at the societal level to the many and varied claimants who believe they are entitled to expect the satisfaction of their needs by society at large. The modern social state is precisely characterized by the (technocratic or consistently chaotic?) management of demands of every kind – simultaneously, consecutively and sometimes contrarily. The demands become privileges, legally prescribed or accorded, for individuals or groups against the collective. The demands are invariably specific, rationally justifiable, "necessary".

And the equity? If we have understood things right, the fact that the "residual amount" of society, or the community that represents society, is not really defined is the cause of the overloading of state structures, of deficit budgets and of the weak growth in most (over)developed modern states. "Equity" does have a clearly financial aspect. The equity of a state is composed of the actual free assets plus the substrate that the state could additionally contribute to its financing – that part that it could still squeeze out of its citizens without them leaving the country. If state activities are financed with debt, then equity so defined is reduced. Current expenditure is being charged against future, conjectural income. When state undertakings are not correctly booked, or not booked at all – balance sheet fraud on the liabilities side – then there is only one item that can repair the damage when it comes to light: future tax revenue.

The taking on of debt and the failure to book items are common practice, even in such an apparently exemplary country as Switzerland. The figure below shows the development of the Swiss Confederation's expenditure and debt compared to economic growth over the last 15 years.

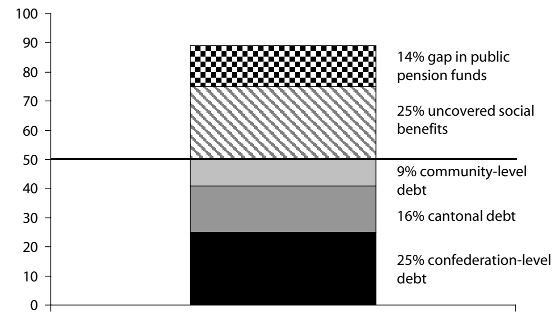
A debt stop?



Source: Eidgenössische Finanzverwaltung – "Öffentliche Finanzen der Schweiz", Bundesamt für Statistik

While it may be admitted that the figures are not particularly remarkable by comparison with other European countries, it must nevertheless be clearly stated that neither the principle nor the tendency are to be taken lightly or underestimated. There are continual encroachments on social equity, and anyone who takes part in them is guilty of confiscatory behavior towards future generations. Simply shrugging one's shoulders is not an adequate reaction to such an accusation. Still worse is the practice of not booking commitments. The non-booked liabilities of Swiss society are, however, known only to a few, and are excluded from discussion. But nor is a shrug of the shoulders at all an appropriate reaction to the accusation of failure to book, even if this is common practice in many countries. For such behavior at individual level falls under criminal law.

The truth about balance sheets



Source: Bruno Gehrig (2004) – *Bedrohte Generationensolidarität*

Including non-booked commitments consisting of the gaps in the public pension funds and uncovered social benefit commitments, Swiss state debt in 2001 was not "a mere" 50 percent, but almost 90 percent of GDP. This is not peanuts.

Democratic structures are wonderful instruments for managing demands, but obviously have a decisive defect when it comes to representing the interests of property, of the common good. The demands are invariably fairly specific and often highly attractive. Who in the world could have anything against the furtherance of home ownership in the city of Zurich, for instance? Not the left, because the building of rented accommodation is also subsidized. And not the right, because this concerns property ownership. And certainly not the building trade. Which is how it came about that at a meeting of the Zurich municipal council on 5 October 2005, it occurred to absolutely no-one to inquire whether it really made sense to rob taxpayers' pockets for the benefit of a few future property owners or renters – whether there might not be more homes built in Zurich if this and various other levies on the common wealth were not made, as tax rates could then be lower. And is such preferential treatment of individual citizens at the cost of an indefinite majority of taxpayers at all justifiable under the rule of law? Not even the otherwise ever so liberal Neue Zürcher Zeitung, from which this report was taken, entertains such obviously deviant thoughts.

It is the asymmetry between the specific purpose (home ownership) of the demands and privileges and the abstract, conjectural nature (tax rates, future tax burden) of the common good, the state's residual amount, that has landed us with debt and expenditure growth, despite and partially also because of democratic structures. By contrast to companies, which are punished by the market for any excessively crass or long-lasting violation of the interests of equity, in a democracy there is no body that defends the residual amount. Not the finance minister (who mostly can only share out, in as politically acceptable a way as possible, the damage already caused by other ministers), nor the members of parliament, who seek to ensure their re-election by satisfying specific claims and demands, nor the constitutional court. Perhaps most likely, the people, by means of direct democratic intervention. But there are limits here too – taxpayers yet unborn have no vote.

6. Reaching the limit

With the individual governance of overcrowded diaries, there comes point at which, utterly exhausted, one simply cannot carry on any longer. Those who try to meet every conceivable (specific, legitimate, "necessary") demand are particularly prone, sooner or later, to a more or less acute attack of burn-out syndrome. With public bodies, it takes a little longer, and the burn-out syndrome is not so easily identifiable.

But when we take a closer look at the German economy, particularly riddled with claims and privileges of every kind, and with an increasingly threatening lack of growth impulses, burn-out syndrome seems a fairly appropriate description. It is by now fairly generally recognized that the common good, the residual amount, is just about used up, as regards both current conditions and also the "earning power" of future levels of taxation. But still, as shown by the recent German elections, no-one is yet ready to launch an attack on the privilege-based economy, or to defend the common good.

Why? A little experiment in game theory shows, naturally in a highly simplified form, how a society can become persistently trapped in a false socio-political set-up. Let us assume that there are only two Germans, and they have to decide whether they will in future waive their privileges or not, or whether they want in future to work (more) or not. Neither knows what the other player will choose. But this directly affects own future prosperity. For if one works and the other not, then the one must finance the other …

Prisoner's dilemma

		Player 2	
		Work	Privileges
Player 1	Work	(4, 4)	(1, 6)
	Privileges	(6, 1)	(2, 2)

The first figure in parentheses represents the "pay-out" for Player 1, the second, that for Player 2.

Source: analysis

The game works like this: both players, regardless of what the other decides, choose the "privileges" option. For the "privileges" option is in any event more attractive, whether the other works or not. And both players together – as a "society" so to speak – are landed with the worst option. This fairly accurately reflects the result of the German elections. Neither of the big parties could bring themselves to advocate genuine reform options, and the privileges are – not only in Germany – distributed throughout the population, at every level, and by no means a specifically left-wing attribute. The game also demonstrates exactly what we spelled out three months ago: only a sharp reduction in all privileges – a declaration of bankruptcy, so to speak – would get the "players" back to work. A clear, unambiguous, once-for-all allocation of the damage that has already been done, and economic growth would occur straightaway.

We may hope, with or without a "grosse Koalition", that this will actually happen one day. Not because it will suddenly become politically attractive, or because the structural asymmetries of democracy will suddenly be done away with, but because international competition will require it. Globalized markets, with work-hungry Indians and Chinese at every stage of the value chain, will not tolerate overprivileged Europeans, and sooner or later the international financial markets will no longer find hopelessly over-indebted European states so amazingly attractive. Italy is already on the way to the scaffold.

7. Parenthesis on "Katrina"

It is part of the story of tragically frivolous, indeed negligent treatment of the common good that in those areas where effective state intervention is really needed, in coping with extraordinary occurrences, the capabilities (if at all available or deployable) are exhausted shockingly quickly. It must be accepted that a storm may cause loss of life – perhaps indeed hundreds of lives. But it is not acceptable that in a financially well endowed commonwealth such as the United States or the State of Louisiana, the emergency services only get going days after the disaster, and the picture is one of misunderstandings and problems in coordination. Clearly there had been a lack of practice drills and exercises. But that is exactly what should be a part of "government governance", the proper management of the reserves of the common good. Not to do this is to speculate that there will in future be no more hurricanes, nor any worse catastrophes (pandemics?). This is no different from drawing a bill on the future, accepting inability to perform in the future as the price of a more relaxed way of life in the present. Such is the point we have reached with the welfare state.

Given this criminal default in the area of disaster management, the vast funds that the Bush administration is now intending to send to New Orleans appear a mockery. Redistribution instead of precaution-taking, once again. „Das eben ist der Fluch der bösen Tat, dass sie, fortzeugend, Böses muss gebären" ["For this is the curse of evil deeds; that they must give birth to further evils"] (Schiller).

How different the reaction in little Switzerland, when faced with this summer's serious floods. Practically without central, state direction, the regional bodies carried out the rescue and clear-up operations, valley by valley, in trained teams led by competent commanders. Precaution-taking obviously still functions at this subsidiary level.

8. Good housekeeping

Whether the residual amount is individual leisure time in the sense of genuine freedom of disposition of a significant portion of that scarce good, time, or whether it is equity as the measure of the maximization of entrepreneurial activity, or whether it is societal reserves in the sense of substance that is untaxed and unregulated (and thus freely disposable for citizens), or whether it is reserve capacity for conceivable emergencies, held by a wise government: the quality of the management of this residual amount clearly has a decisive impact on well-being, prosperity, success and security. "Quality of management" can be regarded as an economic process. Economics comes from the Greek word *oikos,* house. So, it is basically a matter of good housekeeping, and, given all that has been said, it is also clear that economics, as the art of keeping one's own house in order, is tendentially better suited to small organizations. It is easiest to estimate for one's own house which demands are justifiable and which not, where the priorities should be set, and how large and well stocked the reserve larder should be.

A sound ration of skepticism with regard to all the ultimately illusionary efforts to make economics a science for the organization of large and complex systems is eminently appropriate, particularly for prudent investors. Hence this Commentary on the obviously underestimated and largely misunderstood "residual amount".

KH, 10.10.2005