Minimum Effort, Maximum Effect – How Leverage Works in Finance, Bargaining, and Resource Growth

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The financial crisis of 2008 to 2009 is widely regarded as a "leverage crisis" since banks and individuals got into trouble after borrowing funds in order to make investments that promised an outsized return. The financial crisis was brought about by excessive leveraging of borrowed funds, where banks and individuals both got in over their heads and ended up owing more than they could pay on balloon mortgages or borrowed funds.

"Leverage" is a useful concept to explore and unpack, as I have done in my new book, because it is a process that happens in many spheres of modern life – with harmful or helpful results.

The Concept of Leverage

The original concept of leverage comes from the physical world. Essentially, the ancient Greek mathematician and scientist Archimedes introduced the concept to make sense of how levers work. In his physics, Archimedes taught that people could use minimal effort to create a maximum effect – exert leverage, that is – by deploying a mechanism, a fulcrum, to bring about the effect. Famously, Archimedes said, "Give me a place to stand and I will move the earth."

By now, the concept and terminology of leverage are applied in various spheres of life – to refer to aspects of physical, financial, and even intellectual and emotional processes. As a frame of reference, it seems reasonable to distinguish three versions of leverage that play very important roles in American society and indeed human affairs throughout the world: financial or investment leverage, bargaining leverage, and resource leverage. These three versions of leveraging all involve using a minimal effort to create a maximum effect with the use of some mechanism or tool. Interestingly, they are deployed in various societal spheres, in the economy, politics, international relations, and even family and community life.

- **Financial leverage** refers to the sorts of investment processes that set the stage for the financial crisis of 2008 and 2009, in which individuals or financial institutions borrow funds to make investments they hope will lead to very large returns well beyond the repayments they will owe in due course. Wall Street operations and high finance throughout the world use leveraged investments all the time.

- **Bargaining leverage** is quite different from investment leverage. In bargaining leverage, two or more individuals or organizations or countries are involved and one side seeks to achieve some advantage in a negotiation by withholding consent on a pivotal issue. In everything from political negotiations to marriages, both sides may repeatedly try to achieve bargaining leverage over the other.

- **Resource leverage** is the least well-known of the three main kinds of leveraging. Leading management theorists Gary Hamel and the late C.K.Prahalad have a well-known discussion of resource leverage in their landmark 1994 book *Competing for the Future*. Leveraging resources, they explain, is needed in order for firms to be competitive, indeed to transform industries. Everyone has the task of allocating resources to be efficient, but only the firms that leverage resources in creative ways rise to excellence. In today's world, the Internet and information technology more generally are tools frequently used to gain leverage. Thus it is commonplace to hear people say "we have to leverage the Internet to get more customers" – or "more votes" or "more money" or "more friends."

Why Leverage Attempts are Proliferating

Not only are these three types of leverage – of investments, bargaining, and resource allocations – found in all societal sectors, they are arguably more frequently and deliberately deployed now than they were thirty or sixty or ninety years ago. The rise of the Internet itself is one of the reasons, because information power, unlike industrial power, creates manifold leveraging possibilities. Send one email and reach a million people is a prototypical leveraging possibility. In addition, the end of Cold War and the rise of modern family complexities have created many new leveraging possibilities, because older structures of authority have dissolved, leaving behind many players maneuvering in relation to one another. To get things done, whether in international affairs or in kin networks, people have to use targeted resources to move other players in directions they want.

In short, when individuals, organizations, and governments cannot rely on clear lines of authority, they look for new ways to leverage resources and relationships to achieve their ends. To understand leverage in its key manifestations – and growing importance in today's world – we must appreciate historical transformations in systems ranging from geopolitics to the family that are multiplying incentives and possibilities for leveraging efforts.

Searching for "Leveraging Means"

As the recent global financial crisis demonstrated, leveraging – especially "over-leveraging" – can lead to widespread and grievous harm. Investors borrowed too much to attempt overly risky financial bets, and when they could not repay their debts, a chain reaction of investment and real-world financial catastrophes ensued, affecting even people and institutions that were not over-leveraged. Too much leverage, clearly, can be a bad thing.

Leveraging is here to stay, however, so a useful challenge for moral analysts is to think through the range of possible harmful and useful consequences that various types and degrees of leveraging can create – in order to develop norms of what could be called the "leveraging mean." In a philosophical exercise resembling Aristotle's classic search for the Golden Mean, such norms would clarify the types and degrees of leverage that further rather than undermine the public good. Understanding of the leveraging mean could help modern individuals, groups, and institutions see when and where various amounts of leverage deployed in investments, bargains, and efforts to expand resources are likely to lead to constructive – or deleterious – outcomes for the various parties involved.

Read more in David M. Anderson (editor), *Leveraging: A Political, Economic, and Societal Framework* (Springer, 2014).