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BANKNOTES

NELSON NASH MONTHLY NEWSLETTER

Why Do We Use Money?

By Robert Murphy

Although it's a pretty basic question, it's worth asking: *Why do we use money?* Once we think through the answer, it becomes clear just how awful our current monetary system is.

For those wanting a comprehensive treatment, I refer you to our book (co-authored with Carlos), *How Privatized Banking Really Works*. I also refer you to our new podcast, the Lara-Murphy Show, and in particular episodes 15 and 16 where we discuss how governments historically have used inflation to cover their budget shortfalls. (Everything is available at our new website, www.Lara-Murphy.com)

But for our purposes in this article, let me cover the essentials. Again, I ask: Why do we use money? This is such a critical institution in our lives, and yet most people really have no idea. As we'll see, even most economists can't give the kind of deep answer that Austrian thinkers such as Ludwig von Mises provided.

The Shortcoming of Direct Barter

The typical way economists motivate a discussion of the *why* of money goes like this: Direct exchanges (sometimes called barter) are certainly a great thing, which provide win-win improvements on the original distribution of goods. However, the "gains from trade" in this fashion are limited.

For example, there couldn't be much specialization and division of labor if everybody were restricted to direct exchanges of goods or services that they planned on using themselves. Imagine a dentist trying to survive in a world without money. If he wanted meat, he'd have to find a butcher with a toothache. And if the dentist wanted a house, he'd have to find a team of carpenters, roofers, and bricklayers who all needed their teeth cleaned right then.

As these silly scenarios illustrate, we obviously need some way of distributing the trading of goods and services among different people, and across time. In other words, we need a way to split up sales and purchases into separate transactions. Rather than the into separate transactions. Rather than the dentist needing to find the exact butcher and bricklayer who need

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dental work, with the use of money the dentist can simply sell his services to the highest bidders, and then at a later date the dentist can take his pile of money and go buy whatever he needs from the community.

The Ivy League Leaves Us Hanging

As I said earlier, the above analysis about the dentist is not unique to the Austrian School; all intro economics textbooks would give some story about the limitations of direct barter. Yet ironically, if you go on to advanced study at the doctoral level, even at elite universities, you end up using mathematical models of the economy in which *money serves no purpose*.

Let me make sure you understand just how artificial and unrealistic these typical mainstream models are. For example, I remember at NYU in my PhD program we had a test question in macro that asked us to imagine a lone individual on a tropical island, where the only wealth was a coconut tree that shot out coconuts in a predictable pattern over time. The coconuts could not be physically carried forward into the next period (they would rot), and there was nothing the man could do to plant more trees or otherwise increase production in the future. The question also gave us the mathematical form of the man's "utility function," which specified how many "utils" he got from a specified stream of coconut consumption over time. In this setting, the exam question asked, what would be the equilibrium real rate of interest?

I hope the reader can appreciate my perplexity at this question, as I sat there in my exam. What in the heck did it even mean to talk about an interest rate, on an island with one guy, one tree, and no money?!

To end your suspense, the answer they were looking for was something like this: In each period, the interest rate had to be such that the man, when maximizing his utility, didn't want to "sell" his coconuts and then use the proceeds to earn interest and "buy" more coconuts down the road. In other words, since we knew that (by construction) it was impossible for the guy to do anything other than to

consume his endowment of coconuts each period, then in equilibrium it had to be the case that market prices were consistent with the guy voluntarily choosing precisely that course of action.

Once you learn the tricks of the trade and how to think like a mathematical economist, this type of approach is actually logical and has a certain elegance. However, I am sure most people can recognize that a model like this probably does not shed much light on "optimal Fed policy." Similarly, other macro models featured one "representative agent" who was a single individual who lived forever and consumed one good. In this type of world, there is no need for money, since there aren't even other people with whom to trade—we can't tell the story about the dentist and the butcher, since there aren't dentists and butchers in a world consisting of one "representative agent."

The Austrians Have the Insight

As in other arenas, here too Ludwig von Mises—and his followers in the Austrian tradition—is a giant among men. He recognized that the crucial role of money prices was that they allowed entrepreneurs to engage in *economic calculation*.

As Mises (and Hayek) pointed out during the famous Socialist Calculation Debate (which occurred in the first half of the 20th century), the central planners in a socialist government can't come up with an efficient use of society's scarce resources. Even if we stipulate, for the sake of argument, that the central planners are equipped with all of the state-of-the-art technical knowledge, and have the best of intentions, nonetheless they can't use any procedure to determine whether their production plans entail a sensible use of resources.

To see the difficulties involved, consider that there are thousands of different ways to produce and deliver specific goods to specific consumers. For example, even if we take it as a given that some oranges should be produced and distributed to individuals in Alaska, there are many different ways to do so. For example, the oranges could be grown in Florida, or in California, or even in a greenhouse in

Alaska for that matter. And if the oranges *are* grown in Florida, there are different ways of transporting them to Alaska, involving trains, planes, or even mules.

The crucial point is that it's not a mere matter of engineering or agronomy to answer these questions. There are various ways it is physically *possible* to make oranges and put them into the hands of Alaskans. But in order to know *how* this should be done—including the question of how many oranges we produce and move—we must consider the economic consequences. Specifically, we need to consider the tradeoffs involved.

If, for example, we moved a single crate of oranges from Florida to Alaska on a supersonic jet, that would probably be wasteful or “inefficient.” But the reason is that there are more important things to do with a supersonic jet. Yet “importance” in this context is something we can only discover in light of both technological facts and subjective value judgments made by the consumers.

Economic Calculation and Money

What Mises demonstrated was that these almost philosophical conundrums are solved seemingly effortlessly, day in and day out, through the use of money prices. Accountants can tell an entrepreneur how much was spent on “inputs,” and how much revenue was collected from the sale of the product or service, during a given period. If revenues exceeded expenses, then that's the market's way of saying, “You have deployed scarce resources in an efficient manner.”

In contrast, if a business operation is losing money, it means that those resources are more urgently desired elsewhere in the economy. That's *why other* entrepreneurs are bidding up their prices to levels that make it unprofitable to use the resources in the losing operation. To repeat, whether a given business venture is profitable or unprofitable is not a technical or scientific question—it can only be answered if we have genuine market prices to associate with both the inputs and the outputs.

Sound Money

In this context, we see then that the social function of money is to facilitate economic calculation. Money *cannot* do this if its future purchasing power is subject to violent swings because of political intervention. It makes little sense to compare the input and output prices for a given operation, if the purchasing power of money has drastically changed during the production period. This is why Mises and his followers agreed with the classical liberal respect for “sound money,” meaning money that was protected from government debasement.

Conclusion

If we don't understand the social function of money, then we can't appreciate just how badly our current monetary system serves us. Rather than trying (without success) to ensure “full employment” or to hit an arbitrary rate of annual dilution of purchasing power (also known as a price “inflation target”), the government should get out of the business of money altogether.

By returning money to the private sector, where it originated, we can bring the full power of voluntary market solutions to the production of a sound money that has desirable properties such as a predictable purchasing power. We would shudder to hand over control of science or the press to a political institution, and thus we should not let a group of Federal Reserve officials control our monetary destiny.

[Reprinted from the May, 2016 edition of the *Lara-Murphy-Report, LMR*]

The State's War on Student Debtors Is Heating Up

by Douglas French

Unlike most any other debt, student loan debt can't (normally) be dismissed in bankruptcy, and millions of graduates and non-graduates are struggling to live out the American dream saddled with thousands of dollars in student debt, and in some cases bleak job

prospects to pay it back.

If that's not bad enough, *The New York Times* reports, "in 19 states, government agencies can seize state-issued professional licenses from residents who default on their educational debts. Another state, South Dakota, suspends driver's licenses, making it nearly impossible for people to get to work."

"It's an attention-getter," Peter Abernathy, chief aid and compliance officer for the Tennessee Student Assistance Corporation, a state-run commission that is responsible for enforcing the law, told the *Times*. "They made a promise to the federal government that they would repay these funds. This is the last resort to get them back into payment."

However, it is this licensing which, in some cases, forced students to rack up student debt in the first place to satisfy these barriers to entry. Now, these roadblocks are contributing to unemployment.

In a piece for *The Atlantic* entitled, "The Disappearing Right to Earn a Living" Conor Friedersdorf quotes an Institute for Justice report, "In the 1950s, about one in 20 American workers needed an occupational license before they could work in the occupation of their choice," the report states. "Today, that figure stands at about one in four."

A License to Work

You wouldn't guess workers would want the hassle of being licensed. However, to restrict competition in their profession, they support the licensing effort. "In serving as a bottleneck on entry into an occupation, licensing restricts the supply of practitioners, allowing those who are licensed to command more in wages and prices for their services," writes the IJ.

It's also believed that licensure elevates the status of the profession, even though thousands of positions, like university professor, aren't licensed and have status. Of course, the case for licensing is always to protect the health and safety of the consumer even though technology allows customers to rate each and every business to accomplish the very same thing without the force of government.

Texas Supreme Court Justice Don Willett trenchantly

concurring in a 2015 case involving the licensing of eyebrow threading,

"the Texas occupational licensure regime, predominantly impeding Texans of modest means, can seem a hodge-podge of disjointed, logic-defying irrationalities, where the burdens imposed seem almost farcical, forcing many lower-income Texans to face a choice: submit to illogical bureaucracy or operate an illegal business? Licensure absurdities become apparent when you compare the wildly disparate education/experience burdens visited on various professions. The disconnect between the strictness of some licensing rules and their alleged public-welfare rationale is patently bizarre.

However, once licensing is codified in law, licensees "guard it jealously against reform bills or legal challenges. These efforts frequently resemble the original campaigns for licensure," the IJ writes.

Shooting Yourself in the Foot

So it's no small matter when the state threatens to take away a person's ability to make a living. Louisiana's nursing board notified 87 nurses last year their student loans were in default and had to be brought current for their licenses to be renewed.

"It's like shooting yourself in the foot, to take away the only way for these people to get back on track," Daniel Zolnikov, a Republican state representative in Montana told the *Times*.

Non-payers are already punished, Zolnikov points out, "with credit scores dropping, being traced by collection agencies, just having liens. The free market has a solution to this already. What is the state doing with this hammer?"

However, when the federal government lends the money, it uses tactics other lenders can't use to collect. Since 2010, the government has made all student loans directly. With delinquencies over a billion dollars, states have started playing hardball, going beyond garnished non-payers' wages and liened property. "Deny professional licenses to defaulters until they take steps to repayment," the

Department of Education urged in 1990.

In South Dakota, “Nearly 1,000 residents are barred from holding driver’s licenses because of debts owed to state universities, and 1,500 people are prohibited from getting hunting, fishing and camping permits,” the *Times* reports.

Jeff Barth, a commissioner in South Dakota’s Minnehaha County, says it’s “better to have people gainfully employed,” and rightly points out, “the state is taking a pound of flesh.”

Why Not Bankruptcy?

Bankruptcy gives many people a fresh start. The President has filed four times, for instance. But also, Henry Ford, Walt Disney, H. J. Heinz, Milton Hershey and many others who went on to build great fortunes filed bankruptcy.

However, while student debt used to be dischargeable, that has, for the most part gone away. Josh Cohen, Vermont-based attorney who specializes in student loans, explained in *Forbes*,

“Congress made student loans non-dischargeable over a period of years.

At first, [student loans] were dischargeable if they had been in repayment for five years. Then, [Congress] extended it to seven years. Then, in 1998, they removed dischargeability except if a debtor could show that paying back the student loans would create an undue hardship. In 2005, they extended this protection to private student loans.

No one really understands why Congress felt federal loans shouldn’t be discharged. Lots of other federal debt is dischargeable, including Small Business Administration (SBA) loans and taxes.

Andrew Heaton wrote for *FEE* in 2013 that if student debt is “forgiven,” it really is paid either by the alumni or the taxpayer. Heaton wonders, “Why not remove this legal impediment, allowing graduates to decide for themselves the pros and cons of filing for Chapter 7, which results in a personal balance sheet

purged of debt, but a horrendously blemished credit rating?”

What does a principled libertarian do? In his book *The Ethics of Liberty*, Murray Rothbard writes, “Relations with the State, then, become purely prudential and pragmatic considerations for the particular individuals involved, who must treat the State as an enemy with currently prevailing power.”

The state guaranteed these student loans with funds coerced from taxpayers. “Such coercion can never be licit from the libertarian point of view,” Rothbard explains.

For the student/graduate borrower, the state is their enemy, blocking their path toward financial freedom and occupational success, while extracting its pound of flesh.

Douglas French is an Associated Scholar at the Johnson Center at Troy University and adjunct professor at Georgia Military College. He is the author of three books: *Early Speculative Bubbles and Increases in the Supply of Money*, *Walk Away*, and *The Failure of Common Knowledge*.

Millennials Get It Wrong about Socialism

by Benjamin Powell

Last month’s 100th anniversary of the Russian Revolution is an appropriate occasion to remind us of the human atrocities committed by communist regimes. But we also should take time to reflect on the progress that has occurred since the fall of the Soviet Union and its socialist economic system in 1991.

A recent poll of Millennials found that 51 percent of them identified socialism as their favored socioeconomic system, with an additional 7 percent identifying communism as their favored system. Only 42 percent favored capitalism.

Socialism Kills, Always

Most Millennials I’ve met—and I meet quite a few

as a college professor—are nice enough people. Most have no desire to see their fellow humans suffer. So I'm left to conclude that they have no appreciation for how socialism actually works in the real world.

Socialist regimes—through executions, intentional starvation, and brutal prison-work camps—killed more than 100 million of their own citizens in the 20th century. In places such as Cuba, North Korea, and Venezuela the atrocities continue.

Such atrocities are no accident. The nature of a centrally planned economy reduces humans to labor inputs who must be coerced to perform a part of someone else's economic plan. If people are permitted to make their own choices, no economic plan is possible. A socialist system naturally selects leaders willing to exercise coercion to see that the plans are carried out.

The economic track record of socialism is as dismal as its human rights record. But we need not direct Millennials to history books to see it. They need only look at what has happened to former socialist countries during their own lifetimes, as these countries have moved away from socialism and towards capitalism.

Economic Freedom Leads to Better Outcomes

The Economic Freedom of the World Annual Report provides the best measure of the degree to which a country is relatively capitalist or socialist. The index relies, of course, on the availability of reliable data. Consequently, socialist regimes, like Cuba and North Korea, are unranked because of the lack of such data. But the index does allow us to assess changes in former socialist countries since they abandoned socialism.

Russia, for example, scored only 4.3 on the index's 10-point scale in 1995, when it was first ranked. It has since improved its score by 52 percent and now ranks in the top 50 percent of all countries included in the index.

Other former Soviet-bloc countries moved toward capitalism more quickly. In the rankings in 1995,

Estonia scored a 6.2 and Latvia a 5.7, ranking 57th and 75th, respectively. Since then, Estonia has moved up in the rankings to 17th place, and Latvia has jumped from 75th-freest economy in the world to 26th.

Outside the former Soviet bloc, China began its move away from socialism in 1978, just before the first Millennials were born. China's first score was 3.6 in 1980. China has since improved by 76 percent and even this improvement understates China's reforms as many special enterprise zones within China are much freer than the country as a whole.

But the rankings don't tell the entire story. The result of the move toward capitalism has been increased prosperity: The people are better off. Average incomes have increased 250 percent in Russia since 1995. In more economically free Latvia and Estonia, incomes are up 487 percent and 461 percent, respectively. And it's not just the rich getting richer. The percent of the population living on less than \$5.50 per day has dropped 23 percent in Russia, 19 percent in Latvia, and 22 percent in Estonia.

The changes in China are even more striking. Average incomes are 12 times greater now than in 1995. More than 90 percent of the population lived on less than \$5.50 a day back then; today, only about one-third of the population does.

Millennials could delve into history books to learn about Socialist atrocities. But they could also just look at the facts of the world and see how prosperity has increased as the former socialist countries have begun embracing capitalism. If they'd do either, I doubt you'd find many socialists among them.

Reprinted from the Independent Institute

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The Road to Serfdom: What Is Past Is Prologue

by Brittany Hunter

When I decided to read and live-blog *The Road to Serfdom* by F.A. Hayek, I will admit I did not fully understand what I had signed up to do. Reading excerpts from the book is one thing, but endeavoring to read the book in its entirety and also write my accompanying thoughts was an entirely different feat altogether.

Even though I knew ahead of time that I would not always agree with Hayek, I was well aware of his incomparable intellect. And I knew I needed to do my due diligence to pay his prize-winning work the respect it deserved. As it turns out, doing so took a lot of effort not only through reading Hayek's work, but through understanding the historical setting in which it was written.

But understanding the economic and political factors of the two World Wars alone wasn't enough, because Hayek doesn't limit his economic perspective to only that of the recent events of his own day. Instead, he briefly but concisely explains the very foundations of liberalism and how the modern political trajectory was threatening to undo all the progress of the 19th-century.

Hayek takes the reader on a historical journey that traces the roots of free market economics along with the rise of totalitarian governments. Both topics of course not being mutually exclusive to Hayek's primary cause of writing the book.

While the bulk of Hayek's work is contained within 15 chapters, in the final sixteenth chapter, Hayek concludes his work and spells out his final message to the reader: Do not let history repeat itself.

What Is Past Is Prologue

Hayek is quick to point out that, "The purpose of this book has not been to sketch a detailed program of a desirable future order of society." And while he may not have painted a picture of what his ideal society may look like, he does tell the reader what types of

government coercion we should avoid at all costs.

Above all things, this book presents an opportunity for the reader to have a positive impact on history by first learning from it. Hayek has taken a justifiably ominous tone while explaining how totalitarians rise to power and then devastate the economies and people they oppress.

Yet, as hopeless and frustrated as Hayek may seem at times, the book is at its core a beacon of hope that, if used correctly, illuminate the future path toward freedom.

As Hayek says:

"A great deal will depend on how we use the opportunity we shall then have. But, whatever we do, it can only be the beginning of a new, long, and arduous process in which we all hope we shall gradually create a world very different from that which we knew during the last quarter of a century."

Continuing, Hayek says:

"The important thing now is that we shall come to agree on certain principles and free ourselves from some of the errors which have governed us in the recent past."

Hayek's ultimate hope is that each reader of his book will understand the important role they play as individuals. As Hayek has demonstrated in his book, the individual is the greatest threat to the totalitarians and the collectivists of the world. The individual has been a thorn in the state's side that has prevented it from total abuse of power since the beginning of time.

But it is up to each reader of the book to heed Hayek's warnings and prevent the past from occurring once again.

As Hayek writes:

"If we are to build a better world, we must have the courage to make a new start—even if that means some reculer pour mieux sauter [strategic withdrawals]. It is not those who believe in inevitable tendencies who show this courage, not those who preach a "New Order" which is no more

than a projection of the tendencies of the last forty years, and who can think of nothing better than to imitate Hitler.”

So as I finish this book, I would implore others to read it and take a lesson from F.A. Hayek. If he believed the country was in grave economic danger in 1944, the stakes are even higher in our present day.

Brittany Hunter is an associate editor at FEE. Brittany studied political science at Utah Valley University with a minor in Constitutional studies.

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The Corrupt Origins of Central Banking

by Thomas J. DiLorenzo

[Originally published December 2008.]

Central banking has been a corrupt, mercantilist scheme and an engine of corporate welfare from its very beginning in the late 18th century. The first central bank, the Bank of North America, was "driven through the Continental Congress by [congressman and financier] Robert Morris in the Spring of 1781," wrote Murray Rothbard in *The Mystery of Banking* (p. 191). The Philadelphia businessman Morris had been a defense contractor during the Revolutionary War who "siphoned off millions from the public treasury into contracts to his own ... firm and to those of his associates." He was also "leader of the powerful Nationalist forces" in the new country.

The main objective of the Nationalists, who were also known as Federalists, was essentially to establish an American version of the British mercantilist system, the very system that the Revolution had been fought against. Indeed, it was this system that the ancestors of the Revolutionaries had fled from when they came to America. As Rothbard explained, their aim was

To reimpose in the new United States a system of

mercantilism and big government similar to that in Great Britain, against which the colonists had rebelled. The object was to have a strong central government, particularly a strong president or king as chief executive, built up by high taxes and heavy public debt. The strong government was to impose high tariffs to subsidize domestic manufacturers, develop a big navy to open up and subsidize foreign markets for American exports, and launch a massive system of internal public works. In short, the United States was to have a British system without Great Britain. (p. 192)

An important part of the "Morris scheme," as Rothbard called it, was "to organize and head a central bank, to provide cheap credit and expanded money for himself and his allies. The ... Bank of North America was deliberately modeled after the Bank of England." The Bank was given a monopoly privilege of its notes being receivable in all tax payments to state and federal government, and no other banks were permitted to operate in the country. It "graciously agreed to lend most of its newly created money to the federal government," wrote Rothbard, and "the hapless taxpayers would have to pay the Bank principal and interest."

Despite these monopolistic privileges, a lack of public confidence in the Bank's inflated notes led to their depreciation and the Bank was privatized by the end of 1783. But Morris did not give up on his scheme. He recruited a young Alexander Hamilton to serve more or less as his political puppet within the Washington administration. (Rothbard called Hamilton "Morris's youthful disciple.") In fact, the reason why Hamilton became Treasury secretary, despite having no reputation at all in the field of finance, was the recommendation by Morris to George Washington. (During the Revolutionary War, when he was an aide to Washington, Hamilton took the time to write Morris a 30-page letter proclaiming that he agreed with every one of his ideas about protectionist tariffs, corporate subsidies, and a government-run bank to finance them.)

Morris and his fellow Nationalists wanted a king-like chief executive who would rule over a

mercantilist empire, just as the king of England ruled over his mercantilist empire. They, of course, would be the ones to advise and instruct the "king" and benefit financially from such an empire. So their young protégé Hamilton commenced his seven-year crusade to overthrow the first US constitution — the Articles of Confederation — by calling for a new constitutional convention to supposedly "revise" the Articles of Confederation. At the convention, Hamilton laid out his (really Morris's) plan: a permanent president who would appoint all the governors and who would have veto power over all state legislation. Under such a plan, state sovereignty would have been destroyed, and there would have been no escape from the central government's high taxes, protectionist tariffs, heavy debt, and foreign-policy imperialism — the agenda of the Nationalists.

The Hamilton/Morris plan was defeated, of course, as was the proposal made at the convention to include a central bank among the delegated powers to the federal government. But the government was more highly centralized, as "the Nationalist forces pushed through a new Constitution" and "were on their way to re-establishing the mercantilist and statist British model..." (p. 193). They begrudgingly acquiesced in a Bill of Rights in return for the anti-Federalists' support for the new Constitution. And most importantly, writes Rothbard,

A critical part of their program was put through in 1791 by their leader, Secretary of the Treasury, Alexander Hamilton, a disciple of Robert Morris. Hamilton put through Congress the First Bank of the... United States.... modeled after the old Bank of North America [whose]...longtime president and former partner of Robert Morris, Thomas Willing of Philadelphia, was made president of the New Bank.

In making his case to President Washington for the constitutionality of a central bank, which had been explicitly rejected at the constitutional convention, Hamilton invented the idea of "implied powers" of the Constitution. These were "powers" that were not expressly delegated to the federal government in the document, but could be "implied" by clever lawyers

like Hamilton. This of course became a roadmap for the total destruction of constitutional limitations on the powers of the federal government.

The First Bank of the United States "promptly fulfilled its inflationary potential," Rothbard writes in his *History of Money and Banking in the United States* (p. 69). It issued millions of dollars in paper money and demand deposits "pyramiding on top of \$2 million in specie." The Bank invested heavily in the US government, and "The result of the outpouring of credit and paper money by the new Bank of the United States was ... an increase [in prices] of 72 percent" from 1791–1796.

Northern merchants provided the main political support for Hamilton's Bank, whereas southern politicians like Jefferson supplied most of the opposition to it, seeing it as nothing more than a vehicle for financing an American version of the corrupt British mercantilist system, which would be destructive of liberty and prosperity. They were right, of course, and remain right to this day.

The US Constitution Was Never Necessary for Military Defense

by Ryan McMaken

Before the US Constitution of 1787 was ratified, its proponents have claimed a centralized and powerful American state was necessary for the purposes of military defense.

But, as the Anti-Federalists of the time pointed out, the older constitution (known as the Articles of Confederation) had already been sufficient to allow the colonies to defeat what was the most powerful state on earth — the British Empire.

By the time the Federalists were advocating for a new, stronger, more costly constitution, the US was, as Richard Henry Lee put it, "in no immediate danger of any commotions; we are in a state of perfect peace, and in no danger of invasions."

Then as now, though, advocates for more government intervention wrapped up their agenda in

calls for more "security" through a larger, stronger state.

As has happened so many times in American history, the trick worked, and the voters accepted much stronger and expansive government in the name of peace and security.

What they ended up with, though, went far beyond mere military matters.

The new constitution contained a bevy of new powers for the central state to exercise including new powers of taxation, new regulations, and new courts.

These powers on domestic matters were so broad that within two years, Congress had passed the Judiciary Act of 1789 creating a network of domestic federal courts. By 1791, the United States had a central bank. By 1803, with *Marbury vs. Madison*, the Supreme Court had invented the power of judicial review, deciding for itself what were the limits of federal power.

By the end of the 19th century, the US government had established itself as able to regulate countless industries under the guise of promoting "competition" and fair labor relations.

None of these powers, of course, are key in providing for the so-called "common defense," although that's what voters were told was the primary reason for the new constitution.

And to this day, apologists for the new constitution recoil in horror at the suggestion that the Union be disbanded or that member states be allowed to go their own way.

"Why, we'll be invaded by foreign powers!" is the refrain, either implied, or stated explicitly.

In truth, nothing nearly so broad and unrestrained as the current constitution is remotely necessary to provide for an immense military establishment in the United States.

The Geopolitics of Military Alliances

Broadly speaking, it makes a lot of sense for a number of independent states to join together for

purposes of military defense.

This is certainly not the case for other common functions of government. Most of these, from transportation infrastructure, to policing, to welfare benefits, can easily be administered at the level of a small state, or even at the municipal level. All one need to do is look at some of the welfare states of Europe — such as Switzerland and Norway, with populations of 8 million and 5 million respectively — to see that large states are not required in this respect.

Due to the realities of military conflict, however, large frontiers and geographical areas can offer advantages in military defense. This is a primary motivation behind a variety of military alliances, both modern and historical, from NATO to the Hanseatic League.

In the aftermath of the successful war against the British Empire, it made sense to many Americans that the United States would continue on as a military alliance of independent states.

Restricting a Constitution to Foreign Affairs

For many, then, it was clear that even the loose confederation of states that existed under the old constitution offered the necessary benefits of a military alliance. Their recent experience had shown it to be so.

What was not clear was that any further unification was necessary, or that an alliance of a non-military nature was necessary at all.

Understandably, the language of the Articles of Confederation deals overwhelmingly with military and diplomatic matters. Under this agreement, the purpose of the United States government is to engage in activities of external affairs — providing diplomatic and military services. For outside governments, "the United States" would appear to be one entity, although internal relations could continue to be the domain of the independent and sovereign states.

This is what an alliance of mutual military aid, properly understood, would look like. Domestic

affairs would be left to the autonomous members of the confederation.

Instead, the United States became a union rather than a confederation, with direct taxation by the American government, and involuntary membership in the "alliance" by all member states.

The Real Source of American Peace

Supporters of an involuntary and highly centralized union often argue that formal legal union, coerced membership, and direct taxation are necessary to "unite us" into a single national unit. It is even implied that, if all member states are not coerced into a single unified state, then the various states will begin warring among themselves.

In response to this, one might first note that the presence of the current constitution did not prevent the Civil War's bloodbath that lasted from 1861 to 1865.

Second, the assumption that political unity produces peace fails to explain why the US has been at peace with Canada and all the Anglosphere since 1815.

Obviously, those foreign states are not bound by the US Constitution, and we can't attribute the long period of peace to a presence of a strong federal government.

The likely reason peace has endured among these states is that, when it comes to relations among these states, peace is more beneficial than war. Moreover, the populations of these states recognize that peace is more beneficial than war.

This is true for both cultural and economic reasons. Common bonds of culture, language, and trade are powerful deterrents to war. In the Anglosphere, of course, these bonds are especially strong due to the presence of a common language. But even language barriers can be overcome should the peoples of two states share a strong sense of common history and ideology, as is the case between the French and the Americans.

But it's not just any ideology that especially fosters peace. The ideology of liberalism and free markets is

especially effective.

This relationship has been documented by R.J. Rummel who concludes that the "libertarian peace" is an observable phenomenon in which "libertarianism is causally related to foreign violence: The more freedom that individuals have in a state, the less the state engages in foreign violence."¹

Rummel continues:

[S]ystems (like the free market) tend to be self-regulating and to isolate and inhibit conflicts and violence when they occur. They tend to encourage exchange, rather than coercive and violent solutions, in conflict between groups and individuals.

Libertarian states are by theory not only less violence prone, but when foreign relations includes the perception of other libertarian states, this inhibition becomes a mutual barrier to violence. Their mutual domestic diversity and pluralism, their free and competitive press, their people-to-people and elite-to-elite bonds and relationships, and their mutual identification and sympathy will foreclose on any expectation or occurrence of war between them...²

Similarly, Steven Pinker has noted the existence of a "capitalist peace" which discourages wars among nations with well-developed and open economies:

[W]hen it's cheaper to buy things than to steal them, people don't steal them. Also, if other people are more valuable to you alive than dead, you're less likely to kill them. You don't kill your customers or your lenders, so the arrival of the infrastructure of trade and commerce reduces some of the sheer exploitative incentives of conquest ...

I don't think it's the entire story of the decline in war. But I do think it's part of the story. There was a well-known study from Bruce Russett and John Oneal showing statistically that countries that engage in more trade are less likely to get into militarized disputes, and countries that are more integrated into the world economy are less likely

to get into trouble with their neighbors.

The US Could Have Been a Voluntary Cultural and Economic Union

Clearly, these realities apply to groups of American states as well. In the early United States, the various member states were already heavily influenced by ideologies of a high degree of both economic freedom and market freedom. These factors were important in the motivations of participants in the Revolution.

By the end of the 18th century, trade was widespread among the states. Trade had even resumed with the British Empire, and had become extensive.

Most residents of the former colonies already shared a widespread usage of English, similarities in religion, and similarities in political ideology. These are the factors that unified the colonies during the war in the first place. Unity was not achieved by federal mandates imposed from above. On the contrary, the new constitution and its fugitive slave provisions greatly exacerbated conflicts between slave states and free states.

To turn around and claim, therefore, that the result of a weak constitution would be widespread warfare among the newly independent states is not at all convincing. Were the American states to continue in a loose confederation, there is no more reason to believe that Tennessee would benefit from war with Illinois any more than New Zealand would benefit from war with Australia. Such a conflict would be destructive, pointless, and impoverishing, not to mention politically unpopular among the voters.

Equally unconvincing is the claim that foreign powers would pick off American states one at a time, turning them against their neighbors. This is about as likely as the Russians convincing the Canadians to join in an alliance against the United States — Canada's largest trading partner.

Today, supporters of the current constitution often dismiss any significant decentralization or reform out of hand, often claiming the status quo is absolutely necessary to preserve an effective military defense.

This however, has never been true.

The power of the American military establishment has long been more a product of its industrial power and economic wealth, and this is not enhanced by a strong state with vast regulatory powers as the US enjoys today.

Where the new US Constitution of the Federalists limited strictly to matters of military and diplomatic affairs, we might have avoided the central banks, federal regulatory agencies, and vast taxation powers that followed ratification. Unfortunately, the Federalists had much bigger plans than simply forging a better foreign-policy alliance. The document we now call "the Constitution" has always been a document designed to grant vast new domestic powers to the American state. Unfortunately, its defenders then, as now, flock to its defense using a familiar refrain: We need a big government to "keep us safe."

1. Sometimes this position is described as the "democratic peace" which is often misunderstood by libertarians themselves. In *The Next Generation of Austrian Economics*, J. Patrick Rhamey writes:

[T]here is a frequent and unfortunately persistent mischaracterization in Austrian circles of democratic peace theory, often inappropriately conflated with neoconservative foreign policy prescriptions. As but one example, a recent discussion by Hans Hoppe (2013) on the democratic peace grossly mischaracterizes the theory as including the claims 'In order to create lasting peace, the entire world must be made democratic' and 'war must be waged on those states to convert them to democracy and thus create lasting peace.' Such a claim about democratic peace is a complete invention, as there is not a single piece of democratic peace research in international relations that states either. Indeed, the original conceptualization of the democratic peace in modern political science empirical research was labelled the 'libertarian peace' and focused on libertarian normative values (Rummel 1983). Such claims are completely absent in both the normative (Dixon 1994) and institutionalist (Bueno de Mesquita et al. 1999) explanations of the empirical finding, which has been described as 'the closest thing we have to an empirical law in the study of international relations.'

2. See "Libertarianism and International Violence" by R. J. Rummel, in the *Journal of Conflict Resolution*, First Published March 1, 1983.

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A Small Revolution

by Jeff Deist

Dr. Robert Murphy and I enjoyed a robust discussion of the current political landscape this past weekend at the University of Central Florida. A significant percentage of attendees, maybe half, agreed with the proposition that the US is past the point of political solutions. Everyone agreed, regardless of their age and background, that the possibility of America breaking — violently or voluntarily — is very real.

My talk focused on the value of smaller polities. Given the stubborn tendency for governments to emerge and endure in human societies, we should focus our efforts on creating smaller political units that more closely allow for a Misesian vision of democratic self-determination. This may not satisfy libertarians and anarcho-capitalists, but neither will trying to persuade a winning electorate of 70 million Americans to vote for even a reasonably liberty-minded presidential candidate.

Mass democracy, in a decidedly diverse nation of 320 million people, is a recipe for disaster. And we're seeing that disaster unfold in the cold civil war known as the Trump era. Increasingly federalized state power, combined with our winner-takes-all, top-down rule by DC, creates terrible zero-sum outcomes for millions. Five people on the Supreme Court wield an extra-constitutional power that creates deep and lasting cultural divides. 535 members of Congress have the ability to spend, tax, regulate, inflate, and war us into oblivion.

A few salient points from my presentation:

- US politics now takes place in an era of

assumed bad faith, what Tom Wolfe's character Wismer Stroock in *A Man in Full* called "post-goodwill." Both sides, to the extent left and right have meaning, believe the other actively seeks to harm them and make them worse off (this may be nothing new in American history, but social media intensifies it and reinforces our preconceived perspectives). The 2020 presidential election, therefore, will create an atmosphere of antipathy, division, and vengefulness not seen in our lifetimes.

- Trump's election produced two salutary developments. First, millions of American progressives suddenly recognized what libertarians have argued for decades: democratic elections, even when fairly held, do not confer legitimacy on victorious political candidates or the governments they subsequently control. Second, millions of Americans on all political sides now fully recognize that democracy does not create a compromise between two sides, both getting some but not all of their preferred goals.
- A large degree of *de facto* secession among US states can be achieved without addressing thorny questions about federal land, military protection and bases, entitlements like Social Security and Medicare, or realigning physical borders.
- Simply allowing real federalism, and following the Swiss system of pushing all government decisions down to the smallest possible political subdivision, would greatly reduce culture wars. The Swiss federal website explicitly states that federalism is designed to improve social cohesion in their multilingual society.
- The 11 counties and 8 million people of the San Francisco Bay area, for example, could enact the whole panoply of progressive legislative goals here and now — for example, single-payer health care. Yes, some liberty-minded people in the area would be worse off politically (and otherwise, as progressive programs inevitably failed). But it is easier to leave northern California than to leave the US.

- Polls showing significant support for third parties are overstated. Americans had the opportunity to vote outside the box, e.g., for Ron Paul, Rand Paul, Jill Stein, and Gary Johnson in the last two presidential elections — but largely chose not to. And we forget that John Anderson received 6 million votes in 1980, or 6.6% of the electorate, and Ross Perot received an astonishing 19 million votes in 1992, about 20% of all votes. If anything, third party momentum has diminished since then. So while Americans complain endlessly about Republicans and Democrats, and tell pollsters they want a viable third party, their actions say otherwise.
- The 2020 election will be an all-out offensive by progressives to oust Trump. Female candidates will dominate both the narrative and the candidate slates across local, state, and national contests. To the extent any third party presidential candidate is seen to “take” votes from Trump, progressives will vigorously support him/her. But if they appear to split votes away from the Democratic nominee — a charge leveled at both Jill Stein and Gary Johnson in 2016 — expect savage attacks and attempts to rig debate qualifications.
- Virtually every aspect of human life — from business organizations to trade to food to communications to travel to shopping to money to education — becomes more and more decentralized every day. Hub and spoke networks are dying; replaced by nimbler webs and networks. *Only government*, in its hubris, bucks this dominant trend of the digital age. Somehow governance continues to go in the wrong direction: from local to regional, from regional to national, from national to supra-national, and from supra-national to global. And it's not just DC: bodies like the UN, EU, and IMF work every day to centralize the management of human affairs. Why do we put up with this, even as we demand decentralized efficiency in everything else?

Decentralization of political power, subsidiarity, and

“Irish Democracy” are all pragmatic and peaceful responses to our current hellscape of identity politics and ill will. But it will take more people who reject the notion that all Americans, much less the world, must live under one universal political arrangement. It will take people who are not “post-goodwill.”

If we hope to avoid what both conservatives and progressives see as a looming potential for a nasty breakup of America, we would do well to apply a serious dose of Swiss-style federalism to the fraying body politic. At this point a move toward political subsidiarity and outright secession seems the most fruitful, realistic, and humane approach for libertarians. Diversity, the real kind, requires us to understand that millions of Americans don't view the state as we do.

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Jeff Deist is president of the Mises Institute. He previously worked as chief of staff to Congressman Ron Paul, and as an attorney for private equity clients.

Pope Francis Is Mistaken about Free Markets

By Robert Murphy

Meeting with global-finance students recently at the Chartreux Institute in Lyon, France, Pope Francis warned them “to remain free from the lure of money, from the slavery in which money traps those who worship it.” He also counseled them not to “blindly obey the invisible hand of the market” but rather to become “promoters and defenders of a growth in equality.”

The Pope Has a Point

Even though I'm a professional economist, I am sympathetic to Pope Francis's remarks. Indeed, I think many of my colleagues are too quick to dismiss criticisms of the market as being unsophisticated, and they ignore the wise sentiments that motivate the popular distrust of capitalism. In the Independent Institute's new collection of essays, Pope Francis and

the Caring Society, my fellow contributors and I did our best to grapple with the pope's calls for social justice as we unapologetically defended the benefits of private property and market prices.

Regarding his specific remarks to the students in Lyon, I hope we can all agree with Pope Francis that the lure of money is indeed a trap for those who worship it (as he put it). The Bible teaches that the love of money is "the root of all evil," and people of all religious traditions — or none at all — can surely recognize that the single-minded pursuit of material wealth is no way to live.

But He's Not Entirely Correct

Having agreed with the pope thus far, where I strongly differ is in his dismissal of the "invisible hand." It's not merely that I think Pope Francis needs to better appreciate the workings of the market economy. As a Christian myself, I think Adam Smith's famous metaphor illustrates a pattern in the way a loving God deals with His fallen children.

To set the context, in his treatise *The Wealth of Nations* (1776), Adam Smith famously wrote,

"By preferring the support of domestic to that of foreign industry, [an individual] intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.

Smith is showing that the government doesn't need to promote domestic industry, because individuals who seek only their own narrow gain will do so on their own.

This helps us see that Pope Francis has set up a false dichotomy: He seems to be urging those entering the financial sector to ignore market signals and personal gain in order to better help the poor and downtrodden. Yet Adam Smith's point was that people who are pursuing personal gain — as long as their activity relies on exchanges that are consensual among all participants — end up unwittingly

promoting the welfare of others. In modern times, the only way to become a billionaire in the free market is to create a new product or service that millions of people want or enjoy.

The Invisible Hand Is a Benevolent One

Christians especially should appreciate this aspect of capitalism. Just as Genesis has Joseph telling his brothers — who had plotted against him — that God turned their evil actions to serve good, so too did Adam Smith view the "invisible hand" as a benevolent mechanism that harnesses the greed and ambition of the few in order to shower benefits on the masses. Think about it: In modern times, the only way to become a billionaire in the free market is to create a new product or service that millions of people want or enjoy.

If it were just a matter of incentives, then Pope Francis might retort that the invisible hand is a good safety net, but that people should nonetheless strive to do the right thing in the first place. Yet here is where the subsequent work of economists has added to Adam Smith. As thinkers such as Friedrich Hayek emphasized, humans know very little about the modern global economy. Each person, no matter how intelligent, can understand only an extremely tiny fraction of what it would take to improve the general welfare.

To coordinate economic activity and better serve others, humans need to rely on the information embedded in market prices, just as surely as they rely on the information transmitted by phone, radio, and computer. Students entering a career in finance need to be guided by market prices — and their signaling of profit and loss — just as surely as they need to be guided by traffic lights and the rules of grammar.

To best promote the *material* development of the poorest regions on earth — and thereby reduce inequality — people entering the field of finance should play their part in boosting the profitability of firms that engage in voluntary trades. The pursuit of profit won't hurt the world's poor. It does, however, threaten the souls of those who make such a pursuit

their highest goal. In this the pope is absolutely right.

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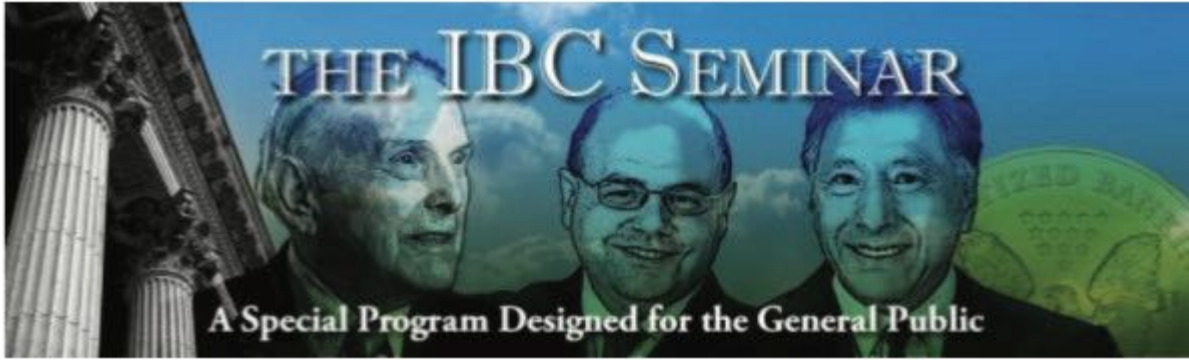
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