Restoring Sound Money: What the *States* Can Do

By Rich Danker
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Executive Summary

Past American experience with high inflation and recent large-scale monetary expansion by the Federal Reserve has prompted a new appreciation for money that cannot be debased, gold in particular. The U.S. Constitution in Article I empowers the states to make gold and silver coin legal tender. In 2011, Utah passed such a law and a dozen others considered similar bills through this year's legislative session. Utah has opened up a pathway toward a legitimate alternative to the paper dollar that offers citizens a way to save and transact in money of objective value.

The Founders held the unanimous belief that hard money (gold and silver) should be the backbone of the monetary system because it could not be manipulated by the government. After four decades of a pure paper dollar, America is turning its attention to our constitutional roots on money. While a gold standard would take significant federal reform to enact, states have the power to treat gold and silver coin as legal tender and encourage its usage as currency. Removing taxes on the exchange of such coin is the primary precondition needed in order to bring this about.

Advances in electronic payment systems hold the potential for hard currency to be used more easily and efficiently than ever before. Debit cards could link customers and vendors into a precious metal system revolving around American Eagle coins, which were first authorized by President Ronald Reagan in 1985. Such technology will allow the coins to be used as money – rather than simply an investment.

The state movement to designate gold and silver coin as legal tender is a low-risk, high-reward initiative to give citizens a prudent choice in currency. While the federal government has only offered more of the same (money printing), the states are in a position to create a different path and point America back to its sound money foundation. It is a state solution to a national crisis that can no longer be postponed.

Money and the Constitution

Organizing a sound monetary system was one of the major policy reasons for convening the Constitutional Convention in 1787. In the preceding era states issued their own paper bank notes, and Congress resorted to money printing (the Continental) to finance the Revolutionary War because it lacked the taxing power, and in the context of the resulting inflation and general financial disorder, the long-term ability of the government to borrow was in question. Alexander Hamilton, the nation's first treasury secretary, insisted upon hard money and the federal assumption of state debts as preconditions to get America on a firm financial footing. His arguments, coupled with the founders' consensus opposition to paper money, carried the day.

Article I, Section 10 of the Constitution is a lengthy list of prohibitions on the states. The third clause says that no state shall "coin money; emit bills of credit; make anything but gold and silver coin a tender in payment of debts." The Founders made it clear that the states no longer had the ability to issue paper notes and declare them legal tender, as they had done during and after the war. Furthermore, they could not coin money, a power reserved to the federal government in the preceding Section 8. *On the subject of monetary policy, the states were restricted to the ability to designate gold and silver coin as legal tender*. This exception to the list of prohibitions reflected the Founders' general view of hard money as good money. It was further embedded in the Coinage Act of 1792 which defined the dollar as a certain weight unit of gold and also set the ratio between gold and silver at fifteen to one.

There continues to be a debate over whether the Constitution gives Congress any other choice but to back the dollar with precious metal: the power to "emit bills of credit," interpreted as printing paper money, was considered and struck from Section 8 in a debate recorded in James Madison's *Notes on the Convention*. In the Legal Tender Cases of the post-Civil War era, the Supreme Court rejected and then later upheld the right of the federal government to issue paper money as legal tender, which it had done to pay for the war with "greenbacks." Still, the United States reinstituted a gold standard as soon as practically possible after reconstruction and never seriously considered continuing the greenback model.

The clear gold-and-silver-only mandate on the states can be viewed through three conceivable intentions: first, the strict prohibition of paper money of any kind being issued by the states; second, the syncing of the federal hard money arrangement with the states; third, a hard money backstop by the

states should Congress embrace paper notes. While the first two of these interpretations are the most intuitive, the third one raises the question of the role of the states in counteracting the current federal paper money policy. If the states retain the limited power to declare gold and silver coin legal tender, should it be used to promote hard money? If so, how can it be used to do so and what are the parameters of this power?

Monetary Policy and Price Stability

The idea of challenging the usage of the dollar, even as a modest alternative in the form of state-sanctioned gold and silver legal tender coin, may appear implausible. The U.S. dollar is not only the domestic medium of exchange and unit of account, but also the money of choice for settling international payments – i.e., the world's reserve currency. As economist Robert Mundell described it in 1974, the dollar is "the major intervention currency, a reserve asset for central banks, the standard of contract, the standard of quotation, the invoice currency, the major settlement currency, the major reserve asset for commercial banks, the major traveler's currency, the major external currency for indexing bonds, and the major clearing currency[1]."

But the dollar only reached this foothold because it was *as good as gold* during America's ascent as a major power. During the international gold standard period surrounding the turn of the century, the American economy became the largest in the world. Following World War I, the dollar joined the British pound as a widely-used international currency. Except for periods of wartime, it was continuously backed by precious metal until 1933, when Franklin Roosevelt rescinded the ability of Americans to redeem their paper notes for a statutory value of gold (he also prohibited private gold ownership). After World War II, America made the dollar redeemable in gold for foreign central banks as the centerpiece of the Bretton Woods international monetary agreement. It wasn't until President Nixon ended this pact in 1971 that the dollar became a pure paper currency, backed only in theory by the goods and services it could buy in the marketplace.

No less than when Mundell described the dollar's dominance in the early seventies, its position as the world's dominant financial instrument is unchecked despite its weakness over time. In fact, as Mundell also observed, *weakness is a primary characteristic* of a reserve currency. The built-in demand for

[1] Wanniski, Jude . "The Mundell-Laffer Hpothesis." *The Public Interest*. Spring 1975.

dollars as reserves leads to overprinting, overexpansion of credit, and asset bubbles, all of which encourage a currency's weakening in the long run. Thus the dollar has managed to stay embedded in the international system as the euro, yen, and yuan remain second-tier currencies. That will continue until the world's largest economies decide to significantly change their currency holdings or, as India and China have begun to do, use gold as a reserve asset.

The divergence in results between the gold-backed dollar and its current form is clear. In his book *Redeeming Economics*, John Mueller measures U.S. Consumer Price Index data and comparable pre-C.P.I. statistics across the spectrum of American monetary history as the dollar gradually became detached from its anchor in gold. He finds that the domestic gold standard era (1834-1861) and international gold standard era (1879-1914) before and after the Civil War the average annual price change was -0.4% and 0.2%, respectively. During the 20th century interwar and postwar gold exchange standard eras, the figures were 1.9% and 3.1%, respectively. The post-1971 paper dollar yielded a 4.5% average annual change through 2009[2]. *The closer the commitment to gold money, the more stable prices were in the long run.*

Gold's Comeback

Yet despite the dollar's dominance, these last four decades have also brought changes in economic results, policy and technology that created the pathway for hard money to be a viable alternative here at home. Persistent inflation and asset volatility have left the public at the very least dissatisfied with the performance of the dollar. According to the 2012 election exit polls, inflation ranked just one point shy of unemployment as voters' top economic concern, even though measurable inflation according to the government is 2% and joblessness is just under 8%. Pockets of the electorate, such as the swaths of voters Ron Paul attracted in his two Republican primary campaigns, have developed a significant understanding of the issue and mobilized on it. The breakthrough in Utah is an aspect of this. The seeds to using gold as currency again were sown by the progress made along the way beginning in the aftermath of the 1971 gold-dollar breakdown.

In 1974, Congress repealed the ban on owning and transacting in gold which had existed since 1933. In 1977, it repealed the ban on gold clauses in contracts. This rejection of the Roosevelt-era prohibition on

[2] Mueller, John. *Redeeming Economics*. Wilmington, DE: Intercollegiate Studies Institute, 2010.

using gold came in the context of high inflation: in the first decade of the pure paper dollar, the Consumer Price Index increased at an average of more than 8 percent per year. Americans wanted the option of reallocating their savings out of dollars and into hard assets, including gold. Early in 1980, gold hit a new all-time high of $850 an ounce. The previous dollar-gold parity maintained by the U.S. government up until 1971 was $35 an ounce. By the end of that year Congress agreed to a commission to study the role of gold in monetary policy, conceived partly in anticipation of an incoming Reagan administration interested in monetary reform toward gold.

Despite Reagan's personal interest in gold, his chief economic advisors moved to sideline comprehensive monetary reform. The U.S. Gold Commission's official report ended up making just one recommendation on gold monetization: the minting of new gold coinage without dollar denomination, legal tender status, or tax liability. These would be government-issued coins denominated solely by weight unit, meant to compete alongside the dollar. Anna Schwartz, the commission's executive director, described the intentions behind it:

> For the pro-gold forces, introducing gold coins into circulation was a first step toward achieving their ultimate objective of linking the monetary system to gold. For them, the step represents provision of a form of currency alternative to paper dollars. They conceive that holders will engage in transactions denominated in weights of coins rather than dollars. The other members who supported the recommendation did not share that conception. They regarded such coins as alternatives to foreign bullion coins that have found a market in the United States. For them, purchase of the coins would reflect an investment, not a transactions , demand[3].

These two views diverged over the question of the role for gold coinage: money or an investment. The former held the potential for use alongside the dollar as a medium of exchange, unit of account, and store of wealth. The latter would treat the coins as a method of hedging against the decline in purchasing power of the dollar, in the way that Schwartz noted was already popular through foreign-minted specie.

In response, Congress sided with the investment view of gold when it passed the Gold Bullion Act in 1985. The law created the American Gold Eagle, which came in four coin sizes (1/10th, 1/4th, 1/2th, and 1 oz) and with dollar denominations ($5, $10, $25, $50). They were declared as legal tender but were

[3] Schwartz, Anna. "Reflections on the Gold Commission Report." http://www.nber.org/chapters/c7509.pdf 1987.

taxable, making them currency in theory but an investment according to the marketplace. Since 1986, approximately 15.5 million 1 oz. pieces, 2.6 million half-ounce pieces, 3.5 million quarter-ounce pieces, and 11.9 million tenth-ounce pieces of the American Eagle Gold Bullion series have been sold by the U.S. Mint. They represent a cumulative value of approximately $30 billion in monetary gold specie tender (there is an approximate total of $1.08 trillion in Federal Reserve Notes in circulation).

The plausibility of American Eagles as money remained latent until the Utah Legal Tender Act of 2011. While the IRS could tax their exchange the same way it taxes art, antiques, and other "collectibles," the states under Article I, Section 10 of the Constitution have the power to treat the coins as money in their own right. The Utah law declared gold and silver coins issued by the federal government as legal tender and removed state capital gains tax liability on them. The tax elimination was the important practical effect of the law. As Larry Hilton, the Utah-based sound money activist who drafted the bill, writes, "The taxation of money essentially demonetizes it, altering its fundamental character from being a medium of exchange to being merely another form of property[4]." The state tax elimination also opened the door for commercial interests to work on monetizing the coins, a framework described in the next section.

Hard Money in Modern Finance

Recent advances in electronic payment systems have enabled buyers and sellers to transact effectively and efficiently. For most of the 20th century, there were just two widely used payment methods: cash and check. In the 1970s, automatic teller machines and credit cards became widely adopted and made consumer finance exponentially more fluid. The spread of swipeable debit cards and e-commerce transactions in the 1990s brought cashless transactions much closer to real time. The debit card in particular emerged as the convenient substitute for cash at the point of sale: for a nominal transaction fee, money could be spent from a checking account without having to be withdrawn in physical form first. Much of the interest and attention now is on the mobile payment space, where companies such as Square facilitate transactions through smartphones.

What has been overlooked until recently is the fact that these innovations hold the same potential for using gold and silver as money as they have achieved for the dollar. Precious metal currency no longer needs to be held in physical form to be acquired or liquidated. Gold and silver, like dollars in a checking

[4] Hilton, Larry. "State Monetary Authority." 2012.

account, can serve as the asset-backing for debit card transactions. Cardholders can spend their checking deposits rather than carry around the coins. As useful and common as e-payments have become in day-to-day financial life, gold and silver currency would achieve even more direct benefits under it than paper currency. Tying specie tender to debit cards removes the inconvenience of carrying the coins and enables them to be spent at fair market value in weight unit – rather than the undervalued dollar denomination of American Eagle coins. The depository institution holding the coins and issuing the cards can then settle balances with the card-taker the same way banks and retailers do now.

Consider this hypothetical arrangement: a customer opens a depository account with a mix of gold and silver legal tender coins. He receives a debit card linked to that account. The card enables him to make purchases just like he would from a checking account, the difference being that the depository debits the coin account and then remits payment to the retailer in dollars. If the retailer also has a depository account, the transaction can be settled in specie tender instead of dollars. At the front end, the transaction is no different than those that involve debit cards now. On the back end, the coins are liquidated or transferred between accounts by the depository.

How close is this model to becoming a reality? There are currently two depositories in Utah until now, and gold holdings are estimated to have increased 50 percent since the legal tender law took effect. The most formidable barrier to integrating gold and silver coin holdings into an electronic payment system is federal taxes, as customers are liable for the collectibles tax on the exchange of the coins (the ordinary income rate if held less than one year; the short-term capital gains rate of 28% if held longer). The depositories will need to be responsible for tracking the taxable transactions and withholding the tax or informing customers of it. Will users be willing to pay what is effectively a capital gains tax on their coins' market value appreciation in order to use them as currency? Like other assets that are taxed the same way (stocks, real estate), there will likely be a built-in bias against incurring a taxable transaction. But they still would be exchanged if the holder feels the need to tap their liquid value. A nascent effort is underway by the trade group Utah Precious Metals Association to challenge the legal basis of the federal taxation of its legal tender coins.

Whether specie tender gains popularity in physical or electronic payments more fundamentally hinges on whether gold and silver are viewed as money as opposed to an investment. The Utah Legal Tender Act passed in part because in that state there was a popular view of precious metals as a store of wealth. This view treats American Eagle coins as an inflation-proof alternative to cash. The investment view considers them an alternative asset used to hedge against the dollar. The more people understand

gold and silver's history and purpose as money, the more likely they will look at it as currency rather than the way most of Wall Street does.

Choice in Currency

Whether or not a state allows the Utah model of specie legal tender comes down the question of choice in currency. Are its citizens entitled to the hard money option afforded to them in Article I Section 10, or are paper dollars settled law and therefore at a point of no return? In other words, do we at least have a choice in the currency we use or are we stuck with the Federal Reserve's monopoly on money printing and the accompanying inflation?

The principles of economic liberty and prudence, as well as a review of American monetary history, justify the need for a hard money choice in currency. Designating gold and silver coin as legal tender is the only systematic way to give Americans an inflation-proof alternative to the paper dollar, and it is a reform that the states are empowered to make despite the federal government's dominance in monetary policymaking. Congress has arguably failed in its constitutional responsibility to regulate the monetary standard when the dollar is a pure paper currency whose value continually fluctuates. The states can preserve the role of hard money by using their separate constitutional authority to recognize it as currency.

The encouraging aspect of this pathway is that it is a bottom-up rather than top-down approach. It relies on the political concept of federalism as expressed in the Constitution and the economic concept of a market-based approach to policymaking. Sean Fieler, chairman of the American Principles Project, observes that, "This state-based effort entails no global conference or vote to close the Federal Reserve. Rather, the state-based strategy, which capitalizes on the libertarian impulse running through our society, would achieve its end of honest money through competition rather than force." He goes on to compare this model to the success of email in dealing with the failures of the post office.

Indeed, the state approach to sound money is emphatically non-governmental. It enables the use of currency (gold and silver coin) that no government can devalue and which is universally recognizable as money. It requires little in the way of government support except for the legal tender designation, the removal of taxes, and potentially the modest regulation of depository institutions transacting in such coin. Unlike paper money, there is no bureaucratic superstructure needed to support hard money. As

Fieler points out, “The states do not want to create a new monetary system that they, the states, will control. They want sound money that neither they nor any government can control[5].”

A choice in currency really means a choice – no one is compelled to accept or tender gold and silver coins, just as they cannot be compelled to use paper notes (consider the retailers who refuse to accept certain denominations of cash altogether). A gold dollar buys far more than a paper dollar, and allowing the buyer and seller to choose between the two and settle on a mutually-agreeable denomination avoids confusing these very different forms of currency. Unlike the return to a full-fledged gold standard, the barriers to setting up this system are low. The coins are already in circulation, at least as an investment, thanks to President Ronald Reagan’s 1985 measure. Another legal tender gold coin, the American Buffalo, was introduced in 2006. Current state taxes raise little in the way of revenue (the fiscal note attached to the Utah bill capped the potential loss at $550,000 in a state with $5.5 billion in tax receipts). There would be no need for a significant waiting period before the law could take operation, as would need to happen with federal monetary reform. No aspect of the paper dollar system – not the Fed, the banking community, or everyday commerce – would be threatened. Success with sound money at the state level will come from citizens making a conscious choice in a currency of objective value and integrating that currency into the local economy on a practical basis. This will send a growing signal to Washington about the failure of the paper dollar. But on its own it will be a tremendous display of federalism that deepens the state’s relationship to the Constitution and creates the conditions to repair a federal breakdown from the state level. Shouldn’t today’s conservatives and libertarians, and all those who have supported state solutions to national problems, embrace this?

Reagan, the only president of the modern paper dollar era who openly questioned it, once said: “I do not want to go back to the past. I want to go back to the past way of facing the future.” This is an approach consistent with the purpose of the sound money model for the states. Using gold and silver over paper currency is not about drifting back to the past into an arcane place in history. It is about letting people choose a medium of exchange, a unit of account, a way of saving, which better orients them toward the uncertain future. It recognizes that bad monetary policy cannot solve bad fiscal policy, because that approach failed us in the 1970s. The states now have the opportunity, legitimized by Utah, to restore the past way of protecting our currency for the long run. Has there ever been a better time or purpose for such a low-risk, high-reward initiative by the states? If this can be achieved, they will have

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[5] Fieler, Sean. “Money’s Muffled Message.” *Roads to Sound Money*. Washington, D.C.: Atlas Network, 2012

done their part to return the nation to its founding principle of sound money, just as the Constitution lays out.