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Free Banking: The Neglected Alternative

Recent U.S. history has raised anew great doubt about the usefulness of money and banking regulation. But the clear and logical alternative of free trade (unrestricted competition) in banking has not received serious consideration. Indeed, it has been long rejected by most monetary theorists as unworkable for various reasons. Without that alternative, debate has centered on types *and* degrees *of official monetary management.*

The possibility of demonopolizing Government's issuance of money has been stymied at least partly by deeply embedded myths about experiences during the supposedly free-banking periods in the 19th century and by the erroneous theoretical inferences drawn from that "history." There is now reason to be more hopeful that those barriers will be broken. In his extensively documented Free Banking in Britain, *Professor Lawrence H. White of New York University corrects major inaccuracies in free-banking history and thereby destroys the dictum that government monopoly of money is grounded in sound economics.* More than any recent single work, Professor White's book (and his related writings) could help to recast the issues of current monetary debate. The debate henceforth might usefully be conducted in terms of the fundamentally different approaches of free trade in money and banking or Government-mandated-and-controlled money and banking. The significance of the outcome extends far beyond the degree of freedom in monetary and economic spheres; it extends into virtually all aspects of life.*

A Free-Banking Theory

In a piece of this length we cannot possibly do justice to the range, depth, and treatment of issues addressed in *Free Banking in Britain*. As topics are covered in our publications, we shall draw on Professor White's work and report more extensively on it. Here we can only give a flavor of its many important aspects. Whenever possible we use the author's own words.

Professor White writes: "Authors in both the nineteenth and twentieth centuries have claimed that freedom of bank note issue, even where issuers are bound to redeem notes for specie, implies inherent instability in the quantity and value of the currency.† The most thorough way to evaluate these claims is to examine in a general theoretical way the operation of a free banking system, seeking to discover whether self-interested agents in that system give rise to stable or unstable monetary processes." [p. 1]

He then proceeds to show there are plausible reasons why an individual, profit-maximizing bank of issue within a free-banking system experiences rising costs of issue at some point.**

> "The rising marginal costs of maintaining notes in circulation set a limit to the bank's ability to expand permanently its holdings of bills and specie through issue of its notes. It may be nearly costless to print up additional notes and to *initiate* their circulation through bill purchases, but it is quite another matter to *maintain* their circulation in a competitive environment under convertibility. A bank must undertake various investments to make its notes relatively attractive for the public to hold. These propositions similarly apply to bank deposits.
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> "The next step is to consider the equilibrium of a free banking system as a whole. It is simplest to assume that it operates within a small open economy on an international specie standard. In that case the domestic purchasing power of money is given by the world purchasing power of specie. The demand for real currency balances by the domestic public then determines the desired nominal currency stock. The total stock of specie in the economy is determined by the conjunction of (1) this desired currency stock with (2) the public's desired ratio of coin to notes, (3) the desired specie-note reserve ratios of the various issuing banks, and (4) the shares of the circulation supplied by those banks. Changes in these four variables will change the domestic stock of specie in predictable ways, with the adjustment taking place through international specie flows.
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> "Examination of equilibrium states is of course not enough. It is necessary next to reconstruct the market mechanisms that move the banks within a free banking system toward equilibrium and so restrain them from overissuing. Having seen that the public's desired quantity of a particular bank's notes is a determinate magnitude, given that bank's optimizing expenditures, we consider the process by which the actual quantity is adjusted to the desired quantity. The overissuing bank will find excess notes returning upon it for redemption as note holders shed their excess notes. This 'reflux' of excess notes occurs either through direct customer redemption or, more commonly, through redemption demands from other banks who have accepted the excess notes as deposits. The second route involves the note-exchange system, an inter-bank clearing mechanism.
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> "Either way the excess notes may return, the overexpansive bank will find its specie reserve dwindling. It must end its expansion and contract to protect itself from running out of reserves. The process by which the notes return may involve temporary changes in domestic prices and self-reversing international specie flows. These will be of greater magnitude the greater is the relative size of the expansive bank (or group of banks acting in concert), suggesting the preferability of free banking to central banking *under a specie standard*." [our emphasis] [p. 2]

Chapter 2 describes "Free banking in Scotland, before 1844," which may have been a better title for the book than the one chosen. That period of Scottish banking is the only known example of a free-banking system in a major country in industrial times. Its high degree of success stands as a refutation of the myth that the Bank Charter Act of 1844 and related legislation in Britain (which "consolidated the privileged position of the Bank of England and suppressed

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* This article is a review of Lawrence H. White's *Free Banking in Britain: Theory, Experience, and Debate, 1800-1845*, New York, Cambridge University Press, 1984, 171 pp., hardcover, $29.95.

† Bank notes are paper currency – Federal Reserve notes in the United States today. They constituted the greater part of the media of exchange (money supply) until the later part of the 19th century. – Ed.

** To White, "free banking" refers to "the system under which there are no political restrictions on the business of issuing paper currency convertible into full-bodied coin." [p. 1] A full-bodied coin is one whose metal-content value equals the face value of the coin.

freedom of note issue in the countryside and in Scotland and Ireland" [p.76]) were enacted out of necessity due to a high degree of instability associated with unregulated rate issue. The Scottish example also provides empirical support for free-banking theory, and that empirical component sets free-banking theory a large step ahead of theories of monetary systems that are simply mental fabrications. In view of the many failures of actual centrally managed systems and the virtual absence of empirical support for imagined arrangements, the free-banking system would seem to be the more useful alternative. Indeed, proponents of centrally controlled or imagined monetary systems have the burden of "proving" the workability of their alternatives.

Different Directions at the Outset

The different directions of the evolution of banking in Scotland and in England after the Bank of Scotland was chartered in 1695 and after the Bank of England was founded in 1694 perhaps were signaled by the initial relations between the banks and the governments. The act creating the Bank of Scotland "prohibited its lending to the government under heavy penalty." [p.25] In contrast, the Bank of England's charter was granted in connection with a 12 million pound loan from the owners to the English government, a loan on which the rate of interest was below-market.* One would find it difficult, if not impossible, to name a banking practice that has proven to be more unsound than extending bank credit to governments.

According to White, the third chapter – "The free banking question in the British monetary controversies, 1800-1845" – "undertakes [successfully in our view] to reinterpret the British currency debates in terms of the free banking question by bringing the neglected literature to light. . . . The standard 'Currency School versus Banking School' framework for recounting the debates of the era, as developed by a number of historians of monetary thought, fails to come to grips with the free banking question." [p.52] By considering one by one the major theoretical banking issues in Britain between 1800 and 1845, Professor White establishes in a subsequent chapter that the free-banking school was a third separate school of thought during the period, distinct from either the Currency School or the Banking School. This chapter, the largest of the book, offers a highly useful framework for organizing today's theoretical monetary controversies, for they are little different from those of early 19th century England.

Consider, for example, today's debate of whether the Fed should be bound by "rules" or have "discretion." White reports: "A number of secondary accounts have characterized the British monetary policy debates of the 1820-50 period as a controversy over the extent to which the monetary authority (the Bank of England) should be governed by rules or allowed discretion. To frame the debates this way obscures entirely the free banking question. Whereas rules versus discretion for the central bank was indeed an issue between the Currency and Banking Schools, the Free Banking School favored neither. It favored an end to the central bank status of the Bank of England, upon which event the question of rules or discretion would dissolve. The free banking advocates wished to eliminate discretion by eliminating the specially privileged position that enabled the Bank of England to pursue discretionary policy in the short run. They had no sympathy with the Currency School's attempt to eliminate discretion by imposition of constructed rules. To them it was not a question of bound or unbound authority, but rather a question of artificially imposed or spontaneously evolved monetary institutions." [p.128] Some other historical issues considered are: whether or not free trade applied to note issue; which types of banks, if any, could overissue; the origin and transmission mechanism (various steps) or trade cycles; the conditions under which the money stock was self-regulating; the real-bills doctrine; and the needs-of-trade doctrine. These remain heated issues today.

Equally Relevant Today

A final chapter speaks to the relevance of free banking today. If today's issues are much the same as in England in the early 19th century, the free-banking arguments may be as relevant. White writes:

"Free banking as a monetary system . . . comprises two conceptually distinct elements: (1) unregulated issue of transferable bank liabilities and (2) unmanipulated supply of basic cash. Government plays no active role respecting the quantity of money produced inside or outside the banking industry.† The experience of Scottish free banking and the arguments of the Free Banking School bear most obviously on the question of deregulation of inside money. But they also shed some light on the potential desirability of an outside money free of central bank control. The desirability of a precious metallic coinage is particularly involved, because one common objection to a specie standard has been the expense of an exclusively metallic money stock and the supposed instability of a banking system that economizes on specie by introducing fractional reserve inside monies.

"An appreciation of the success and stability of Scottish free banking takes on special importance in light of the notoriety of nineteenth-century American experience with state-regulated banking systems commonly but misleadingly called 'free banking.' Many economists today who favor deregulated free markets for other goods and services, yet fail to extend laissez-faire principles to money and banking, apparently believe that unregulated banking proved a failure in the last century. Like the Currency School did, they misleadingly point to American experience as an example of unregulated banking in practice. Unlike the Currency School, which had to try to explain away Scottish experience, today's monetary economists are evidently unaware of a strong counterexample." [pp. 138-139]

"These constitute the lessons, as we see them, taught by free banking theory and Scottish free banking experience. . . . [T]he record of free banking in Scotland indicates, contrary to what otherwise might be plausible, that under free conditions (1) bad bank notes do not drive out good; (2) counterfeiting does not pose a major problem; (3) banks are not inherently prone to overissue and suspension; (4) banks will not hold chronically insufficient or excessive reserves; (5) bank runs are not an endemic problem; (6) there is no clear need for a lender of last resort; (7) no pyramiding of reserves, making credit inherently unstable, takes place; (8) no natural monopoly exists in the production of paper currency; and (9) proliferation of bank note brands is not a problem.

"These lessons are obviously relevant to banking policy today, where they support the case for thorough deregulation. Their bearing on the choice among alternative monetary systems is less obvious. It is not possible here to analyze in adequate depth the shortcomings of current monetary arrangements or to consider every plan from moderate to radical that has been offered to remedy the monetary problems perceived by reformers. . . . What we may do . . . is to consider the implications of free banking thought for the choice between commodity money and fiat money. Though the proponents of a gold or silver standard are today in the minority among monetary economists, let alone among policy makers, their arguments have gained an increasingly respectful hearing in recent years.

"One objection to a gold or silver standard that has commonly been raised by contemporary economists is that the use of precious metals ties up real resources of greater value than are tied up by a fiat paper standard. One estimate for the United States placed the

* See G. J. Santoni, "A Private Central Bank: Some Olde English Lessons," Federal Reserve Bank of St. Louis, *Review*, April 1984.

† "Inside" money consists of the liabilities issued by private financial institutions that are used as purchasing media by the public. "Outside" money consists of central bank or government liabilities that are used as purchasing media by the public or are used by private financial institutions as settlement media. Federal Reserve notes held by the public and as vault cash by banking institutions, plus Federal Reserve bank deposit liabilities to private banking institutions, constitute outside money in the United States today. "Outside money" and "basic cash" are synonymous in White's usage.

annual resource cost of a 'pure commodity standard' at 2.5 percent of net national product.* That estimate supposed, however, that banks under such a standard must hold 100 percent commodity reserves against paper currency, demand deposits, and time deposits. In a free banking system there are no such reserve requirements. Banks are free to hold fractional reserves, allowing society to economize greatly on the use of gold. If banks generally find their optimal reserves of specie to be in the neighborhood of 2 percent of demand liabilities, as several Scottish banks did, the annual resource costs of bank reserves fall enormously. We must add to the costs of reserves the costs of the public's holdings of coin, since we assume that a free banking system would operate with full-bodied coins. We then arrive at an estimate of annual resource costs of between 0.01 and 0.03 percent of gross national product.

"This sort of utilitarian cost calculation is of very limited import when the comparative benefits of alternative monetary systems defy ready quantification. The case for a specie-based free banking system is particularly difficult to capture in terms of measurable costs and benefits aggregated over society. Approaching the question in that way treats it as if a benevolent central mind could properly construct an ideal monetary system on behalf of an entire economy's members. The genius of free banking is not conformity to a blueprint, but evolution of institutions and modes of conduct in response to the decentralized decisions an economy's members make for themselves. The monetary system that emerges under free banking is 'the result of human action but not the execution of any human design,' to use a phrase employed in another context by the Scottish philosopher Adam Ferguson. Free banking thought has little in common with the sort of argument for a pseudo-gold standard that depicts stabilization of the exchange rate between a distinct national currency and gold as the optimal rule for central bank policy. Under a specie standard there is no distinct national currency. Free banking means the elimination and not the redirection of the central bank.

"Although specie-based free banking might perform better than current policy regimes in respect to particular macroeconomic policy goals – price level predictability, interest rate stability, low opportunity costs of holding money, high growth of real output, low variance of real output, and so on – it would be inconsistent with the spirit of free banking to view it as though it were a clever design for achieving specific ends. The monetary system of free banking is not a government device for the achievement of government policy goals, but a private means toward – and the product of – the individual pursuit of private ends. The rationale of free banking is simply that of a spontaneously evolved or 'natural' monetary order. The idea of free banking may today have little appeal to those who believe that a monetary system ought to be rationally constructed to produce specific results. But its relevance to contemporary debate will grow as skepticism grows concerning the widsom of monetary design. The prospect exists, as James William Gilbart . . . expressed it [in 1841], that 'when a few more theories have been tried' by monetary authorities, and a few more severe business cycles suffered as the result, 'then we may discover that all our attempts to regulate the currency have been productive of mischief, and we shall be willing to let the currency regulate itself.'" [pp. 147-150]

If one of the theories to be tried, however, leads to an extensive loss of freedom, the associated suffering from the "experiment" may be much greater in magnitude and duration than that of any business-cycle contraction – even the Great Depression. Now that monetary theorists are imagining and proposing schemes for "world" managed monies, the potential for mischief also takes on world proportions. And if the industrialized world becomes the laboratory of the money manipulators, from where would come the counterexample? There would be none in the future.

Professor White's book provides it from the past. It behooves all who would understand the fundamental competing schools of monetary thought and who would seek to preserve and extend programs through free trade (and freedom more generally) to read *Free Banking in Britain* and share the lessons it offers with as many other concerned Americans as may be fruitful. The battle between free banking and world-managed banking is in its early phase.

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* Milton Friedman, *A Program for Monetary Stability*, New York: Fordham University Press, 1960, p. 5.

MORE EVIDENCE

Recently published details for 1982 tax returns provide additional evidence of a "supply-side" response to lower tax rates. The income brackets subject to the new 50 percent top rate, where the largest percentage point rate reductions occurred, were the only brackets that generated more taxes in 1982 than in 1981. This cannot be explained away as simply reflecting the recession, deferring 1981 income into 1982, or "bracket creep."

The Internal Revenue Service recently published additional data on individual income tax returns for 1982, showing the amounts of income tax due in each tax bracket. The accompanying table shows the amount of taxable income reported for 1981 and 1982, the tax generated, and the change from 1981 to 1982. These data are grouped by tax bracket according to the extent of the reduction in the tax rate (2 percentage points, 3 percentage points, etc.) resulting from the Economic Recovery Tax Act of 1981, signed by President Reagan in August of that year.

Since the time of their initial proposal, the 1981 tax cuts were assailed as favoring the "rich." Such assertions evidently arose because the largest percentage point decreases in tax rates were given to the highest brackets and/or because the new rates reduced the dollar amount of taxes due from a hypothetical taxpayer with a large amount of taxable income much more than they did for taxpayers with low incomes. For example, applying the 1982 rate (50 percent) to the $24.7 billion of 1981 taxable income that was taxed at rates of 55 to 70 percent suggested that only $12.3 billion would be collected from such income in 1982 – $3.7 billion, or 23 percent less than the $16.0 billion collected in 1981. Such a reduction would have been much larger per taxpayer or as a percentage of 1981 taxes paid than the apparent respective reductions in lower brackets.

But look what actually happened. The amount of 1982 taxable income reported at levels that would have been taxed at 54 percent and at 55 to 70 percent in 1981 soared as did the taxes paid on such income. These comparisons are grossly misleading, however. Much of the surge in taxable income reported in the brackets taxed at 49 and 50 percent in 1982 was income that would have qualified for special 50 percent alternative rates in 1981 (see the note to the table). Even so, *total* income reported at levels that would have been taxable at 50 percent or more in 1981 increased $18.8 billion or 29 percent (from $65.8 billion to $84.6 billion), and the total taxes paid increased $5.1 billion, or 13.8 percent (from $37.0 billion to $42.1 billion). A static analysis (applying 1982 rates to 1981 income) would have indicated that taxes on such income would have decreased $4.2 billion. In short, the taxes paid at rates of 49 and 50 percent in 1982 were $9.3 billion *more* than a static analysis had indicated – and those were the *only* brackets that generated more tax in 1982 than in 1981.

As the last two columns in the table show, the actual changes in tax receipts in the lower brackets were closer to the estimate ("putative tax cut") obtained via static analysis.

These data provide further evidence of a "supply-side" response to lowering tax rates, especially in the upper brackets. But several objections remain, some serious and some fatuous. Most fatuous is the notion that the surge in high-bracket incomes is "proof" that the tax cuts favored the "rich." The data, it should be remembered, are for reported *taxable* incomes. But, as anyone who has ever studied or prepared a typical high-income tax return will understand, such amounts seldom bear much resemblance

1981 AND 1982 FEDERAL INCOME TAXES CLASSIFIED BY BRACKET*
(Dollar Amounts in Billions)

More taxes were paid in the highest brackets in 1982 than in 1981, even though the largest rate reductions occurred there.

Tax Brackets (Percent)			*Income Subject to Tax*			*Taxes Collected*			*Putative*
1981	*1982*	*Change†*	*1981*	*1982*	*Change*	*1981*	*1982*	*Change*	*Tax Cut***
0	0	0	$240.8	$241.5	$ +0.7	$ 0.0	$ 0.0	$ 0.0	$ 0.0
14-24	12-22	−2	769.9	788.2	+18.3	144.0	131.9	−12.1	−15.4
26-34	23-31	−3	202.0	219.9	+17.9	60.2	59.0	−1.2	−6.1
36-44	32-40	−4	95.6	103.8	+8.2	38.4	37.3	−1.1	−3.8
46-49	41-44	−5	27.6	29.7	+2.1	13.5	13.1	−0.4	−1.4
50	††	††	30.8	††	−30.8	15.4	††	−15.4	††
54	49	−5	10.3	21.4	+11.1	5.6	10.5	+4.9	−0.5
55-70	50	−5 to −20	24.7	63.2	+38.5	16.0	31.6	+15.6	−3.7
			$1,401.7	$1,467.7	$+66.0	$293.1	$283.4	$−9.7	$−30.9

* The 1981 Tax Act provided for "across the board" rate reductions for 1982 (as well as for 1983 and 1984). Nominal-dollar income tax brackets remained the same for each level of taxable income and filing status, but the rates were reduced as indicated in the table.

† Percentage point change. ** Tax on 1981 income calculated at 1982 rates less actual 1981 tax.

†† There was no 50 percent bracket in 1981. Income subject to this rate included "earned income" ($26.8 billion) and 40 percent of long-term capital gains realized after June 9 ($4.0 billion). Presumably these amounts were reported by taxpayers who had some taxable income subject to rates above 50 percent so that the calculation of tax at the special alternative 50 percent rate was advantageous.

Note: Details may not add due to rounding. Source: *SOI* (*Statistics of Income Bulletin*), Internal Revenue Service, Fall 1983 and Spring 1985.

to everyday or even to accountants' notions of income. That taxable incomes reported in what became the 49-50 percent brackets in 1982 increased markedly may indicate that the "rich" are better off, but only to the extent that they achieved more discretion over the uses of their funds. That is, the lower rates encouraged them to obtain more taxable income, pay the tax, and use the remainder in any way they chose rather than to invest in lower yielding, but tax-exempt or "sheltered" investments favored by the tax code. That the share of total income taxes paid in the top brackets increased from 12.6 percent ($37.0 billion out of $293.1 billion) in 1981 to 14.9 percent ($42.1 billion out of $283.4 billion) in 1982, would seem to indicate that the tax cuts in fact favored the "poor"

A related objection is that 1982 was a year of recession and that the shift of the share of taxes paid away from the lower brackets in that year 1982 reflected the depressed incomes of workers then. The "rich" may be in a better position to sustain their "lifestyles" in recessions than unemployed workers; however, in fact the types of taxable income that generally accrue to the "rich" are far more cyclical than aggregate wages. In 1982, as in other recessions, interest rates tumbled, dividend growth slowed, managerial bonuses were slashed, rental vacancy rates soared, etc. Despite the stock market rally that began in August, security prices remained below year-earlier levels for most of the year. If anything, the recession in 1982 should have decreased the share of taxes paid by the "rich," as occurred during prior recession years.

Nevertheless, the 1982 data were subject to distortion in two ways. First, because the reductions were foreseeable in 1981, some taxpayers may have deferred income into 1982. But the extent of this distortion probably was not large. Total income subject to tax at rates above 50 percent increased from $33.8 billion in 1980 to $35.0 billion in 1981. This increase was proportionally less than the increase in all incomes subject to tax, which may have reflected the recession as noted earlier. But even assuming that the below average growth of high-bracket incomes in 1981 reflected "gaming" the system, only about $2.5 billion of 1981 income would appear to have been shifted to 1982.

"Bracket creep" may be a more serious distortion. Prices rose about 6 percent in 1982, and taxpayers who maintained their real incomes in 1982 paid a larger proportion of their tax in their highest 1981 bracket and/or paid some tax in the next highest bracket. Obviously this did not apply to people at the top, whose bracket could creep no higher. For the purposes of this discussion, the pertinent question is the extent to which the $18.8 billion 1982 increase in incomes taxed in the top bracket simply reflected inflated incomes of taxpayers who were in the brackets immediately below 50 percent in 1981.

There were about 500,000 more returns with income subject to tax at 50 percent in 1982 than there were returns with income subject to tax at rates greater than 50 percent in 1981. For that year, 1.7 million returns had income taxed at 46 to 49 percent. But given that these brackets are relatively large ($45,800 to $60,000 for joint returns), with most returns clustered near the bottom of the brackets (e.g., many more at $46,000 than at $59,000), it is unlikely that a substantial number were boosted into the 50 percent bracket in 1982 purely as a result of their inflated incomes, and even then the additions to total taxable income in the top bracket would have been small. For example, if there were 200,000 joint returns with $57,500 of taxable income in 1981 and they all reported 6 percent more in 1982, it would have added only about $1.5 billion to total 1982 income subject to tax at 50 percent.

In short, the 1982 surge in income reported by the "rich" (and taxed) cannot be explained away by special factors. We expect that additional data for 1983 and 1984, when further tax cuts were implemented, mainly in the lower brackets, will also indicate that the share of taxes paid by the "rich" increased as a result of the 1981 law.

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