

THE INFLUENCE OF KEYNESIAN ECONOMICS IN JUDICIAL DECISIONS

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Abstract

This paper explores the influence of economic theory in Supreme Court resolutions and in the institutional development. It intends to show that certain Constitutional rights and institutions reflect the influence of Keynesian economics, not only through legislative and executive decisions but also, and more decisively, through judicial rulings. In particular, the paper analyzes the association between the Gold Clause cases of the U.S. Supreme Court and the doctrine of the ‘euthanasia of the rentier’ described by John Maynard Keynes in his *General Theory*.

Resumen

El artículo analiza la influencia de la economía keynesiana en las resoluciones de la Suprema Corte de Justicia y en el desarrollo institucional. Intenta demostrar que ciertos derechos e instituciones constitucionales reflejan dicha influencia, a través de decisiones legislativas y ejecutivas y - más decisivamente- las decisiones judiciales respecto de esos derechos e instituciones. En particular, se analiza la relación entre los casos Gold Clause de la Corte de U.S.A. y la doctrina de la “eutanasia del rentista” descrita por Keynes en su *Teoría General*.

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Judges as Regulators: The Origins of a Keynesian Constitution

The Supreme Court is a regulator. Much of the time the Court regulates the operations of government. It reviews what other branches have done and claims the last word. As government grows in relation to the private sector, the Court's role as governor of the government seems to grow more than proportionally (Easterbrook, 1984).

As Judges both resolve disputes and create rules, the Supreme Court possesses discretionary jurisdiction, designed so that the Justices may concentrate on creating rules for the guidance of others. A number of unifying principles influence the legal rules that govern economic conduct; these rules indicate how all the Justices perceive economic issues. During a long time, Keynesian economic models influenced the way justices interpreted the economic Constitution. In a way, these decisions have established for many years a Keynesian Constitution.

In the case of lower courts their opinions are not a large source of rules but the cases that reach the Supreme Court are used for the creation of new rules that shall be applied in future cases. These constitutional decisions influence the structure and conduct of government, and determine the rights of individuals and corporations; these decisions are based in an economic ideology that shall be the basis for the future economic policy based in those principles. When the Court tries to influence the conduct of actors in the economic sphere, the clarity of rules becomes more important.

To assess the Court's performance in understanding and creating rules for the economic system three views could be envisaged, which will be explored in the next sections: the first focuses on *ex-ante* analysis, the second looks at an understanding of marginal effects, and the third approaches the dynamics of the legislative process.

***Ex-ante* and *Ex-post* Perspectives**

The nature of litigation invites judges to treat the parties' circumstances as fixed and to apportion gains and losses. Often the application of legal rules requires no more than that. By the time the judges see the case, it may be too late for the parties to do anything in response to a decision.

The principles laid down in a case today will influence whether similar parties will be in similar situations tomorrow.

It is nonetheless startling how often these arguments collapse to claims about 'fairness,' which in the law almost always means some appeal to an equitable division of the gains or losses among existing parties given that certain events have come to pass. Fairness arguments are *ex-post* arguments, and few lawyers or judges are comfortable arguing about or deciding a case without invoking the ideal of fairness. Who is for unfairness? Many of the Keynesian arguments, including the rejection of hoarding, are arguments based on fairness. The degree to which fairness or other *ex-post* arguments dominate in legal decision making is directly related to courts' assumptions about the nature of the economic system. Judges who see economic transactions as zero-sum games are likely to favor 'fair' divisions of the gains and losses.

Incentives Work at the Margins

An *ex-post* perspective of judicial decisions is only useful if you know how people respond to incentives. Yet the dynamics of litigation often hide marginal effects from judges. The court sees only the gross, average effects rather than the margins at which people are trading. When the Court misses these marginal effects, the rules it designs may have unanticipated or perverse consequences. And the marginal effects may be subtle. In the long run there are substitute ways to do almost anything. Coase (1960) showed that people may bargain and adapt to legal rules, and if transaction costs are negligible, people will go on adjusting and substituting until they reproduce the situation

that would have prevailed in the absence of regulation. Justices should understand the ways people can substitute one product or one strategy for another as the correct way to apply economic decisions.

Laws and Interest Groups

Legislation could be interpreted by judges as representing the general will of the people as written by Congress, if that is the case, the judge considers the statute as a way in which evils could be rectified. In that case he has a free hand in interpretation. The statute's reach expands so long as there are unaddressed objectionable results. The judge interprets omissions and vague terms in the statute as evidence of want of time or foresight and fills in these gaps with more contents in the same vein.

But if legislation is the result of negotiation between legislators and different interest groups, the judge treats the statute as a contract. He first identifies the contracting parties and then seeks to discover what they resolved and what they left unresolved. For example, he may conclude that a statute regulating the price of fluid milk is a pact between milk producers and milk handlers designed to cut back output and raise price, to the benefit of both at the expense of consumers. A judge then implements the bargain as a faithful agent but without enthusiasm; asked to extend the scope of a back-room deal, he refuses unless the proof of the deal's scope is compelling.

If statutes generally are designed to overcome 'failures' in markets and to replace the calamities produced by unguided private conduct with the ordered rationality of the public sector, then it makes sense to use the remedial approach to the construction of statutes—or at least most of them. If, on the other hand, statutes often are designed to replace the outcomes of private transactions with monopolistic ones, to transfer the profits ('rents') of productive activity to a privileged few, then judges should take the beady-eyed contractual approach.

One of the implications of modern economic thought is that many laws are designed to serve private rather than public interests. People demand

laws just as they demand automobiles, and some people demand more effectively than others. Laws that benefit the people in common are hard to enact because no one can obtain very much of the benefit of lobbying for or preserving such laws. Smaller, more cohesive groups are more effective lobbyists. These groups can obtain a greater share of the benefits of laws targeted to assist people who have common characteristics, and so they will raise more money and campaign for legislation more effectively. It also turns out that small, cohesive groups can get more for themselves by restricting competition and appropriating rents than by seeking rules that enhance the welfare of all. Thus we should expect regulatory programs and other statutes to benefit the regulated group; they need not 'capture' the programs, because they owned them all along. The burgeoning evidence showing that regulatory programs increase prices for consumers and profits for producers supports this understanding.

Judicial Decisions and the Creation of the Administrative State

Thus, the liberal state would be transformed by science to become the administrative state with the goal of eradicating social ills. In this view, Keynes and the Keynesians must be seen as providing the scientific blessing for the American welfare and regulatory state. Judges accepted eagerly the erroneous idea that government bureaucrats could be entrusted to devise schemes of social control that would outperform the 'accidental' outcomes of *laissez-faire*.

In acting in these way judges gave an active normative role to economic theory. This normative vision of economics is contrary to James Buchanan's idea that the task of economics as a public science is to provide an understanding of the workings of an organized economy to citizens and the consequences of alternative interventions into that working economy, so that these citizens can be informed participants in the democratic process. In Buchanan's way of thinking, economists must differentiate between the analysis of what is, what could be, and what ought to be in performing their task

of providing citizens with the information required to make intelligent democratic decisions (1996: 30-36).¹ This vision is even more valid for judges.

By the beginning of the twentieth century, the dominant school of economic thinking in the United States was critical of neoclassical economy and advocated an institutional economics that demanded a more activist government to regulate and control the economy and promote efficiency and social justice. Of course, there were pockets of defenders of classical political economy, and even more practitioners of the new science of neo-classical economics; but the Progressive era organized the intellectual domination of the institutional school of economic thought. This domination was not limited to the teachings of economics, but permeated law schools and the budding discipline of public administration, mainly through the works of Veblen and John Commons. In a letter that Keynes wrote to Commons in 1927 he said “*there seems to me to be no other economist with whose general way of thinking I feel myself in such general accord*”. Similarly, Robert Skidelsky, in a recent biography of Keynes, describes Commons as “*an important, if unacknowledged influence on Keynes*” (Skidelsky, 1995:229 in Atkinson et al., 1998).

The normative element in Keynesian economics influenced legal thinking and many of its doctrines was used by judges to justify the intervention to the markets and the artificial expropriation of savings. Keynes was not a democrat; he would gladly have ignored republican institutions and replaced them by a benevolent despotism of enlightened bureaucrats. His emphasis was on results and not institutions through which such results might be reached. The small elite of his ideal was not to be limited by the two main limitations of power, the division of powers or judicial review. Political institutions were irrelevant for the formulation of his policy presumptions. The application of the Keynesian precepts would reduce the possibilities for a constitutional democracy. As a result, Keynesian policy decisions changed democratic political institutions into an authoritarian or bureaucratic regime.

When the Great Crash of 1929 turned into the Great Depression of the 1930's, the remaining voices for laissez-faire were silenced. Economists who had held the classical position were either ignored or they changed their

song to be more in tune with the times. Government had to do something to address social ills. Of course, some economic research argued that the Great Depression was caused by government policy failures- a credit expansion of the 1920's generated a boom-bust cycle, and government interventions in the 1930's, most notably trade restrictions, hampered the ability of the market adjustment process to work to eliminate the crisis. But this message was ignored. Instead, the message that resonated with policy-makers, the public and a new generation of economists was that laissez-faire capitalism was prone to monopoly and business cycles as revealed in the Robber Baron age, the fraud perpetrated on consumers by poor products, the exploitation of workers in factories, and the indignity of unemployment as experienced in the 1930's. It was the 'job of the economists' to address these social ills with the tools of the discipline and the expertise of public administration.

Keynesian economics filled this demand perfectly. Keynes's work, *The General Theory of Employment, Interest and Money* (1936) provided a critique of the classical model of self-regulation of markets, a diagnosis of why the economies of Great Britain and the U.S. had entered a depression and policy advice on how to alleviate the problems of unemployment and instability. For the sake of this discussion, what matters most are the general ideas behind this promise. Keynes argued that investment was unstable because it was based on the volatile expectations of investors and their moods of optimism and pessimism.

In addition, Keynes claimed that the introduction of money into an economic system repudiated the classical law of markets that maintained self-regulation. Prices were not linked to the supply and demand for money anymore than investment was determined by the interest rate in the modern economy, according to Keynes. The introduction of expectations into economic analysis ruptures the old relationships that were established in classical economics. For example, during a recession, because of expectations that the economy is caught in a liquidity trap, attempts to get out of that trap through a monetary policy stimulus will be ineffective. If investment is not rational, but instead based on 'animal spirits,' then private mar-

kets cannot be relied upon to assess the marginal efficiency of capital allocations among competing projects. Finally, in the economy so described by Keynes, resources can remain idle and not be reemployed in alternative uses. The automatic adjustments that classical economics assumed do not come into operation because the economy can get stuck in unemployment equilibrium. By definition, equilibrium is a point where no one in the system has any incentive or inclination to move from their current position. To move out of that equilibrium, a force outside the system must be introduced. Keynes forcefully argued that government was the entity that could most effectively affect social change.

As Roger Garrison has argued, Keynesian economics is the income-expenditure Keynesianism of basic textbook economics. This simple model served as the basic tool for understanding Keynesian public policy for a generation of economists, and it was a staple of Samuelson's presentation in his *Economics*. In fact, the Keynesian shift from analytical perspective to social philosophy is embodied in Samuelson's textbook. In the 1948 edition, for example, Samuelson does not introduce basic supply and demand analysis until page 447, precisely because of the notion that microeconomic principles only become effective after one has ensured that the macroeconomic system is in balance. Left to its own devices, the capitalist system will suffer from aggregate demand failure and results in an unemployment equilibrium. It is the economist's task to engineer this full employment equilibrium, at which point the self-regulating tendencies of a market economy may be relied upon in situations in which externalities are absent, production and exchange is limited to private goods, and not public goods, and the market structure is deemed competitive. Samuelson wrote:

No longer is modern man able to believe "that government governs best which governs least." In a frontier society, when a man moved farther west as soon as he could hear the bark of his neighbour's dog, there was some validity to the view "let every man paddle his own canoe." But today, in our vast interdependent society, the waters are too crowded to make unadulterated "rugged individualism" tolerable (1948:152).

Samuelson admits that this system of ‘rugged individualism’ led to rapid material progress, but he quickly adds that it also resulted in business cycles, the wasteful exhaustion of resources, income inequality, political corruption by moneyed interests, and the substitution of self-regulating competition in favour of all-consuming monopoly (Boettke et al., 2006).

For our story, the significant point to recognize is how Keynes’ *General Theory* and Samuelson’s *Economics* reverse Mill’s *Principles*, where the presumption was still with laissez-faire and the interventions of government in the economy were exceptional. By the time we get to Keynes and later on Samuelson, the presumption is that government must intervene at all times to maintain “economic civilization” and that only in certain circumstances could the laissez-faire principle be relied upon. In addition, it is important to realize the changing role of economists that this shift in presumption requires. At the time of Mill, the economist could still take the stance of student of society, but by the time we get to Keynes and Samuelson the economist’s task is to assume the role of society’s saviour utilizing the scientific tools of his craft to maintain societal balance and right social wrongs. ‘Where the complex economic conditions of life necessitate social coordination and planning,’ Samuelson wrote, “there can sensible men of good will be expected to invoke the authority and creative activity of government” (Boettke et al).

After Alvin Hansen and Samuelson brought Keynes to America in the immediate aftermath of World War II, the notion that experts could regulate the economy, thus eliminating bubbles and panics, grew in apparent infallibility.

The Conflict between Keynesian Economics and Judicial Review

Traditionally, the deleterious effects of Keynesian models on institutions have been associated with its incompatibility with the democratic polity, mainly with the behaviour of Congress or the Executive. But its Keynesian economics have had since the mid thirties an important influence on the

judiciary in resolutions like the “euthanasia of the rentier”, put forward as an economic justification for takings policies made by greedy governments.

There is interdependence between the basic political structure of society and the economic theory of policy, and there are constitutional limits to economic policy. These limits are imposed by the Constitution and the limits in the social contract. Judicial review is the means to comply with the constitutional limitations. This abandonment of the protection of economic rights following economic theory was clearly described in the U.S. Supreme Court case *FERGUSON v. SKRUPA*, 372 U.S. 726 (1963), which included the naming of economists, with the evident pre-eminence of Keynes. The judges said:

This intrusion by the judiciary into the realm of legislative value judgments was strongly objected to at the time, particularly by Mr. Justice Holmes and Mr. Justice Brandeis. Dissenting from the Court’s invalidating a state statute which regulated the resale price of theatre and other tickets, Mr. Justice Holmes said,

“I think the proper course is to recognize that a state legislature can do whatever it sees fit to do unless it is restrained by some express prohibition in the Constitution of the United States or of the State, and that Courts should be careful not to extend such prohibitions beyond their obvious meaning by reading into them conceptions of public policy that the particular Court may happen to entertain” [372 U.S. 726, 730].

And in an earlier case he had emphasized that, “The criterion of constitutionality is not whether we believe the law to be for the public good.” *Adkins v. Children’s Hospital*, 261 U.S. 525, 567, 570 (1923) (dissenting opinion).

The doctrine that prevailed in *Lochner*, *Coppage*, *Adkins*, *Burns*, and like cases - that due process authorizes courts to hold laws unconstitutional when they believe the legislature has acted unwisely - has long since been discarded. We have returned to the original constitutional proposition that courts do not substitute their social and economic beliefs for the judgment of leg-

islative bodies, who are elected to pass laws. As this Court stated in a unanimous opinion in 1941, “We are not concerned . . . with the wisdom, need, or appropriateness of the legislation.” Legislative bodies have broad scope to experiment with economic problems, and this Court does not sit to “subject the State to an intolerable supervision hostile to the basic principles of our Government and wholly beyond the protection which the general clause of the Fourteenth Amendment was intended to secure.” It is now settled that States “have power to legislate against what are found to be injurious practices in their internal commercial and business affairs, so long as their laws do [372 U.S. 726, 731] not run afoul of some specific federal constitutional prohibition, or of some valid federal law.”

In the face of our abandonment of the use of the “vague contours” of the Due Process Clause to nullify laws which a majority of the Court believed to be economically unwise, reliance on *Adams v. Tanner* is as mistaken as would be adherence to *Adkins v. Children’s Hospital*, overruled by *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937). Not only has the philosophy of *Adams* been abandoned, but also this Court almost 15 years ago expressly pointed to another opinion of this Court as having “clearly undermined” *Adams*. We conclude that the Kansas Legislature was free to decide for itself that legislation was needed to deal with the business of debt adjusting. Unquestionably, there are arguments showing that the business of debt adjusting has social utility, but such arguments are properly addressed to the legislature, not to us. We refuse to sit as a “superlegislature to weigh the wisdom of legislation,” and we emphatically refuse to go back to the time when courts used the Due Process Clause “to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, [372 U.S. 726, 732] or out of harmony with a particular school of thought.” Nor are we able or willing to draw lines by calling a law “prohibitory” or “regulatory.” Whether the legislature takes for its textbook Adam Smith, Herbert Spencer, Lord Keynes, or some other is no concern of ours. The Kansas debt adjusting statute may be wise or unwise. But relief, if any be needed, lies not with us but with the body constituted to pass laws for the State of Kansas.

This doctrine was reaffirmed in 439 US 96 1978:

This Court has recognized that, “[l]egislative bodies have broad scope to experiment with economic problems. . . .” *Ferguson v. Skrupa*, 372 U.S. 726, 730 (1963). States may, through general ordinances, restrict the commercial use of property, see *Euclid v. Ambler Realty Co.*, 272 U.S. 365 ...

These cases indicate how economic theory influenced constitutional doctrine in such a way as to eliminate limits in the activity of legislators and administrators in regulating contracts and financial activities. The origin of this normative economic thinking can be traced to Supreme Court cases in the '30s.

The ‘Euthanasia of the Rentier’ and the Protection of Human Rights

Towards the end of *The General Theory*, Keynes argued that the supply of capital would increase over time, and that the price of capital, the market interest rate, would fall. The result of this historical process would be the end of the capitalist class; an eventuality Keynes called “the euthanasia of the rentier” (1936:374-77). Quite apart from the fact that many more people live off interests today than when Keynes wrote, there are a number of reasons to disagree in principle with Keynes’ critical assertion - perhaps the wilful daydream of an old man on the eve of another war- that “the demand for capital is strictly limited” (1936:375).² While not discussed by Buchan, one of the reasons the demand for capital is unlimited is that capital is a mechanism of control. And while the demand for material goods may be limited, it is difficult to imagine satisfying the lust for power (Westbrook: 2004).

Keynes criticized the ‘cumulative oppressive power of the capitalist to exploit the scarcity value of capital’ and warned of the dangers of basing society on the protection of the money-motives of a ‘rentier’ class that lives solely on income derived from interest. He argued that owners of

capital can obtain excessive interest because capital is kept scarce by convention and by central bank policy, although ‘there are no intrinsic reasons for the scarcity of capital’ (in Robinson 1962:376). Writing during the Great Depression, Keynes predicted that the eventual ‘ethanasia of the rentier, of the functionless investor, will be nothing sudden, merely a gradual but prolonged continuance of what we have seen recently ... and will need no revolution’ (in Robinson 1962:376). For some of its followers, the rentier has not just refused to disappear, but has come to predominate over enterprise by dominating the interest rate and monetary policy-making process (Medoff and Harless, 1996:46-53).

As Hermann Hoppe indicates, since interest, according to Keynes, is a purely monetary phenomenon, it is only natural to assume that it can be manipulated at will through monetary policy (1992:199-223). It is ‘comparatively easy to make capital goods so abundant that the marginal efficiency of capital is zero (and) this may be the most sensible way of gradually getting rid of many of the objectionable features of capitalism’ (Keynes 1936: 221). It is ‘possible for communal saving through the agency of the State to be maintained at a level where it ceases to be scarce’. Never mind that this would imply no need for maintenance or replacement of capital any longer (for, if this were the case, capital goods would still be scarce and hence command a price) and that capital goods would instead have to be ‘free goods’ in the same sense in which air is usually ‘free.’ Never mind that if capital goods were no longer scarce, then neither would consumer goods be scarce (for, if they were, the means employed to produce them would have to be scarce too). And never mind that in this Garden of Eden, which Keynes promises to establish within one generation, there would no longer be any use for money. For, as he informs us, ‘I am myself impressed by the great social advantages of increasing the stock of capital until it ceases to be scarce’ (Keynes, 1936: 325). Who would dare disagree that a lower interest rate supposedly increases and decreases investment simultaneously? And it is to get out of this logical mess that Keynes comes up with a conspiracy theory: for, while the interest rate must be reduced to zero in order to eliminate scarcity, as we were told, the lower the interest

rate, the lower also the reward for parting with liquidity. The lower the interest rate, that is to say, the lower the incentive for capitalists to invest because their profits will be reduced accordingly. Thus, they will try to undermine, and conspire against, any attempt to resurrect the Garden of Eden. Driven by ‘animal spirits’ (ibid.: 161) and ‘gambling instincts’ (ibid.: 157), and ‘addicted to the money-making passion’ (ibid.: 374), they will conspire to ensure ‘that capital has to be kept scarce enough’ (ibid.: 217). ‘The acuteness and peculiarity of our contemporary problem arises, therefore,’ writes Keynes, ‘out of the possibility that the average rate of interest which will allow a reasonable average level of employment [and of social income] is one so unacceptable to wealth owners that it cannot be readily established merely by manipulating the quantity of money’ (ibid.: 308-9). In fact, ‘the most stable, and least easily shifted, element in our contemporary economy has been hitherto, and may prove to be in the future, the minimum rate of interest acceptable to the generality of wealth owners’ (ibid.: 309). There is a way out of this predicament: through ‘the euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital’ (ibid.: 376, 221). For ‘the business world’ is ruled by an ‘uncontrollable and disobedient psychology’ (ibid.: 317), and private investment markets are ‘under the influence of purchasers largely ignorant of what they are buying and of speculators who are more concerned with forecasting the next shift of market sentiment than with a reasonable estimate of the future yield of capital assets’ (ibid.: 316). As a matter of fact, don’t we all know that ‘there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable’ (ibid.: 157); indeed, that the decisions of private investors depend largely on ‘the nerves and hysteria and even the digestions and reactions to the weather’ (ibid.: 162), rather than on rational calculation? Thus, concludes Keynes, ‘the duty of ordering the current volume of investment cannot safely be left in private hands’ (ibid.: 320). Instead, to turn the present misery into a land of milk and honey, “a somewhat comprehensive socialization of investment will prove the only means” (ibid.: 378). ‘The State, which is in a position to calculate the

marginal efficiency of capital-goods on long views and on the basis of the general social advantage [must take] an ever greater responsibility for directly organizing investment' (ibid.: 164).

The gradual spread of Keynesian notions was accompanied by the demise of certain principles, both economic and constitutional. There was more political intervention throughout the market, and at the same time the need of a legal culture that accepted these interventions in spite of constitutional limitations.

The following paragraph on the doctrine of the 'euthanasia of the rentier' is eloquent as a termination of all economic constitutional rights:

Now, though this state of affairs would be quite compatible with some measure of individualism, yet it would mean the euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital. Interest today rewards no genuine sacrifice, any more than does the rent of land. The owner of capital can obtain interest because capital is scarce, just as the owner of land can obtain rent because land is scarce. But whilst there may be intrinsic reasons for the scarcity of land, there are no intrinsic reasons for the scarcity of capital (Keynes, 1936)

Without consideration of the economic reasons that reject this type of argumentations, it is the demise of economic liberties. It is also the normative economic argumentation to change the constitutional doctrines existing since *Marbury vs. Madison*.

The 'Euthanasia of the Rentier' and the Gold Standard Cases

The origin of the influence of the 'euthanasia of the rentier' in constitutional discourse could be traced to the 'Gold Standard Cases'. In his first week in office, Roosevelt took the United States off the gold standard; he conceded that "what you are coming to now really is a managed currency"

(Dam). On March 9th he sought confirming legislation; in the same day the Emergency Banking Act was approved, giving authority to the Secretary of the Treasury to require the surrender of all gold coin, gold bullion, and gold certificates against payment of paper money of the same face value. At the time “inflation” had wide support in society, support that included businessmen and banking experts such as Marriner Eccles, Governor of the Federal Reserve Board, and Representative Steagall, Chairman of the House Banking and Currency Committee. There was no unanimity, however, as to the methods for achieving inflation and the economic reasons as to why they would work. These were given immediately after by the *General Theory* of Keynes. Roosevelt’s goal was to achieve higher prices, but his strategy turned less on inflating the money supply than on direct means to increase prices. The National Recovery Administration’s much publicized system of industry wide production cartels is a characteristic example. To Roosevelt, another means was the devaluation of the dollar. The effect would be, in his view, to rise directly and proportionately the prices of farm products and raw materials traded internationally and perhaps to raise other prices as well.

Congressional authorization to devalue the dollar was obtained by the Agricultural Adjustment Act in 1933 that reduced the weight of the gold dollar. At the request of the Administration, Congress first took the precaution by a Joint Resolution of June 5th, 1933, of invalidating gold clauses in public and private contracts. This Joint Resolution provided that “every provision ... with respect to any obligation which purports to give the obligee a right to require payment in gold or a particular kind of coin or currency ... is ... against public policy’ and that all past or future obligations, whether or not any such provision is contained therein ... shall be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender.” The most important purpose of the Act was to give private debtors with gold clause obligations protection and to assure that creditors would not be able to enforce gold clauses when the dollar was devalued.

The gold buying program succeeded in raising the price of gold from

an initial price of \$31.36 an ounce to \$34.45 by January 1934. The dollar depreciated more or less to the same extent in foreign exchange markets, although Keynes characterized the “recent gyrations of the dollar” as “more like a gold standard on the booze than the ideal managed currency of my dreams” (Keynes, 1933:181). On January 15, 1934, the President requested authority to devalue the dollar in terms of gold to between fifty and sixty percent of its original value and authority for the Treasury to buy and sell gold and foreign exchange to stabilize the dollar in foreign exchange markets. The authority was granted in the Gold Reserve Act and on January 31, 1934 the President proclaimed a new gold content of 15-5/21 grains 9/10 fine gold, a reduction to 59.06 of the former weight, equal to an official gold price of thirty-five dollars an ounce. The Gold Reserve Act of 1934 took one further step to eradicate remaining gold standard symbols. In Roosevelt’s own words, the Act “abolished gold coin as a component of our monetary system.” All gold coin was to be withdrawn from circulation and formed into gold bars. Even the Treasury was thenceforth to hold gold only in the form of bullion. Gold was thereafter to be a commodity, not money. It could be sold for industrial and dental uses. Coin collectors could still hold gold coins but only those of numismatic value.

The four major gold clause cases were decided by the Supreme Court in 1935. The cases of *Norman v. Baltimore & Ohio Railroad* and *United States v. Bankers Trust Co.* were decided together 294 U.S. 240 (1935) and involved private obligations. The Joint Resolution invalidating gold clauses was held constitutional and corporate bonds containing gold clauses were therefore held dischargeable at the nominal face amount. *They established a constitutional precedent valid to the present day, and created a normative validity of the economic doctrine that Keynes would immediately draft of the ‘euthanasia of the rentier.’*

The reasoning was straightforward. Congress had broad power over the value of money and of the financial obligations written in contracts, which included a confirmation of the regulation of loans and mortgages.³

In execution of those powers Congress had the power of “frustrating the expected performance of contracts,” and such an impact on private

contractual relations did not constitute a taking. Since, under the circumstances prevailing in 1933, gold clauses constituted an “actual interference” with its broad monetary powers, Congress had the power to invalidate such clauses.

The other two cases, *Nortz v. United States* 294 U.S. 317 (1935) and *Perry v. United States*, 294 U.S. 330 (1935) involved obligations of the federal government. In *Nortz*, a holder of gold certificates acting under compulsion of the nationalization orders and regulations had surrendered the certificates to the Treasury on January 17th, 1934. At that time gold was being purchased by the Treasury at \$34.45 (and therefore traded on world markets at approximately that price) and two weeks later the President, acting under authority he had sought from Congress on January 15th, had devalued the dollar, changing the official gold price from \$20.67 to \$35.00 per ounce. Nonetheless, the plaintiff, having sued for recovery at \$33.43 per ounce (the London price on January 17th), was held to be entitled to be recompensed for his gold certificate only at the rate of \$20.67 per ounce.

Unlike the private obligation cases where the Court had held that no taking had occurred, the taking was conceded but “just compensation” was held to require payment only at the \$20.67 price. The theory was that even if gold coin had been paid out by the Treasury, the holder would have had no alternative but to return the coin to the Treasury and to be compensated at the official gold price. Since gold coin could not be sold at the \$34.45 bullion price available to gold producers and since it was then unlawful to export gold coin in order to receive the world price, the holder was entitled to no more than the nominal value of the certificate, which was calculated at the \$20.67 price. The Court emphasized that a gold certificate was currency, not a warehouse receipt for gold, but the decision did not turn on that point. In effect, price controls had held the price of gold certificates to \$20.67, and so the holder was entitled to no more.

Perry, a case involving a 1917 U.S. government bond that was called for redemption in April 1934, extended the *Nortz* reasoning. Because the \$10,000 bond made principal and interest “payable in United States gold coin of the present standard of value “DD” and because under prior Supreme

Court rulings U.S. government obligations could not be invalidated by subsequent legislation, Chief Justice Hughes, speaking for a four-member plurality, ruled the Joint Resolution unconstitutional insofar as it applied to gold clauses in such obligations. But the Court nonetheless relegated the holder of the government bond to receiving merely the face amount of \$10,000 in legal tender currency. The Court reasoned that unlike the post-Civil War period, when coin and paper money floated in the marketplace at prices determined by supply and demand, the period of the Gold Clause Cases had a “single monetary system with an established parity of all currency and coins.” Even under the pre-1933 legislation, a gold coin could have been legal tender only for its face amount, not for the value of its gold content. Thus even if the bond had been paid in gold coin and even assuming that gold coin did not have to be surrendered to the government at the \$20.67 price under the 1933 regulations, the bondholder could not have exchanged his gold coin at the thirty-five dollar price because no recipient would have been required to treat it as legal tender for more than its face amount. Moreover, he could not have exported the gold coin or sold it for its gold content. As a result, the holder had no legally cognizable loss of purchasing power. Since there was no ‘actual loss,’ recovery of money at the gold value (\$1.69 per \$1.00 face amount of the bonds) would ‘constitute not a recoupment of loss in any proper sense but an unjustified enrichment.’

Which were the economic and social reasons that led a majority of the Court to invalidate - *de jure* for private obligations and *de facto* for public obligations- solemn promises that had anticipated the depreciation of the currency in terms of gold? The Court reasoned in *Norman* with words that easily remind Keynes’ arguments: “to increase the demand for gold, to encourage hoarding, and to stimulate attempts at exportation of gold coin” (294 U.S. at 313) without giving legal or economic arguments for the taking of private property.

At the same time, the clauses could be interpreted as merely requiring payment of the present day currency equivalent of the promised gold coin; then no impact on gold holdings, public or private, could be anticipated.

The Court's concern to protect the congressional decision to "choose ...a uniform monetary system, and to reject a dual system" became irrelevant because gold value clauses could be enforced without according any monetary role to gold. It would suffice to determine the present market value of gold equal to coins of the weight and fineness referred to in the contractual clause. The question consequently became how requiring a private debtor to pay \$1.69 instead of \$1.00 for each face dollar of principal and interest would interfere with the monetary power of Congress. In attempting to give a satisfactory answer to that question, the Court emphasized the large volume of gold clause obligations. The result of enforcing the clauses, even on a gold value basis, would be "dislocation of the domestic economy" (294 U.S. at 315).

The Court contented itself with the rhetorical flourish that 'it requires no acute analysis or profound economic inquiry to disclose' the dislocation that would result if 'debtors under gold clauses should be required to pay one dollar and sixty-nine cents in currency while respectively receiving their taxes, rates, charges and prices on the basis of one dollar of that currency.' There is no analysis, in the arguments of the decision, why complying with one's debts could harm the economy. Some corporations might indeed become insolvent if the debt were interpreted to be \$1.69 rather than \$1.00, but that need not necessarily result in either lower output or higher unemployment in the economy. But the decision would indeed make creditors poorer, in a sudden euthanasia of rentiers.

The government's brief in *Bankers Trust*⁴ made some effort to calculate the impact of holding gold clauses valid. It analyzed debt service (interest plus amortization of principal) and concluded that enforcement of gold clauses on both public and private debts would raise annual debt service some \$3.0 billion to more than \$10.9 billion. But it was in no sense a monetary drain since every dollar paid was received by someone else. And then, as at other times, the principal of long-term debt was often refinanced.

Arguments other economic ones motivated President Roosevelt, the Congress, and the Court. The most reasonable hypothesis is that the purpose of

prohibiting the enforcement of clauses even on a gold value basis was *to redistribute income from creditors to debtors*. The Court did endorse the idea that enforcement would be unfair to the debtor in the context of a devaluation of the dollar in terms of gold. It is unfairness to the debtor, a concept that would have a macroeconomic equivalence and justification in the writing of Keynes, that appears to lie behind the otherwise puerile observation previously noted that gold clause debtors would have to pay ‘one dollar and sixty-nine cents in currency while respectively receiving their taxes, rates, charges and prices on the basis of one dollar of that currency’ (*Norman vs. Baltimore*).

The willingness of the Court to endorse the redistributive desire to help debtors at the expense of creditors may seem rather odd when one considers that the actual obligors in the Gold Clause Cases were large railroads, banks, and the United States itself and that many of the bondholders were doubtless individuals, perhaps even ‘widows and orphans.’ But the government had gone out of its way to emphasize that gold clauses were common in farm and home mortgages. The Court had already revealed a willingness to uphold legislative interference with such mortgage obligations in the case of *Home Building & Loan Association v. Blaisdell*.

In any case, the inclusion of a gold clause may be expected, on general principles, to have resulted in a lower interest rate since it protected the creditor against inflation. The gold clause was, in short, a primitive form of indexation. Yet the government argued in *Perry* that gold clauses were ineffectual: bonds sold at the same price, whether or not they contained a gold clause. This latter argument seems particularly misleading since the natural conclusion is that a higher interest rate was required when a gold clause was not used.

The Arguments of the Supreme Court

The arguments in the Norman case are particularly eloquent in the creation of the constitutional precedent of the ‘euthanasia of the rentier’. Since

then, this legal opinion is considered the correct law of the land with reference to the legal regulation of financial contracts. It has transformed Keynesian arguments into constitutional law.

The arguments run as follows. Chief Justice HUGHES delivered the opinion of the Court:

We are of the opinion that the gold clauses now before us were not contracts for payment in gold coin as a commodity, or in bullion, but were contracts for the payment of money. The bonds were severally for the payment of \$1,000. We also think that, fairly construed, these clauses were intended to afford a definite standard or measure of value, and thus to protect against a depreciation of the currency and against the discharge of the obligation by a payment of lesser value than that prescribed. When these contracts were made, they were not repugnant to any action of the Congress. In order to determine whether effect may now be given to the intention of the parties in the face of the action taken by the Congress, or the contracts may be satisfied by the payment dollar for dollar, in legal tender, as the Congress has now prescribed, it is necessary to consider (1) the power of the Congress to establish a monetary system and the necessary implications of that power; (2) the power of the Congress to invalidate the provisions of existing contracts which interfere with the exercise of its constitutional authority; and (3) whether the clauses in question do constitute such an interference as to bring them within the range of that power.

Contracts, however express, cannot fetter the constitutional authority of Congress. Contracts may create rights of property, but when contracts deal with a subject [475 U.S. 211, 224] matter which lies within the control of Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them.

Dealing with the specific question as to the effect of the Legal Tender Acts upon contracts made before their passage, that is, those for the payment of money generally, the Court, in the legal tender cases, recognized the possible consequences of such enactments in frustrating the expected perform-

ance of contracts-in rendering them 'fruitless, or partially fruitless.' The Court pointed out [294 U.S. 240, 305] that the exercise of the powers of Congress may affect 'apparent obligations' of contracts in many ways. The Congress may pass bankruptcy acts. The Congress may declare war, or, even in peace, pass non-intercourse acts, or direct an embargo, which may operate seriously upon existing contracts. And the Court reasoned that, if the Legal Tender Acts 'were justly chargeable with impairing contract obligations, they would not, for that reason, be forbidden, unless a different rule is to be applied to them from that which has hitherto prevailed in the construction of other powers granted by the fundamental law.' The conclusion was that contracts must be understood as having been made in reference to the possible exercise of the rightful authority of the government, and that no obligation of a contract 'can extend to the defeat' of that authority. (Knox v. Lee, supra, pages 549-551 of 12 Wall).

Here, the Congress has enacted an express interdiction. The argument against it does not rest upon the mere fact that the legislation may cause hardship or loss. Creditors who have not stipulated for gold payments may suffer equal hardship or loss with creditors who have so stipulated. The former, admittedly, have no constitutional grievance. And, while the latter may not suffer more, the point is pressed that their express stipulations for gold payments constitute property, and that creditors who have not such stipulations are without that property right. And the contestants urge that the Congress is seeking, not to regulate the currency, but to regulate contracts, and thus has stepped beyond the power conferred.

If the gold clauses now before us interfere with the policy of the Congress in the exercise of that authority, they cannot stand.

This was a narrow decision, since four justices dissented. Justice McREYNOLDS, in dissenting, wrote:

The enactments here challenged will bring about confiscation of property rights and repudiation of national obligations. Acquiescence in the decisions just announced is impossible; the circumstances demand statement of our

views. 'To let oneself slide down the easy slope offered by the course of events and to dull one's mind against the extent of the danger, ... that is precisely to fail in one's obligation of responsibility.'

Just men regard repudiation and spoliation of citizens by their sovereign with abhorrence; but we are asked to affirm that the Constitution has granted power to accomplish both. No definite delegation of such a power exists; and we cannot believe the farseeing framers, who labored with hope of establishing justice and securing the blessings of liberty, intended that the expected government should have authority to annihilate its own obligations and destroy the very rights which they were endeavoring to protect. Not only is there no permission for such actions; they are inhibited. And no plenitude of words can conform them to our charter.

The dissent also indicated that the decision was contrary to international law. In *Serbian and Brazilian Loans*, Publications P.C.I.J., Series A, Nos. 20, 21 (1929) the Permanent Court of International Justice had declared:

The gold clause merely prevents the borrower from availing itself of a possibility of discharge of the debt in depreciated currency,' and 'The treatment of the gold clause as indicating a mere modality of payment, without reference to a gold standard of value, would be, not to construe but to destroy it. (...)

It is true to say that the gold clauses 'were intended to afford a definite standard or measure of value, and thus to protect against a depreciation of the currency and against the discharge of the obligation by payment of less than that prescribed.' Furthermore, they furnish means for computing the sum payable in currency if gold should become unobtainable.

Counsel for the government and railway companies asserted with emphasis that incalculable financial disaster would follow refusal to uphold, as authorized by the Constitution, impairment and repudiation of private obligations and public debts. Their forecast is discredited by manifest exaggeration. But, whatever may be the situation now confronting us, it is the outcome of attempts to destroy lawful undertakings by legislative action;

and this we think the Court should disapprove in no uncertain terms. Loss of reputation for honorable dealing will bring us unending humiliation; the impending legal and moral chaos is appalling.

Indeed the Gold Clause Cases were the beginning of a judicial ‘road to serfdom’ which was continued in several cases throughout the following decades (Siegman: 415). At the same time, the influence and prestige of the precedents of the U.S. Supreme Court made this doctrine to be followed in many legal systems to the present day, particularly in Latin America, with deleterious consequences.

NOTAS

- 1 See also Buchanan, (1975), Ch. 6, The Paradox of “Being Governed”.
- 2 James Buchan, 1997:276-77, *Frozen Desire: The Meaning of Money* pp. 276-77 New York: Farrar, Straus and Giroux, 1997.
- 3 See *Home Building & Loan Association v. Blaisdell* 290 U.S. 398 (1934)
- 4 Brief for the United States and the Reconstruction Finance Corporation at 35 n.14, *United States v. Bankers Trust Co.*, 294 U.S. 240 (1935), quoted in Dam.

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