IN REVIEW

Gresham's Law in the Stablecoin Age

BY PHIL R. MURRAY

In his recent book *Beyond Banks*, Cornell law professor Dan Awrey "attempts to understand why the United States was able to send twenty-four men to the moon, but seems chronically incapable of delivering a cheap, fast, secure, and universally acceptable system of money payments." Awrey is well qualified to write about money because of his career path. "I have spent my entire adult life in finance," he tells readers, "first in information technology, then as a lawyer and adviser to financial services firms, and now for the past fourteen years as a scholar of banking and financial regulation." In this book, he offers his thoughts on the future of money and banking.

Updating Gresham / For an asset to be money, it must be a medium of exchange. In Awrey's framework, it need not also be a unit of account or a store of value.

He distinguishes between "good money" and "bad money." Two characteristics make a medium of exchange good money. One is that it exhibits a "stable *nominal* value." The author explains, "A stable nominal value means that when you go to spend one dollar, euro, or peso, it is accepted as representing that precise value and not, for example, 95 cents." To paraphrase, if the price of a loaf of bread is $5, handing over $5 will get you the loaf of bread. One wonders when handing over more or less than $5 would happen; perhaps during a period of hyperinflation sellers want more than the posted price, and during deflation sellers will accept less.

The other characteristic of good money is that it serves as a "*means of payment.*" If an asset serves as a means of payment, Awrey explains, "users should be able to quickly, easily, and securely use it within a relatively large network of individuals, households, businesses, and governments." Dollar-denominated currency and dollar-denominated bank deposits are good money. Cryptocurrency is bad money because people use it in few transactions relative to all transactions.

A reader will encounter the term "monetary IOUs." These are "*debt contracts*" between an institution and a customer. Awrey writes, "Bank deposits are the quintessential monetary IOUs: a contractually enforceable promise made by a bank to its depositors that serves as both a nominal store of value and a means of payment." The law makes bank deposits the ultimate monetary IOUs. Ordinary bankruptcy procedures do not apply to banks. "Bankruptcy law is then replaced with tailor-made bank resolution frameworks," Awrey informs us, that are "specifically designed to reduce the risk that depositors will have their money frozen or be forced to write down the value of their monetary IOUs." Bank customers do not fear losses much, even if their bank fails. That is not necessarily the case with owners of cryptocurrency, stablecoins, or other monetary IOUs.

Readers will remember Gresham's Law, the idea that "bad money drives out good." Ostensibly, this means that if there are two currencies, one reliable and one not, people will hoard the reliable currency and use the unreliable. This notion is debatable, though: Why would anyone accept unreliable currency? It's just as likely that reliable currency will drive out unreliable. Awrey tries to fix this conundrum:

> First, during periods of institutional and systemic stability, where consumers are more sensitive to the benefits of good payments, *bad money will drive out good.* Second, during periods of institutional and systemic instability, where consumers are more sensitive to the benefits of good money, the resulting flight to safety means that *good money will drive out bad.*

Today, he writes, "Make no mistake: what we are witnessing is Gresham's new law in action." Central banks in the major economies have gained people's confidence. As a result, bad money is crowding out good money and the implications are serious. If the economy becomes turbulent, people holding bad money may suffer from a decrease in its value. If the institutions creating bad money go bankrupt, financial crisis and deflationary recession may occur.

Awrey fears a crisis so severe that it causes government instability. Nevertheless, he believes that by designing appropriate regulations, consumers will reap the benefits of good money and good payments.

Renovation, regulation, and risk / Those unfamiliar with the evolution of money and banking will find it in this book; those already familiar may learn something new. For instance, "*credit*-based" money predates "*commodity*-based" money. Sometimes people primarily used commodity money such as precious

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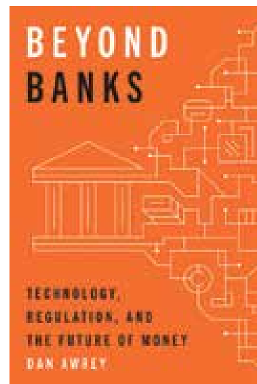
metal coins. Other times people primarily used monetary "IOUs." And sometimes both types of money circulated together. During one period, goldsmiths discovered that they could create monetary IOUs against their customers' deposits of gold and silver, which the public adopted as a medium of exchange. Other significant developments include the central bank, the clearinghouse, and the "financial safety net."



Beyond Banks: Technology, Regulation, and the Future of Money

By Dan Awrey

291 pp.; Princeton University Press, 2024

Banking is different. Bankers use leverage: They use debt to finance their acquisition of assets. Their primary source of funds (deposits) is short-term. Their primary use of funds (loans) is long-term. Bank liabilities and bank assets are mismatched another way: The deposits are liquid—that is, easy for depositors to withdraw—and the loans are illiquid—hard for the banks to effectively call in. These characteristics contribute to "bank fragility."

Governments created a "safety net" to make banks safer, reducing bank runs and financial crises. The safety net consists of central bank lending in times of crisis, deposit insurance, and "special bankruptcy or 'resolution' regimes." The safety net makes bank deposits good money.

There are, however, unintended consequences. Bank depositors and other creditors neglect to sufficiently monitor bank management, which can use too much leverage and take too much risk. Thus, there are additional government interventions: reserve requirements, capital requirements, and bank examinations.

Having explained why banks are regulated, Awrey reasons that "the enormous costs of ongoing compliance with bank regulation and supervision can represent a formidable barrier to entry—especially smaller, technology-driven firms that we might expect to serve as important catalysts of innovation." He puts it bluntly, "The US banking industry has been relatively slow to roll out a variety of new payment technologies." His solution is to let entrepreneurs have a go.

Another phrase a reader will encounter is "new institutions and platforms." These are the innovators in the shadow monetary system. One group is "stablecoin issuers" such as Tether, Circle, and Paxos. Another group is "cryptocurrency exchanges like Binance, Coinbase, and Kraken." There are "peer-to-peer (P2P) payment platforms like PayPal, Wise, WeChat Pay, and Alipay," and "mobile money platforms" such as Kenya's M-PESA.

These institutions and platforms apply new technology to payments. In conducting business, they "issue new and exotic types of monetary IOUs." This is where Gresham's new law becomes relevant. According to Awrey, "While the monetary IOUs of these new entrants may initially seem like close functional substitutes for good old-fashioned bank deposits, the reality is that many are an important and growing source of bad money." We should be concerned that bad money will drive out good and precipitate a financial crisis.

The gist of the public's problem is financial naivete. Consumers opt for good payments, acquire bad money, and take on risk without realizing it. If an institution goes bankrupt, regular corporate bankruptcy law will apply, and holders of the institution's monetary IOUs will be surprised to lose much of what they thought was their "money." To get both good money and good payments, institutions may self-regulate. "These private law strategies" that institutions may adopt "include contractual portfolio constraints, the use of trusts, bailment, and other property law tools, and structural separation." Few firms self-regulate because some strategies, such as restricting their investments to the most liquid, least risky assets, reduce profits. Also, few firms self-regulate because of state regulations. States regulate "money transmitters" by stipulating the assets they may purchase, imposing minimum capital levels, and mandating reserves to pay off customers in case of insolvency.

Awrey's proposal / These regulations do not convince Awrey that the money transmitters, "a veritable *Who's Who* of the shadow monetary system," are creating good money for their customers that will be safe in the event of a bankruptcy. Thus, he shares his ideas for regulation.

His "blueprint for reform" has three features:

- a "payments charter"
- an "open access rule"
- a "new governance structure"

A traditional bank charter would remain in existence. New firms, however, could operate with a payments charter that establishes "a separate ring-fenced subsidiary—a payments entity." The payments entity would issue monetary IOUs on the conditions that it refrains from financial intermediation, invests in "high-quality liquid assets (HQLA)" or "central bank reserves," and refrains from issuing debt other than its monetary IOUs. In return for operating within those confines, the open access rule grants a payments entity "direct access to central bank reserve accounts." "Open access" means new payment entities will have an expanded network of payers and payees, which will enable them to achieve economies of scale in delivering payment services and more effectively compete against banks. The new regulator would oversee both the open access rule and "long-term planning and investment in the technological infrastructure supporting the US payment system."

Entrepreneurs are applying new technology in the realm of payments faster than the public can understand it and faster than legislators can regulate it.

Awrey believes that if we adopt his proposal, several advantages would follow: Consumers would get good money and good payments. There would be greater stability at the firm level in the financial industry. (For illustration, the author describes how the failure of the crypto exchange FTX in late 2022 led to the demise of the commercial bank Silvergate the following year. Also in 2023, the failure of Silicon Valley Bank destabilized the shadow money operator Circle. The author figures his scheme would reduce the likelihood that the failure of a new institution would take down a conventional bank and vice versa.) The financial industry in general would be more stable. Awrey reckons that as new institutions grow, "thereby reducing our structural reliance on a small number of large incumbents," the too-big-to-fail problem would become less threatening.

The author is confident that his plan would produce good outcomes, but he is not overconfident. He admits that "regulatory arbitrage" would be a problem. If "state money transmitter laws" remain on the books, new institutions may prefer that regulatory structure to his plan, which would severely restrict their investment options. To prevent that from happening, Awrey would have Congress redefine "deposit" so that the types of monetary IOUs new institutions create would fall under federal regulation. New institutions would have to choose "either a conventional bank charter or a new payments charter." If state regulators do not impose similar regulations, institutions with federal charters would be barred from "accepting transactional deposits" from institutions without federal charters. One may wonder how new institutions that may only acquire funds by issuing monetary IOUs and may only use those funds to buy HQLAs or central bank reserves would make a profit. Awrey's answer is that if a firm sells goods such as video games, consumers may use the firm's IOUs to buy those goods. If a firm doesn't sell goods, its payment services would have to be so good that consumers would pay "user fees" that cover costs.

Critics of this regulatory overhaul may argue that the banking industry would contract because of the new competition. Awrey recognizes that new firms issuing their monetary IOUs would compete against banks issuing their deposits, and he maintains that the competition would be good for consumers. Bank customers would have alternatives to bank deposits, but the safety net would remain in place. Critics may argue that competition between banks and new firms—coupled with new firms being barred from financial intermediation—would reduce business investment. The author downplays this possibility not least because nonbank financing is already on the rise and banks have alternative sources of funds besides deposits. Finally, he welcomes the possibility that technology firms such as Google and Amazon would enter the payments market, but he would not object to "separating *payments* from commerce."

Awrey has faith in what his "legal engineering" can accomplish. He tempers that faith by imagining unintended consequences and how to deal with them. Economists, legal scholars, and financial regulators would benefit by engaging with his ideas. Legislators currently grinding out legislation on cryptocurrency and stablecoins would be wise to consider what he knows. *R*

A Limited Book

REVIEW BY THOMAS A. HEMPHILL

In his new book *Some Future Day*, tech attorney Marc Beckman foresees artificial intelligence (AI) technologies as the progenitor of an "Age of Imagination" in the near future of American—and potentially global—society. He discusses what this will mean to a range of productive pursuits, e.g., business, healthcare, warfare, the arts, media, finance, and education.

Beckman is a senior fellow of emerging technology and an adjunct professor in luxury marketing in the Stern School of Business at New York University, and he hosts the podcast *Some Future Day*, where he focuses on technology, culture, and law. He also is co-chair of the New York State Bar Association's Task Force on Crypto Currency and Digital Assets and CEO of the advertising agency DMA United. He has executed campaigns for the NBA, Pepsi, Sony, and Warner Bros., among others, employing AI technologies, spatial computing, and blockchain technology to augment advertising campaigns.

His role as an entrepreneur forms the conceptual foundation for his book. His theme of the Age of Imagination is fueled by what he sees as the entrepreneurial opportunities now and in the near future emerging from the increasing deployment of ever more powerful AI technologies. He is especially interested in large-language models (LLMs) in commercial usage across industries, applications, and professions.

Shape of AI to come / Beckman focuses on specific industries and areas of AI technologies applications. He is both insightful and creative in this. In the business environment, he predicts that AI will couple with blockchain technology—a digital public record that ensures the accuracy of data—and shift the economic power from centralized production ventures to individual creators. In healthcare, he examines existing and potential medical applications of AI technologies that he argues will improve both physical health (to assist physicians by providing increased diagnostic accuracy and speed in the examining room) and mental health

(by helping mental health practitioners to better diagnose issues like depression and anxiety by evaluating DNA and family data to look for inherited conditions like chronic depression). In national defense, he foresees enhanced AI technologies quickly correlating data for battlefield situations. He believes it will be an invaluable tool for American military leaders attempting to make decisions about where and how to engage an enemy, suggesting new strategies in real-time and giving those leaders additional opportunities and options.

Some Future Day: How AI Is Going to Change Everything
By Marc Beckman
306 pp.: Skyhorse Publications, 2025

For artists and creatives, the Age of Imagination is opening up all sorts of creative possibilities. For example, AI technologies can create music, and artists can use it to brainstorm and provide inspiration. Voice artists will be able to sell or license their digital voice to other creators, with secondary creators creating "digital duets" with the original singer and the secondary singer collecting royalties, thus creating new revenue streams. From the perspective of social media, emerging AI technologies will encourage content engine pipelines to converge, making it easier for American consumers to access, deploy, and be creative with AI technologies while using blockchain technology to verify the authenticity of both content and imagery. This development will give greater power to people getting their message out to their fellow citizens, and more people will retain their money in a currency—crypto in nature—that is not subject to the capricious decision making of government.

Concerning individual financial security, Beckman predicts an Age of Imagination where people can see in real-time exactly how secure their money is, because we now have increasing options to move wealth to stable cryptocurrencies that are minted to the blockchain. In education, Beckman notes that, while AI technologies will never fully replace human teachers, they can augment traditional instruction and help students learn in new ways (including with the use of AI tutors). AI will empower students everywhere by letting them learn from *anywhere*. College students will not need to attend *physical* locations to acquire their knowledge (and credentials), instead using an accessible, cost-effective digital/AI educational platform.

As we move into the Age of Imagination, Beckman does not believe that AI "Luddites" will be able to stand in the way of technological change. Yet, he explicitly recognizes a need for strong human oversight of AI technologies, as illustrated by Elon Musk's AI assistant xAI (Grok) recently experiencing disturbing "hallucinations," including branding itself "MechaHitler" and producing antisemitic responses to conspiracy theories about Jewish people as well as naming Donald Trump "the most notorious criminal" in Washington, DC.

While there are many options available for the AI technological path forward, Beckman argues that "going backward" is not one of them. He is generally effective in arguing that the benefits of AI technologies far outstrip the potential negative costs—or regulatory challenges—of embracing it.

Regulatory approaches / Beckman favors "a free, open [AI] marketplace devoid of over-regulation and government intrusion." What he means by "over-regulation" is not explicitly defined, but it can be inferred from his philosophy on "public" regulation of AI technologies.

He is an advocate of business communities in Western nations establishing ethical guidelines for AI developers to follow. Two of these that are currently in place are the IEEE Global Initiative on Ethics of Autonomous and Intelligent Systems and the European Union's Guidelines for Trustworthy AI. Beckman considers both of these to be foundational frameworks for further development of industry-wide safeguards. The author recommends that we ensure that the development of ethical AI technologies is incentivized through thoughtfully designed public funding, grant awards, and investment capital that require recipients to state explicitly how their work will be developed within accepted ethical guidelines. He recommends that societal practices and safeguards can be designed that allow users to identify and report ethical problems with AI products so they can be remedied. In short, Beckman is a skeptic about the ability of government and the legal system to regulate AI technologies, and he argues that—when proof of an unethical system is made public through traditional and social media—an "educated," critical-thinking American citizenry will demand that companies self-correct and repair any ethical lapses related to AI technologies development.

Beckman is making the case for industry self-regulation, with a healthy dependency on market forces rapidly correcting any company violations of industry AI ethical guidelines. His views on market forces as a regulating force on AI development appear to follow the idea of "permissionless innovation," meaning that unless a compelling case can be argued that a new invention will bring serious harm to society, technological innovation should be allowed to continue without government permission. This raises the question: What is "technological harm" to society? Would Beckman recognize a socially constructed consensus definition of AI "technological harm"—that is, a safety-related issue for consumers or businesses—as *not* being "over-regulation" or unnecessary "government intrusion"?

Applications vs. policy challenges / I am of two minds about *Some Future Day*. As an introduction to the potential opportunities that AI offers the American consumer who is still questioning the efficacy of

this new technology and to entrepreneurs wondering how AI technologies will be of value in their future endeavors, Beckman succeeds in his efforts. He delivers a well-written and insightful review of what AI technologies are providing us today and what opportunities lie ahead. He also offers a valuable appendix of resources at the end of the book, including a compendium of the most influential businesses in AI, 20 key analytical tools, 39 performance marketing tools, and 60 blockchain and cryptocurrency tools, among others.

From a regulatory policy perspective, however, I am less sanguine. Granted, while Beckman did not write this book from a policy perspective, the US regulatory environment surrounding the deployment of AI technologies is in a state of flux, with regulatory actions being legislatively imposed at both the federal and state levels. This is troublesome for many entrepreneurs interested in applying AI in their business and should have been addressed by the author. He also does not explain how existing artificial narrow intelligence (AI focused on specific tasks) differs from proposed artificial general intelligence (AI that can apply to many different tasks) and how this evolution will likely affect society over the next five to 10 years. Moreover, while he is optimistic about how copyright ownership and royalties will be negotiated in the marketplace between creators/owners and AI users, the evidence appears to be that this situation is far from legally or socially (voluntarily) resolved.

One last criticism: A major peeve of mine is Beckman's lack of citations and references. While some identifying information is included in his narrative examples, it falls short of my expectations as a writer and policy researcher. I am convinced he has these information sources, and they should have been included in the book to support his often-interesting arguments and ideas.

In conclusion, the book is an interesting read for the inquiring entrepreneur or novice to AI, but it is of limited usefulness for the regulatory policy scholar. *R*

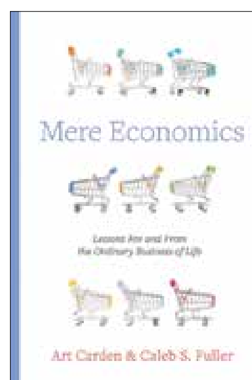
A Defense of Markets

REVIEW BY GEORGE LEEF

There is a genre of books devoted to persuading the average reader that a society based on private property, free enterprise, and government limited to the protection of individual rights is optimal. Think of Henry Hazlitt's *Economics in One Lesson*, for instance. The purpose of these books is to counter the omnipresent cries that such a society has so many terrible flaws that extensive government intervention is necessary. They endeavor to persuade the reader that government intervention can only make things worse.

A new entry in this genre is *Mere Economics* by economics professors Art Carden (Samford University) and Caleb S. Fuller (Grove City College). They call upon their long experience in teaching to produce a book that admirably argues that a free, truly liberal society works much better than most people realize and that coercive policies meant to improve society bring a host of unintended effects.

Carden and Fuller write from a Christian perspective, borrowing from C.S. Lewis for their title and working scriptural passages into their text at many points. Their religious convictions do not detract from their message, which will appeal just as much to non-Christians and religious skeptics. The book's Christian foundations may give it added force with the many Americans who have absorbed the idea that capitalism and Christianity are at odds. The authors show that to be completely mistaken.



Mere Economics: Lessons For and From the Ordinary Business of Life

By Art Carden and Caleb S. Fuller

305 pp.; B&H Academics, 2025

Tradeoffs / The book covers all the fundamentals of economics: scarcity, exchange, opportunity costs, investment, entrepreneurship, money, profit, and loss. Here is a sample of the authors at work:

> Exchange is a nifty way to tackle a problem at the heart of economics: scarcity. We can always do something with more. Alas, limited time and materials mean we must choose.… Saying yes to more of one thing means saying no to more of another. We can't make an omelet with the eggs you just cracked into the waffle batter.

That sounds pretty obvious and uncontroversial, but not to everyone.

The authors continue:

> We hear you saying, "Doesn't economics teach us to focus on omelets and waffles for ourselves?" We should reach for the transcendent rather than the merely material. Economics preaches love of appetite instead of love of neighbor.

That is just what many people, especially Christian socialists, think: Economics is a sophisticated cover for avarice, so don't bother listening to economists and their jargon. Carden and Fuller have no doubt heard that many times from students, college colleagues, and others. They reply this way:

> Economics doesn't tell you what to value, only that there are trade-offs. Even good things (e.g., feeding the homeless across the street) cost something (e.g., feeding the homeless across town.)

Well said, and probably sufficient to keep all but the most adamant opponent of economic analysis reading.

Improving lives / The central question of the book is what conditions make it possible for humans to flourish. Unquestionably, people live far better today than they did in the past. Kings and queens lived without comforts that today's poor enjoy. For nearly all humans, life is no longer the Hobbesian state of nature: solitary, poor, nasty, brutish, and short.

The authors point to some compelling data, such as the dramatic decline in the time-cost of acquiring staples of life. For instance:

> In India, the time cost of daily rice fell from 7 hours in 1960 to less than 1 hour today. In Indiana, it has fallen from 1 hour to 7.5 minutes. Notice too that the gains going to the relatively poor (Indians, 6 hours) are far larger in absolute terms than those accruing to the relatively wealthy (Indianians, 52.5 minutes.)

So, it's not the case that the poor are getting poorer while the rich get richer, as we so often hear, but rather that *everyone* is getting richer. The lot of the poor has been rapidly improving, and the authors take pains to make sure their readers understand how and why this is occurring. It was not because of government actions, but instead because of the work and innovations of free people who figured out how to make better use of scarce resources, earning profits for themselves while creating new and/or less expensive goods for everyone else.

There are, however, several conditions that must be met for that to happen. For one thing, property rights need to be secure because people are not inclined to devote their time and effort to investments if it's probable that others, including government, will take their property from them. The "Green Revolution" that so reduced the cost of rice and other foodstuffs would never have occurred under a state-controlled economy.

But the word "profit" triggers opposition in many minds. Profits, they believe, are the result of exploitation. Capitalists put profits before people, they claim. Carden and Fuller explain that profits (and losses) are crucial in making the best use of resources. They write:

> We could make cars virtually indestructible, and we could force car companies to earn losses doing so. The "people before profits" people probably wouldn't lose any sleep over it, but they should. Safer cars require more wires and engineers that are now unavailable for other things, like smoke detectors, medical devices, and anything else our neighbors value. The Smith family has a safer car, but they skimp on the costlier smoke detectors. It's not clear if they're safer on net. No one's first impulse connects safer cars with house fires, but economics helps us see connections that aren't apparent.

Thus, the profit and loss system enables producers and consumers to optimally balance the various goods and services they desire. It should be appreciated, not condemned.

What about helping the poor? Many Christian socialists (and other varieties) argue that we must have a host of government programs to alleviate the suffering of poor people. We should be Good Samaritans, not profit maximizers. Carden and Fuller understand the good intentions underlying that view, but they point out that trying to do good deeds is complicated, often producing unintended consequences such as what James Buchanan dubbed the Samaritan's Dilemma: the beneficiary becoming dependent on charity instead of pursuing self-reliance. Carden and Fuller write, "The Samaritan Dilemma suggests that we need wisdom, not just good intentions in dealing with the less fortunate, lest we unintentionally make them worse off in the long run." That, they show, has often been the case.

It's not the case that the poor are getting poorer while the rich get richer, as we often hear, but rather that everyone is getting richer.

Unintended consequences / This brings us to a crucial part of the book: the authors' many demonstrations of the ways in which apparently well-intentioned government programs turn out to have adverse consequences for the people they're supposed to help. For example, nearly everyone agrees that it's good to help people who have disabilities, so why not have a law forbidding employment discrimination against them? The United States did that with the Americans with Disabilities Act (ADA). Trouble is, the ADA has had unexpected negative consequences for the disabled. Carden and Fuller write:

> The ADA, it turns out, *decreased* the employment of disabled men of all working ages and reduced the employment of disabled women under age forty. Mere economics explains why. Begin with the fact that most discrimination lawsuits originate from employees who claim mistreatment. Most suits aren't from applicants alleging that they weren't hired for reasons of disability. Now, put yourself in an employer's shoes. It starts looking risky to hire someone with a disability.

The wrong sort of help actually hurts.

Here's another instance where the

instinct to make things better by passing a law ends up doing harm: laws against "price gouging" after a natural disaster. Isn't it just greedy for companies to charge more for necessary items after a disaster? Shouldn't officials punish that kind of behavior? No, the authors argue, because higher prices are important in signaling that lots of things must change if we are to alleviate the effects of the disaster as soon as possible. As they explain:

> Counterintuitively, high prices in the short run are the cure for high prices in the long run. Higher prices after a natural disaster tell people to flood the area with supplies, which they do. When the supplies flood in, prices come hurtling back to earth.

Similarly, readers learn that minimum wage laws, rent control laws, antitrust laws, child labor laws, and others do more harm than good. That includes taxes that are supposed to make companies and wealthy people "pay their fair share." Carden and Fuller show that taxes don't usually have the effects that politicians claim they will. The new taxes may be imposed on businesses, but they stick to consumers and workers, such as the United States' luxury yacht tax of the early 1990s that caused lots of job losses among the people who built yachts.

Readers also get a good education in the reasons why our representative government so often does things that benefit well-organized interest groups at the expense of consumers. The authors ably explain that democracy often works against the interests of ordinary people because of the rational ignorance of voters, coalitions of "Baptists and Bootleggers" (i.e., altruists joining forces with the self-interested), and so on.

Economic freedom and morality / In an uplifting paragraph near the book's end, the authors argue that everyday economics and everyday morality are "bidirectional." They write:

> A commercial society's institutions are the wind beneath these virtues' wings. Want to love your neighbor as yourself? Respect his private property rights. Want dishonesty and deception penalized? The profit and loss system and the common law tradition are surprisingly good at it. Want industriousness rewarded and sloth punished? We know of no better system than market competition. Want wise and prudent use of society's scarce resources rather than intemperate waste? Then you need to understand that profit and loss accounting helps us maximize value and minimize waste.

Readers with an open mind will find a lot to think about, arguments they probably had never encountered before. And the authors make the book easy to comprehend and use: no abstruse jargon, no mathematics, no graphs, but lots of readily checked links to supporting as well as opposing writings.

Mere Economics is an estimable effort at spreading the word that economic freedom dovetails with morality. I would suggest giving copies to anyone you know who has embraced the notion that we should jettison capitalism in favor of socialism. R

A Byzantine and Defective System of Bank Supervision

REVIEW BY VERN MCKINLEY

How can the public have confidence in banks? Currently, the United States applies a blend of federal and state bank supervision, depending on how the bank is chartered. In a previous era, private clearinghouses also played a supervisory role.

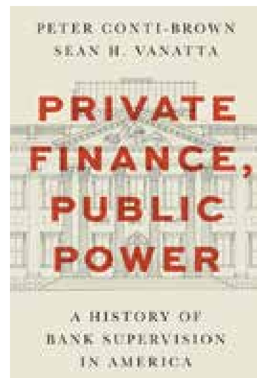
Peter Conti-Brown, an associate professor of financial regulation at the Wharton School of the University of Pennsylvania, and Sean Vanatta, a senior lecturer at the University of Glasgow, trace the history in their ambitious book *Private Finance, Public Power*. Once I learned the two were working on this book, I eagerly awaited its release, as I had previously reviewed Conti-Brown's *The Power and Independence of the Federal Reserve* ("The Ulysses/Punch Bowl View of the Fed," Winter 2016–2017) and Vanatta's *Plastic Capitalism* ("To Control Capitalism or Not?" Spring 2025).

Supervision gone awry / *Private Finance, Public Power* leads with an introductory chapter that chronicles Silicon Valley Bank (SVB), which failed spectacularly in mid-March 2023. SVB is a good, contemporary starting point for a review of bank supervision: The failure raised a flood of pertinent questions, many of which have still not been satisfactorily answered.

The primary federal supervisor of SVB, the Federal Reserve, and the state supervisor, the California Department of Financial Protection and Innovation, were blindsided by its sudden implosion. Another federal bank supervisor, the Federal Deposit Insurance Corporation (FDIC), held its quarterly press conference on bank performance in late February of that year, and SVB was not on the list of problem banks released that day, nor was it a contingency in the FDIC's December 2022 financial statements.

There was a massive run on SVB, notwithstanding FDIC coverage up to $250,000 per depositor. Federal bank supervisors ultimately agreed to bail out *all* depositors, including those above that

level, even several billionaires. The intervention may have worsened the panic. Conti-Brown and Vanatta are on point about the awful optics of the bailout: "[Uninsured] depositors … clamored to be made whole, despite no plausible legal claim in their favor." They also highlight the contradiction between the bailout and recent reform measures: "The country had a proper banking crisis, just fifteen years after the last one that was, in Barack Obama's famous words, supposed to put a stop to taxpayer bailouts once and for all."



Private Finance, Public Power: A History of Bank Supervision in America

By Peter Conti-Brown and Sean H. Vanatta

413 pp.; Princeton University Press, 2025

The SVB failure was a repeat of over a century of similar breakdowns: "supervisors did not fully appreciate the extent of the vulnerabilities as [SVB] grew in size and complexity." This explains the book's title: "These public officials are responsible [for SVB's risk-taking]…. The truth is that the system of banking in the United States is composed of private finance, backed inescapably by public power."

Why so many bank supervisors? / As Conti-Brown and Vanatta trace the history of bank supervision, it becomes clear how we ended up with so many supervisors. Most banks in the early 1800s were state chartered:

> State-chartered banks came into existence as extensions of sovereign state authority. Monitoring and oversight … were the prerogative of the sovereign, exercised through the common law "visitorial power" … to ensure that charter provisions were being followed and to take corrective action if they were not.

In other words, there were many supervisors because political leaders wanted them supervised.

The federal government only "exercised monitoring and visitation over the [First Bank and Second Bank] of the United States" during their separate 20-year federal histories, (1791–1811 and 1816–1836, respectively). Oversight varied for the two banks: The First Bank's oversight was limited to the submission of basic "balance sheet information to the Treasury," while the Second Bank's oversight involved "more affirmative investigatory powers."

It wasn't until the Civil War era that the first dedicated federal bank supervisory agency came on the scene. The National Bank Act of 1863, which created the Office of the Comptroller of the Currency (OCC), led to "a streamlined administrative process for chartering national banks … [while the OCC] would have additional discretion to investigate banks." The first comptroller, Hugh McCulloch, "would decisively shape the early practices of federal bank supervision by making the Currency Bureau an effective, autonomous institution and by essentially creating the system of regular federal bank examination." The separate state oversight of state-chartered banks continued and still does to the present day.

But as banking panics became frequent in the late 1800s and early 1900s, the authors argue it was clear the federal system

> was not equipped to confront financial crisis…. In times of crisis, supervisors needed money, and plenty of it…. [F]ederal officials and financial reformers alike recognized that the federal government remained politically responsible for the fate and function of the financial system…. After the Panic of 1907, the public would seek to reassert control.

The politics was divided on the topic, but

> many Democrats, drawing on populist tradition, insisted on greater public authority through enhanced government oversight…. It was into this mix that Congress inaugurated the Federal Reserve System as yet another risk management alternative…. Woodrow Wilson … decided to make currency reform one of the keystone efforts of his administration.

Layering of federal bank supervision began with the Federal Reserve also becoming "lender of last resort" during crises.

What supervisors do / In the life cycle of a bank, supervisors take on a variety of roles. In the book's chapters on the early history of bank supervision from the late 1700s to the 1860s, these are discussed in the context of when states chartered and supervised banks. According to the authors, there were five banks in the United States by 1791 and over 300 banks by 1820. At the beginning of a bank's life, the charter could be secured through a "special legislative charter" or, in free-banking jurisdictions, upon application to the supervisor "on the basis of clear … rules, most often linked to minimum capital standards and requirements to back note issues with bonds deposited with the state." The applicant bank would coordinate with the state banking commissioner, "who verified that bank organizers had satisfied chartering requirements." At the end of a bank's life, the supervisor is called upon to revoke the charter. The authors make clear that there was a dearth of options between a bank's chartering and its failure to address the condition of a weak bank: "There is no punishment but death."

My first job after graduating from university involved examining banks, another task for bank supervisors. The FDIC handed me a Hermes typewriter,

and I spent the next three years in Texas during a deep, statewide banking crisis. The authors describe this type of work as "the first public instance of the institutionalized discretionary approach to bank supervision." Teams of bank examiners are on the front lines of supervision, meeting with bankers and conducting a deep review of documentation on a bank's operations.

The practice began as a relatively narrow application of authority with a risk-based focus:

> Before the 1820s, bank examinations sometimes occurred but were ad hoc affairs, usually taking place when chartering officials, believing a bank to be insolvent, used their common-law visitorial authority to investigate the bank.

In the subsequent centuries, examinations have been conducted on strong and weak banks alike, with greater resources committed to examining the latter. In the 19th century, examiners were responsible for a heavy workload and

> could not afford to spend sufficient time in banks. In 1892, there were 42 national bank examiners and 3,759 national banks, 89.5 banks per examiner.… [T]he amount allowed an examiner for the examination of smaller banks [was] not sufficient to compensate him for the time necessary.

Supervisors are also heavily involved with the related and alliterative tasks of failure and forbearance. The authors summarize the importance in early supervision history of safeguarding against failure:

> Bank failure loomed over nearly every aspect of banking practice and policy in the antebellum era.… More than 15 percent of antebellum banks closed without redeeming their notes at full value.

During this period, the winding up of a bank was not undertaken by an expert administrative agency, but rather by "local courts and judges." During the late 19th century, comptroller John Jay Knox Jr. developed the option of "forbearance—the intentioned choice not to exercise authority available to a bank supervisor[;] … a tool made for crisis." As the need to respond to the panics of 1873, 1884, 1893, and 1907 presented the financial authorities with an opportunity to refine their crisis management skills, forbearance was employed in the hope that, with a little bit of time, a weak bank could morph into a strong one. Often, this hope was dashed.

When the day comes when depositors run on the bank, that extra period it remained open and sustained losses means a deeper haircut for depositors.

The bank holiday and deposit insurance / Conti-Brown and Vanatta set the scene for bank supervision as the Great Depression set in:

> On the eve of the banking crises, the U.S. banking system retained its uniquely byzantine institutional and supervisory complexity.… The new Federal Reserve System overlaid this structure.… These supervisory institutions, never in harmony, sharply diverged, laying bare shortcomings that would compound in the face of systemic crisis. The banking system's most important weakness was that state and federal chartering competition enabled the formation of too many weak banks. By 1920, the nation was blanketed by nearly 30,000 individual banking firms, most of them small, under-capitalized, geographically confined, rural, and ripe for collapse.… Between 1921 and 1929, more than 600 banks failed each year.

In response, President Herbert Hoover panicked and "instructed the Comptroller not to do anything to rock the boat, and not to have any more bank failures.… [F]ederal officials united behind extraordinary forbearance." Hoover chose denial, thinking that forbearance and patience would lead to a happy ending. Unfortunately, a bank that is insolvent and unprofitable gets deeper and deeper into insolvency. When the day comes when depositors run on the bank, that extra period of time the bank remained open and sustained losses means a deeper haircut for depositors.

As part of the 1933 nationwide bank holiday imposed by President Franklin Roosevelt, the authorities did the necessary triage to further cull the population of banks. An initial estimate revealed that only about "2,200 out of 5,938 national banks could be reopened at once and meet all demands on them." A Treasury assessment placed the banks into categories: Class A (best), Class B, and Class C (worst). "The essential work of the holiday … would be drawing the lines between these categories and then working out a means of opening as many Class B banks as quickly as possible." The discussion in the chapter on the bank holiday is quite strong.

Another "layer" of bank supervision was added in the 1930s with the establishment of the FDIC. "Advocates [of deposit insurance] had hoped that, by providing depositors confidence that bank promises would be honored even if the bank failed, insurance would halt deposit runs before they began and panics would pass into history." This hope was not fulfilled when individual states set up such schemes "in the generation before the Great Depression," and it has not been fulfilled to this day with the FDIC, as the failure of SVB made clear.

Doing something about the mishmash / In 1947, Hoover was appointed to lead a commission to rationalize the New Deal bank supervision structure: "Hoover saw the problem only through duplication, inefficiency, and opaque lines of authority; he wanted the prerogatives of an institutional designer starting afresh." According to Conti-Brown and Vanatta:

> The problem was not simply that agencies multiplied after major crises.… The problem … was that Congress created agencies to address similar risk management challenges from different, sometimes conflicting and sometimes complimentary, positions.

Many reengineering efforts have been introduced since the 1940s, but the vested interests have defended the indefensible and the structure remains.

Conclusion / Two of the final chapters' major conclusions are puzzling. First, the authors both criticize and compliment the layered system of supervision that has emerged over the past 160 years of federal dominance at great fiscal cost:

> No one would set out to design a supervisory system identical to … the United States.… Even so, the creaky set of institutions that has emerged through contingency and stress manages that risk in remarkably effective ways.

So, is the system effective or not? I'm unsure what the authors' grand conclusion is here, but mine would be much more critical based on their own history.

Second, they end their history at 1980, and give this explanation for why:

> We end in the 1970s in part because it marks the end of what historians have called the "New Deal Order" and the beginning of what has become increasingly characterized as the "Neoliberal Order." … [W]e ended the book in 1980 because … the approach to managing residual risk during the Reagan–Bush–Clinton eras departed dramatically from the pendulum swings that had characterized the century before.

Do the authors consider the neoliberal era more stable than the "pendulum swings" of the New Deal Order? Given other things they write, I don't think so. So, what to make of the above passage?

Regardless, *Private Finance, Public Power* offers an exhaustive history of US bank supervision, complete with 63 pages of substantive endnotes. I came away with a clearer understanding of how that supervision developed and what flaws resulted from that development. *R*

From the Past

Today, through Hayek's Eyes

REVIEW BY PIERRE LEMIEUX

From industrial policy, to the Department of Justice becoming the president's personal enforcer, through the replacement of invasive regulations by whimsical commands and threats, the current political situation in America is worrisome for many if not most Americans. Similar developments have been simmering elsewhere in what used to be called the free world.

This comes some six-plus decades after the University of Chicago Press published Friedrich Hayek's 1960 book *The Constitution of Liberty*. (The definitive edition of the book, under the scholarly editorship of the late Ronald Hamowy and published by Routledge, came out in 2012.) In it, Hayek had much to say that is relevant today. The book's chief aim, he wrote, is the "interweaving of the philosophy, jurisprudence, and economics of freedom." (He used the terms "freedom" and "liberty" interchangeably; classical liberals and libertarians generally prefer "liberty.") In 1974, he won a Nobel economics prize, and the book was one of the reasons for the award.

Hayek was a classical liberal who is often chastised as too moderate for radical libertarians and too radical for moderate classical liberals. He did not like the term "libertarian" and preferred the label "Old Whig," which is pretty esoteric for contemporary readers.

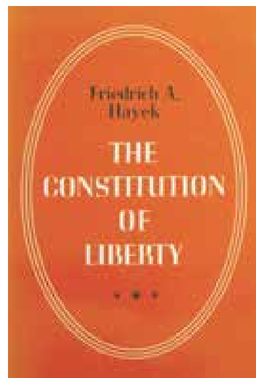
This review will focus on the ideas in *The Constitution of Liberty* that seem most instructive for today's America, in the 250th anniversary year of the Declaration of Independence. It will emphasize the classical liberal ideas that provide foundations for a free-market economy and a free society. I use "classical liberal" as encompassing moderate libertarians. Like Milton Friedman, I believe that classical liberals should reappropriate the term "liberal" tout court, and that is how I use it.

Value of individual liberty / Like many other classical liberals, Hayek defined individual liberty or freedom as the absence of coercion from other individuals in society. The concept is broader than just "political liberty." "It can scarcely be

contended," he noted, "that the inhabitants of the district of Columbia, or resident aliens in the United States, or persons too young to be entitled to vote do not enjoy full personal liberty because they do not share in political liberty." The fact that resident aliens are not as secure as they were when Hayek wrote these lines does not erase the difference between the two concepts of liberty but indicates that permanent alien residents have lost a chunk of their individual liberty, just like many citizens have. Liberty as the absence of coercion was also the original meaning of the word, as the opposite of slavery.

A useful definition of coercion is not easy to formulate. For Hayek, people are coerced when they are subject to the arbitrary will of an individual or group of individuals and are thus prevented from pursuing their own purposes, ends, or goals. "Arbitrary" in this case means that somebody else makes the decision. A free and voluntary exchange between two parties, on the contrary, is the paradigm of non-arbitrariness because both have to agree to the terms for the exchange to take place.

As we will see, this definition ties in with the rule of law, which protects individuals by allowing the government (only) to enforce non-arbitrary rules and levy taxes for that purpose. Like most classical liberals and libertarians, Hayek was not an anarchist.



The Constitution of Liberty
By Friedrich Hayek
576 pp.; University of Chicago Press, 1960

Unknown civilization in America / Hayek's argument for free markets relies on the theory that they transmit information (he used the term "knowledge") efficiently and do this without any central and coercive manager. "Knowledge exists only as the knowledge of individuals," he explained. "The sum of the knowledge of all individuals exists nowhere as an integrated whole." By using their own information for their own purposes (typically, but not necessarily, self-interested), both on the demand and supply sides of markets, individuals and private groups contribute to the formation of prices, which incorporate and transmit this information throughout the economy. Free market prices incorporate the knowledge of all market participants and, in turn, coordinate their actions. In his later three-volume work *Law, Legislation, and Liberty* (1973, 1976, 1979), Hayek went one step further and wrote that "the essence of freedom" is "that the several individuals act on the basis of their own knowledge and in the service of their own ends." This is how prosperity becomes possible.

The "creative powers of a free civilization" depend on individual liberty, which allows the use of all knowledge, both explicit and tacit. There is no way a central planning bureau (or an inspired autocrat) could have access to all that knowledge, which explains why planned economies are boring if not poor. They always struggle to imitate, and catch up with, the innovations, institutions, and ways of doing things that develop in free societies. "Liberty is essential," wrote Hayek, "in order to leave room for the unenforceable and the unpredictable; we want it because we have learned to expect from it the opportunity of realizing many of our aims." He continued:

> It is therefore no argument against individual freedom that it is frequently abused. … It is because we do not know how individuals will use their freedom that it is so important.

The Constitution of Liberty is dedicated "to the unknown civilization growing in America," which testifies to Hayek's (guarded) optimism for the future of American society—because it was, or could be, a free society.

Rule of law / The rule of law and how it relates to individual liberty constitute the central part of *The Constitution of Liberty*. The rule of law is the classical liberal's conception of the legal system of a free society. Laws have certain essential features. They are "long-term measures, referring to yet unknown cases and containing no references to particular persons, places or objects." A prohibition like "Thou shalt not kill" or "Thou shalt not steal" is an example. A law also applies equally to everybody, discriminating against or in favor of no one. This principle of equality before the law is also referred to as the "generality" of law. It follows that laws apply equally to government officials and agents—except for the legitimacy of levying taxes for the purpose of enforcing true laws, which are those that meet the above criteria.

Hayek admitted that "no entirely satisfactory criterion has been found that would always tell us what kind of classification is compatible with equality before the law," but we may say "that those inside any group singled out" by a law must "acknowledge the legitimacy of the distinction as well as those outside it." This sort of unspoken unanimity is not easier to apply in practice than James Buchanan's unanimous social contract. In theory, though, when we obey true laws, "we are not subject to another man's will and are therefore free," Hayek wrote. "It can be said that laws and not men rule."

Hayek recognized that these necessary features of laws are not a sufficient condition for a free society. The content of laws, and not only their form, must be such that the market and the general system of voluntary cooperation "will work tolerably well." Laws thus have a "substantial" content and not only a "formal" aspect: They must protect the equal private sphere of individuals.

A law constitutes "a limitation on the power of all governments, including the powers of the legislature":

> If a law gave the government unlimited power to act as it pleased, all its actions would be legal, but it would certainly not be under the rule of law. … The rule of law is therefore not a rule of the law, but a rule concerning what the law ought to be, a meta-legal doctrine or a political ideal.

The rule of law means that an individual and his property are not to be used as means to serve somebody else's purposes. Laws are fundamentally different from commands, which are given by a superior to a subordinate. An arbitrary government is one that does not act in conformity with laws. A government diktat is not a law, even if issued by a democratic government. The opposition between law and arbitrary power has been a defining feature of classical liberal theories.

The main function of law is to secure individual liberty. A constitution, written or unwritten, is a law that has priority over ordinary laws but is also part of the rule of law. This conception of law must be able, in some cases, to justify civil disobedience by private individuals, although Hayek did not discuss that issue.

He insisted that the rule of law does not prevent public policies, except if they infringe on the protected sphere of individuals. In Hayek's system, public policies don't entail coercion if they don't establish or protect government monopolies or try to control prices or quantities in the private economy. In more conventional terms, economic policies must support markets, not interfere in them.

The rule of law "requires independent judges who are not concerned with any temporary ends of government." Judges must stop the government when it violates the law. The requirements of government policy cannot be an argument before a judge—a principle very different from current experience in so-called free societies. In the United States, the Department of Justice regularly defends the requirements of public policy before the courts instead of invoking the conformity with standing non-political laws. The current administration has pushed this practice aggressively.

In light of the multiple "national emergencies" that have recently been declared in America as a way to bypass the rule of law, the author of *The Constitution of Liberty* looks a bit cavalier when he writes:

> Even the most fundamental principles of a free society, however, may have to be temporarily sacrificed when, but only when, it is a question of preserving liberty in the long run, as in the case of war.… It is necessary that such actions be confined to exceptional cases defined by rules.

Leviathan—the unbridled state—is not easy to constrain.

Rise of law / A good way to understand the rule of law is to follow its history as summarized in *The Constitution of Liberty*. Its origins may go back to ancient Greece (under Pericles in the 5th century BC, not Demosthenes a century later) and the late Roman Republic. Rome's Laws of the Twelve Tables declared that "no privileges, or statutes, shall be enacted in favour of private persons, to the injury of others contrary to the law common to all citizens." Cicero, who influenced David Hume and many classical liberals, "became the main authority for modern liberalism." However, the emperors reestablished the rule of men.

The 13th century Magna Carta was referred to as the *Constitutio Libertatis* ("Constitution of Liberty") in Henry Bracton's contemporaneous work on the laws and customs of England. During the 17th century, it became established that exclusive rights to produce any good was "against the common law and the liberty of the subject." On the eve of the English Civil War, "prerogative courts" and especially the Star Chamber were abolished. The latter was, in the words of British historian F.W. Maitland, "a court of politicians enforcing a policy, not a court of judges administering the law." Equality before the law was advancing. At the end of the 17th century, Scottish philosopher and historian Gilbert Burnet wrote, "The chief design of our whole law, and all the several rules of our constitution, is to secure and maintain our liberty."

In a famous ruling in 1765 (*Entick v. Carrington*), Lord Camden wrote, "With respect to the argument of state necessity, or a distinction that has been aimed at between state offences and others, the common law does not understand that kind of reasoning, nor do our books take notice of any such distinctions." In the same year, William Blackstone wrote in his *Commentaries on the Laws of England*,

> In this distinct and separate existence of the judicial power in a peculiar body of men, nominated indeed, but not removable at pleasure, by the Crown consists one main preservative of the public liberty.

By the end of the 18th century, however, different ideas—including the French concept of political liberty—were already undermining this conception of law as the bulwark of individual liberty.

To America / The torch of the rule of law was relayed to America. The colonists had inherited the British tradition of classical liberalism, and they "were singularly fortunate, as perhaps no other people has been in a similar situation, in having among their leaders a number of profound students of political philosophy." I don't think anybody could make the same observation about today's rulers of America.

Alexander Hamilton wrote in Federalist No. 78:

> By a limited constitution, I understand one which contains certain specified exceptions to the legislative authority; such,

> for instance, as that it shall pass no bills of attainder, no *ex post facto* laws, and the like. … Limitations of this kind can be preserved in practice no other way than through the medium of the courts of justice; whose duty it must be to declare all acts contrary to the manifest tenor of the constitution void.

In the first session of the First Congress, James Madison declared that the courts would "consider themselves in a peculiar manner the guardians of those rights; they will be an impenetrable bulwark against every assumption of power in the Legislative or Executive."

The 1780 Massachusetts Bill of Rights aimed at "a government of laws and not of men." According to historian William Clarence Webster, all state constitutions before 1787 expressed similar ideals (suspicious of government, all even forbade standing armies in time of peace). However, Hayek observed that "these admirable principles remained largely theory and … the state legislatures soon came as near to claiming omnipotence as the British Parliament had done."

The US Constitution, concluded Hayek, was conceived "as a protection of the people against all arbitrary action, on the part of the legislative as well as the other branches of government." It was meant to be "a constitution of liberty." (We can add that, alas, it was not so for the slaves.)

Decline of law / Hayek insisted that majority rule is a method of government, not per se a way of discovering the people's long-term opinion that (hopefully) determines the general rules limiting government. Majority voting can, over a period of time, contribute to revealing the state of opinion, but it is mainly a peaceful and less costly way of changing the ruling politicians. Liberal democracy, also known as constitutional democracy, limits the majority's whims with the rule of law. Historically, the problem is that "democracy" took over the rule of law and became "the justification for a new arbitrary power."

Interestingly, Hayek's liberal democracy sometimes looks like Buchanan's unanimous contractarianism: "To [the liberal] it is not from a mere act of will of the momentary majority," Hayek wrote, "but from the wider agreement on common principles that a majority decision derives its authority. … And this common acceptance is the indispensable condition for a free society."

The clash between unlimited democracy and the rule of law has produced a decline of the latter. Studying this decline in 18th century Britain and 20th century America offers a complementary way to understand what is the rule of law in classical liberalism.

Legal positivism / The doctrine of legal positivism is the opposite of the rule of law. It claims that law is nothing other than commands that are to be obeyed. A law is simply ("positively") what a political authority says is compulsory and has the will and power to impose. In short, the law is what the state commands.

This doctrine gripped Germany in the second half of the 19th century, spread to other Western countries, and started exerting a large influence after World War I. For the German jurist Hans Kelsen, a leading legal positivist, the impossible freedom of the individual "recedes into the background and the liberty of the social collective occupies the front of the stage," as he wrote in the 1920s. He welcomed this "emancipation of democratism from liberalism." He claimed that "a wrong of the state must under all circumstances be a contradiction in terms." Hayek suggested that this approach opens new possibilities for an unlimited dictatorship, which "were already clearly seen by acute observers by the time Hitler was trying to gain power."

The fascist and communist theories of law were an extension of legal positivism. In the 1920s, a Russian legal theorist, Aleksandr Malitzki, argued that "the fundamental principle of our legislation and our private law, which bourgeois theories will never recognize, is: Everything that is not specifically permitted is prohibited." Another Russian legal theorist, Evgenii Pashukanis, wrote that "the subordination to a general economic plan" means "the gradual extinction of law as such." When Pashukanis fell from favor with Stalin, he disappeared. Harvard law professor Roscoe Pound later wrote that if there had been law instead of administrative orders in the communist regime, "it might have been possible for [Pashukanis] to lose his job without losing his life."

Legal positivism fueled the decline of law in the free world. The continental European conception of administrative powers partly shielded from judicial review was introduced in the United States even earlier than in England. The New Deal accelerated the movement. In 1937, American historian Charles McIlwain observed, "Slowly but surely we are drifting toward the totalitarian state." In 1941, Pound lamented that public officials were allowed "to identify one side of a controversy with the public interest and so give it a greater value and ignore the others."

In *The Constitution of Liberty*, Hayek did not ask why classical liberalism started to decline so rapidly. One reason may be that it is a threat to those lusting for power. Another one would be that classical liberal philosophy contradicts the tribal instincts as Hayek later emphasized in *The Fatal Conceit* (1988).

Conservatism, socialism, liberalism / Today, the welfare state has replaced traditional socialism, which originally meant the nationalization of the means of production. The main danger of the welfare state comes from its goal of redistribution and "social justice," and the extensive regulation and subsidization required for those purposes. But, Hayek argued in the third part of *The Constitution of Liberty*, intentional redistribution

is not the same as aiding the poor, "a minimum welfare for all," insurance in areas where only the state can provide it, or measures to buttress the market economy (say, in education and research). He believed that the strict limits to state action entailed by the rule of law, the absence of any state monopoly (except in levying taxes to enforce general laws), and no progressive taxation would be sufficient to prevent a continuous drift to the sort of government we now have and whose power continues to grow.

Classical liberalism is different from both socialism and conservatism. The postscript of *The Constitution of Liberty*, titled "Why I Am Not a Conservative," focuses on the problems of conservatism.

Hayek was speaking more of European conservatives than the American variety that was once close to classical liberalism. Like in England, American conservatives have moved toward a collectivism of the right. To add to the confusion, and especially in America, the label "liberal" has been monopolized by socialists notably since the New Deal. The real political spectrum, Hayek argued, is better represented by a triangle than a one-dimensional axis from left to right. On one corner of the triangle stand the socialists, on another the conservatives, and the classical liberals on the third corner.

He explained that he rejects conservatism for its fear of change, its distrust for "both abstract theories and general principles," its authoritarian tendencies, often for moral or religious reasons, its obscurantism, its belief that democracy instead of unlimited government is the problem, and "its hostility to internationalism and its proneness to a strident nationalism." Like the socialist, the conservative "does not object to coercion or arbitrary power so long as it is used for what he regards as the right purposes."

Lessons and hopes / Hayek brilliantly observed that the conservatives' nationalist bias "frequently provides the bridge from conservatism to collectivism: to think in terms of 'our' industry or resource is only a short step away from demanding that these national assets be directed in the national interest." He suggested, in different terms, that the main strands of socialism and conservatism share the same preference for collective and political choices over individual and private choices. That is why their economic and social policies have come to be so similar. When they appear not to be, they nonetheless share authoritarianism. For example, using the same anti-discrimination legislation, Democrats imposed "Diversity, Equity, and Inclusion" mandates on private organizations; Republicans are now using it to keep private organizations from voluntarily adopting such policies. Politicians who claim to combat leftist dirigisme with rightist dirigisme have something fundamental to learn.

As long as the state exists, Leviathan) presents a permanent danger. Hayek argued for a general presumption of liberty: "The argument for liberty, in the last resort, is indeed an argument for principles and against expediency in collective action." "In each particular instance," he explains, "it will be possible to promise concrete and tangible advantages as the result of a curtailment of freedom, while the benefits sacrificed will in their nature always be unknown and uncertain." The rule of law implies that whatever is not explicitly forbidden by a general rule is allowed.

British legal theorist A.V. Dicey wrote in more radical terms about the tendency to prefer the visible benefits, or promises, of government intervention: "This natural bias can be counteracted only by the existence in a given society … of a presumption or prejudice in favor of individual liberty, that is, *laissez faire*." Hayek himself did not like the radical and rationalist connotations of the concept of laissez-faire; in *The Constitution of Liberty*, he explicitly distanced himself from it. Yet the regime he advocated with its limits on power would certainly be a great improvement on today's situation.

In this book, Hayek occasionally slips into expressions that look strangely socialist or conservative, such as "society as a whole," "the interest of the community," "the public interest," "the true interest of society," and even the Rousseau-flavored "general interest." What he probably and gauchely referred to is the need for the *coordination* of individual expectations and actions in society, which he rightly thought only a free society can achieve in a way that preserves individual liberty and promotes prosperity. He later became more conscious of the risk of defending individualist (or methodological-individualist) ideas with even mild Collectivist Speak.

One thing is as sure as anything can be: Any new power granted to a "good" politician will certainly be later used by a "bad" one. History is replete with illustrations. Hayek encapsulated this idea in a reflection that is typically liberal and close to American ideals: "The main merit of individualism which [Adam Smith] and his contemporaries advocated is that it is a system under which bad men can do least harm … which does not depend for its functioning on our finding good men for running it." *R*

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IN REVIEW

Working Papers ➼ BY PETER VAN DOREN

A SUMMARY OF RECENT PAPERS THAT MAY BE OF INTEREST TO *REGULATION*'S READERS.

Small Aircraft Safety Inspections

■ **Welch, Ivo, 2026, "Regulatory Excess: The Case of Frequent FAA Inspection Mandates for Small Aircraft," SSRN Working Paper no. 6066607, January.**

Every year, the Federal Aviation Administration conducts mandatory inspections of around 170,000 small piston-driven airplanes at a cost of about $3,000 each, totaling $500 million. There are about 520 single-piston-engined airplane accidents annually, resulting in about 120 deaths. Most are caused by pilot error; only 26 of the deaths involve some sort of mechanical failure, according to the National Transportation Safety Board, which investigates airplane accidents.

This paper calculates that, assuming a value of a statistical life of $14 million, the benefits of inspection are about $360 million per year, much smaller than the cost of the inspections. The FAA should experiment with longer inspection cycles for these aircraft to find a more cost-effective regime.

Financial Crises

■ **Choi, Albert H., Jacob E. Gerszten, and Jeffery Y. Zhang, 2025, "Limits of Contingent Convertible Bonds (CoCos): Evidence from the Credit Suisse Collapse," SSRN Working Paper no. 5696183, November.**

After the financial crisis of 2007–2008, many financial economists recommended the use of catastrophe bonds in banks' capital. (See Working Papers, Winter 2010–2011.) Catastrophe bonds (also known as "contingent convertibles bonds," or "CoCos") are bonds during normal times, with a maturity date, but they convert to equity if a bank's financial condition deteriorates past a predefined threshold, and they can be written down to zero. Regulators encouraged banks to issue CoCos as liabilities on their balance sheets to increase their regulatory capital buffers. The goal was to improve the issuing banks' stability in times of stress. In response, international banks have issued over $1 trillion in CoCos over the past 15 years.

In March 2023, Silicon Valley Bank (SVB) in California failed, and the shock spread to Switzerland and, in particular, to Credit Suisse. Even though Credit Suisse held billions of CoCos on its balance sheet prior to the panic, the Swiss government had to engineer an emergency bailout that ultimately resulted in its merging with UBS. CoCos were unable to save Credit Suisse from failure.

This paper asks two questions: First, were banks with more CoCos perceived by the market as safer? Second, how has the CoCos market evolved after the Credit Suisse failure?

The first question was examined by comparing abnormal returns of common stocks and probabilities of default (based on credit default swap spreads) with the use of CoCos. Holding higher levels of CoCos was associated with worse equity performance and greater probability of default. And the result was not caused by selection (that is, inherently weaker banks issuing more CoCos). In fact, prior to 2023, weaker banks—those with more volatile assets and greater leverage—issued fewer CoCos.

The second question was examined with hand-coded data on contractual terms. A bank's experience during the SVB crisis does not predict adjustment of subsequent contract terms. But new issuers of CoCos are less liquid than their predecessors and concentrated in Continental Europe. Banks in the United Kingdom and China have largely stopped issuing CoCos.

Green Energy Subsidies

■ **Gaarder, Ingvil, Morten Grindaker, Tom G. Meling, et al., 2025, "Green Waste," SSRN Working Paper no. 6048714, December.**

Some economists argue that an optimal policy to address climate change would include both research-and-development subsidies to clean technologies and a carbon tax. The subsidies would be introduced first to incentivize the development of clean technology, and once such technology exists, the carbon tax would encourage its use. The idea is that the overall cost of the transition to a clean energy future would be lower with the combination of early subsidies and a later carbon tax than with only a carbon tax.

This paper examines green technology subsidy expenditures in Norway from 2012 to 2023. One would expect the Norwegian government to rank the clean technology proposals by expected emission reductions per subsidy cost, and direct the subsidies sequentially to the greatest-return-per-spending projects until the program's budget was exhausted. The authors find that decision makers *were* able ex-ante to identify the projects with the highest ex-post carbon emission reductions, *but* they were unwilling to select those projects because of non-emission motives. Prediction errors (i.e., difference between actual and predicted emission reduction) played only a minor role in the bad allocations. Norway could have achieved the same level of carbon emission reductions at less than half the cost. R

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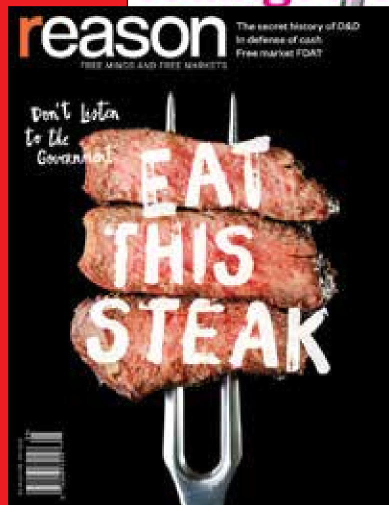

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