Government, Fiscal Responsibility, and Free Banking

BY RICHARD M. EBELING

There has been no greater threat to life, liberty, and property throughout the ages than government. Even the most violent and brutal private individuals have been able to inflict only a mere fraction of the harm and destruction that have been caused by the use of power by political authorities. The pursuit of legal plunder, to use Frédéric Bastiat's well-chosen phrase, has been behind all the major economic and political disasters that have befallen man throughout history.

We often forget the fundamental truth that governments have nothing to spend or redistribute that they do not first take from society's producers. The fiscal history of mankind is nothing but a long, uninterrupted account of the methods governments have devised for seizing the income and wealth of their citizens and subjects.[1] And parallel to that same sad history must be an account of all the attempts by the victims of government's legal plunder to devise counter-methods to prevent or at least limit the looting of their income and wealth by those in political power.

Every student who takes an economics class learns that governments have basically three methods for obtaining control over a portion of the people's wealth: taxation, borrowing, and inflation—the printing of money. It was John Maynard Keynes who pointed out 85 years ago that "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they also confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. . . . There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."[2]

To prevent the use of inflation to attain their fiscal ends, various attempts have been made over the last 200 years to limit the power of governments to print money to cover their expenditures. In the nineteenth and early twentieth centuries the method used was the gold standard. The idea was to place the creation of money outside the control of government. As a commodity, the amount of gold available for both monetary and nonmonetary uses is determined and limited by the same market forces that determine the supply of any other freely traded good or service: the demand and price for gold for various uses relative to the cost and profitability of mining and minting it into coins or bullion, or into some other commercial form.

Any paper money in circulation under the gold standard was meant to be money substitutes—that is, notes or claims to quantities of gold that had been deposited in banks and that were used as a convenient alternative to the constant withdrawing and depositing of gold to facilitate everyday market exchanges.

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Under the gold standard, the supply of money substitutes in circulation was meant to increase and decrease to reflect any changes in the quantity of gold in a nation's banking system. The gold standard that existed in the late nineteenth and early twentieth centuries never worked as precisely or as rigidly as it is portrayed in some economics textbooks. But, nonetheless, the power of government to resort to the printing press to cover its expenditures was significantly limited.

Governments, therefore, had to use one of the two other methods for acquiring their citizens' and subjects' income and wealth. Governments had to either tax the population or borrow money from financial institutions. But as James Buchanan and others have pointed out, before World War I many of the countries of North America and western and central Europe operated under an "unwritten fiscal constitution."[3] Governments, except during times of national emergency, were expected to more or less balance their budgets on an annual basis. And if a national emergency (such as a war) compelled a government to borrow money to cover its unexpected expenditures, it was expected to run budget surpluses to pay off any accumulated debt when the emergency passed.

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This unwritten balanced-budget rule was never rigidly practiced either, of course. But the idea that needless government debt was a waste and a drag on the economic welfare of a nation served as an important check on the growth of government spending. When governments planned to do things, the people were more or less explicitly presented with the bill. It was more difficult for governments to promise a wide variety of benefits without also showing what society's tax burden would be.

Gold Standard Shelved

This all changed during and after World War I. The gold standard was set aside, and Keynes, who in 1919 had warned about the dangers of inflation, soon was arguing that gold was a "barbarous relic" that needed to be replaced with government-managed paper money to facilitate monetary and fiscal fine-tuning.[4] And that unwritten fiscal constitution which required annual balanced budgets was replaced with the Keynesian conception of a balanced budget over the phases of the business cycle.

In practice, of course, this set loose the fiscal demons. Restrained by neither gold nor the limits of taxation, governments around the world went into an orgy of deficit spending and money creation that led some to refer to a good part of the twentieth century as the "age of inflation." Politicians and bureaucrats could now far more easily offer short-run benefits to special-interest groups through growth in government power and spending, while avoiding any mention of the longer-run costs to society as a whole.

Beginning in the late 1960s and 1970s a counterrevolution against Keynesian economics emerged, especially in the United States, which has come to be identified with Milton Friedman and monetarism.[5] To restrain government's ability to create inflation, Friedman proposed a "monetary rule": the annual increase in the money supply should be limited to the average annual increase in real output in the economy. Put the creation of paper money on "automatic pilot," and governments would once more be prevented from using the printing press to capriciously cover their expenditures.[6]

But in the years after receiving the Nobel Prize in economics, Friedman had second thoughts about the effectiveness of his monetary rule. He has stated that Public Choice theory—the use of economic theory to analyze the logic and incentives in political decision-making—persuaded him that trying to get central banks to pursue a monetary policy that would serve the long-run interest of society was a waste of time. Just like the rest of us, politicians, bureaucrats, and central bankers have their own self-interested goals, and they

will use the political power placed at their disposal to advance their interests. "We must try to set up institutions under which individuals who intend only their own gain are led by an invisible hand to serve the public interest," Friedman said.[7] He also concluded that after looking over the monetary history of the twentieth century, "leaving monetary and banking arrangements to the market would have produced a more satisfactory outcome than was actually achieved through government involvement." [8]

The Case of Panama

Panama, from its beginning as an independent country 100 years ago, found an external check on the danger of domestic inflation through what has become known as "dollarization." For the most part, control of the money supply has been placed outside the hands of the Panamanian political authorities by using U.S. dollars as the primary currency. The Panamanian government has been unable to arbitrarily print money to cover its expenditures. And while the Panamanian people may have a variety of objections to the size and scope of their government, the power to directly create inflation is not one of them.[9]

However, a political authority still has ultimate decision-making power over the money that the Panamanian people use. It is just that this authority resides in the Federal Reserve Bank headquarters in Washington, D.C. Given the history of monetary mismanagement by governments in Latin America in both the nineteenth and the twentieth centuries, it is certainly true that Panama has fared far better than many other countries in this part of the world by using the U.S. dollar instead of a paper money produced and controlled by its own local government. The dollar has more or less played the role in Panama that gold was supposed to play under a gold standard.

It may be that for the foreseeable future, political circumstances will make it advantageous to continue to have the dollar play this role. But there is another possible path that a country like Panama can follow. It is the path of monetary freedom. Under a regime of monetary freedom the government would no longer have any role in monetary and banking affairs. The people would have, to use a phrase popularized by the Austrian economist F. A. Hayek, a "choice in currency."[10] The law would respect and enforce all market-based, consensual contracts regardless of the currency chosen by the parties. And the government would not give a special status to any particular currency through legal-tender laws.

Monetary freedom encompasses what is known as "free banking." That is, private banks are at liberty to accept deposits in any commodity money or currency left in their trust by depositors and to issue their own notes or claims against these deposits. To the extent these notes are recognized and trusted by a growing number of people in the wider economic community, they may circulate as convenient money substitutes. Such private banks would settle their mutual claims against each other on behalf of their respective depositors through private clearinghouses that would have international connections as well.

Few advocates of the free market have included the privatization of the monetary system among their proposed policy reforms. Most notable in the twentieth century was the Austrian economist Ludwig von Mises.[11] But the last 20 years have seen the emergence of a body of serious and detailed literature on the desirability and workability of a fully private and competitive free-banking system as an alternative to central banking.[12]

Its political advantage is that it completely removes all monetary matters from the hands of government. However effective the old gold standard may have been, it nonetheless remained a government-managed monetary system that opened the door to eventual abuse. Panama's dollar standard ultimately depends on the decision-making of the monetary central planners in Washington, D.C., and therefore is not free from changing political currents and pressures within the United States.

Furthermore, a free-banking system fulfills Milton Friedman's recommendation that the monetary order should be one that harnesses private interest for the advancement of the public interest through the "invisible hand" of the market process. The interests of depositors in a reliable banking system would coincide with the self-interest of profit-seeking financial intermediaries. A likely unintended consequence would

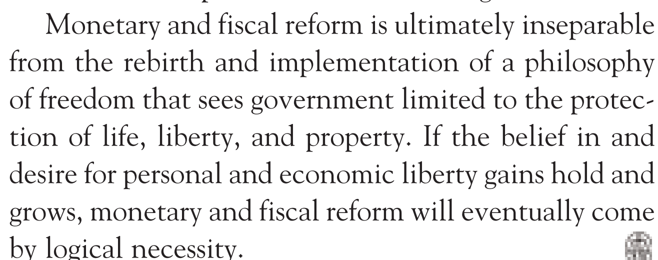
be a more stable and adaptable monetary system than the centrally planned monopoly the world labors under now.

No Central Bank to Abolish

Because Panama is small and generally open to world trade, it may be able to shift to a fully market-based monetary and banking system more easily than a relatively large country where the internal and external political pressures to maintain the status quo may be much greater. Indeed, a major stumbling block to monetary freedom need not be overcome in Panama precisely because there is no national central bank to abolish.

Of course, a system of monetary freedom does not do away with the continuing motives for government to grow and spend. As the recent financial crisis in Argentina demonstrated, even limits on the government's ability to create money to finance its expenditures does not preclude fiscal irresponsibility, with damaging economic consequences for a large segment of the population.

In the long run, the only way to limit the growth of government spending and power over society is to change political and ideological thinking. As long as many people want government to use its power to tax and regulate to benefit them at the expense of others, it will retain its power and continue to grow.



Monetary and fiscal reform is ultimately inseparable from the rebirth and implementation of a philosophy of freedom that sees government limited to the protection of life, liberty, and property. If the belief in and desire for personal and economic liberty gains hold and grows, monetary and fiscal reform will eventually come by logical necessity.

1. See Joseph A. Schumpeter, "The Crisis of the Tax State" [1918] in *The Economics and Sociology of Capitalism*, ed. Richard Swedberg (Princeton, N.J.: Princeton University Press, 1991), p. 100: "The fiscal history of a people is above all an essential part of its general history. An enormous influence on the fate of nations emanates from the economic bleeding which the needs of the state necessitates, and from the use to which its results are put."

2. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace, 1920), pp. 235–36.

3. James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

4. John Maynard Keynes, *A Tract on Monetary Reform* (New York: Harcourt, Brace, 1924), p. 187.

5. Milton Friedman, "The Counter-Revolution in Monetary Theory" [1970] in *Monetarist Economics* (Cambridge, Mass.: Basil Blackwell, 1991), pp. 1–20.

6. Milton Friedman, *A Program for Monetary Stability* (New York: Fordham University Press, 1960).

7. Milton Friedman, "Economists and Economic Policy," *Economic Inquiry*, January 1986, pp. 1–10.

8. Milton Friedman and Anna Schwartz, "Has Government Any Role in Money?" *Journal of Monetary Economics*, 1986, p. 59.

9. Juan Louis Moreno-Villalaz, "Lessons from the Monetary Experience of Panama: A Dollar Economy with Financial Integration," *Cato Journal*, Winter 1999, pp. 421–39.

10. F. A. Hayek, *Choice in Currency: A Way to Stop Inflation* (London: Institute of Economic Affairs, 1976).

11. Ludwig von Mises, *The Theory of Money and Credit* (Indianapolis: Liberty Classics, 1981 [1924]), pp. 434–38; "Monetary Stabilization and Cyclical Policy" [1928] in Israel M. Kirzner, ed., *Classics in Austrian Economics: A Sampling in the History of a Tradition, Vol. 3* (London: William Pickering, 1994), pp. 85–88; *Human Action: A Treatise on Economics* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 4th ed., 1996), pp. 440–48; see also Lawrence H. White, "Mises on Free Banking and Fractional Reserves" in John W. Robbins and Mark Spangler, eds., *A Man of Principle: Essays in Honor of Hans F. Sennholz* (Grove City, Pa.: Grove City College Press, 1992), pp. 517–29.

12. See Lawrence H. White, *Free Banking in Great Britain: Theory, Experience, and Debate, 1800–1845* (New York: Cambridge University Press, 1984), *Competition and Currency: Essays on Free Banking and Money* (New York: New York University Press, 1989), and *The Theory of Monetary Institutions* (New York: Blackwell, 1999); George A. Selgin, *The Theory of Free Banking: Money Supply Under Competitive Note Issue* (Totowa, N.J.: Rowman & Littlefield, 1988) and *Bank Deregulation and Monetary Order* (London/New York: Routledge, 1996); Kevin Dowd, *Private Money: The Path to Monetary Stability* (London: Institute of Economic Affairs, 1988), *The State and the Monetary System* (New York: St. Martin's Press, 1989), *Laissez-Faire Banking* (London/New York: Routledge, 1993), and *Money and the Market: Essays on Free Banking* (London/New York: Routledge, 2001); and Kevin Dowd, ed., *The Experience of Free Banking* (London/New York: Routledge, 1992). See also Steven Horwitz, *Monetary Evolution, Free Banking, & Economic Order* (Boulder, Colo.: Westview Press, 1992).