Understanding Interest Rates in Cash Value Life Insurance

By Robert P. Murphy, PhD

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Cash value life insurance policies can be very complicated, making it difficult for the newcomer to evaluate claims made about these mysterious creatures. One of the chief ambiguities concerns the distinction between the “guaranteed interest rate” and/or “credited interest rate” on a cash value policy, versus the very familiar concept of “internal rate of return” on more traditional financial products.

I know from personal experience that I was briefly indignant when a representative from my insurance company told me on the phone that I had a certain “guaranteed interest rate” on the cash value of my whole life policy, because I had earlier worked up an Excel spreadsheet and seen that my policy illustrations showed no such return, not even by the 40th year of the policy. The representative tried to explain to me what the “guaranteed interest rate” really meant—hint: it’s not the internal rate of return on the gross premium payments—but I nonetheless left that phone call with a bad taste in my mouth. I thought it was a very misdealing term to be throwing around, since it didn’t mean what the average person would think that it meant.

Now that I have studied more of the actuarial science behind permanent life insurance policies, I understand why the representative thought he was being quite helpful and truthful in what he said. Even so, it’s important for owners and especially agents to understand at least the basic mechanics of what makes these policies tick. The present article will be somewhat academic in nature, but I hope that going through the process step-by-step will shed light on this potentially confusing topic.

Permanent Life Insurance: Where the Simple Becomes Complex

In principle, a cash value policy such as an ordinary whole life policy is a simple thing: The policyowner agrees to pay a stream of premium payments to the insurer so long as he is still alive, while the insurer agrees to pay a stated...
death benefit upon death or upon the attainment of a certain age (such as 100 or 121).

However, in practice even a plain vanilla whole life policy becomes difficult to evaluate quantitatively, because it involves two moving parts, as it were: (1) discounting future cash flows and (2) taking into account the uncertainty of death, which will greatly influence the composition of those future cash flows.

In order to shed light on the terminology and behavior of permanent life insurance, in this essay I’ll start from an easy case and then build upwards. Our first stop is the analysis of a simple bond.

Baby Step 1: A Simple Bond With Various Discount Rates

First let’s focus purely on the time factor. Suppose a financial institution tells a man, who happens to be 35 years old, that it will pay him $1,000 in exactly sixty-five years, when the man will happen to be 100 years old. Now the question is, how much should the man value that promise right now? Another way of putting it is to ask, if the man can sell this IOU from the company, how much would he be able to fetch for it in the marketplace? Let’s take risk out of the analysis entirely, and assume that no one has any doubt whatsoever that the company will be around in sixty-five years, and that it will indeed honor its promise to pay $1,000 at that time.

Clearly the IOU—or what we will call a bond from now on—isn’t currently worth the full $1,000, because a dollar today is more valuable than a dollar that will only be delivered decades in the future. That means we have to discount that future $1,000 payment.

In order to calculate a total discount for the entire period, it is standard practice to assume the man uses an average annualized discount rate. Figure 1 below shows the present discounted value (PDV) of the bond, at various points in the man’s life, at three different discount rates.

![FIGURE 1. Present Discounted Value (PDV) of $1000 Bond at Different Discount Rates](image)

Notice that if we fix the ultimate payout, then there is a tradeoff between the height of the PDV at any time, and the rate of its growth. In other words, the red line is always higher than the other two lines, but the bond’s value in that trajectory grows the most slowly (at only 2% per year). In contrast, the green line is consistently below the other two lines, yet the bond’s market value grows very quickly here (8% per year).

Even with this simple bond example, we can illustrate a distinction that comes up in the analysis of life insurance: calculating the present value of an asset using either a prospective or a retrospective approach.
In our example above, consider the market value of the bond at age 80. At a discount rate of 2%, Figure 1 tells us that the value is $672.97. There are two (equivalent) ways of arriving at this figure. In the prospective approach, we look at future events and use them to determine the present value. In this simple case, the only cash flow that will occur is a payment of $1000 to the man, which will happen (from his perspective at age 80) in twenty years. If we divide that $1,000 payment by \((1.02)^{20}\), we end up with $672.97. To repeat, this is the prospective approach.

On the other hand, we could reach the same figure by the retrospective approach. The original market value of the bond—what the man would have had to pay for it at auction—was $276.05. That original investment then grew at a 2% compounded annual rate for forty-five years, so its present value is $276.05 times \((1.02)^{45}\), or $672.97.

Thus we see that the prospective and retrospective approaches yield the same current market value, at least if we assume nothing relevant changes during the man’s lifetime regarding the discount rate or the cash flows associated with the bond.

**Baby Step 2: Level Contributions for a Certain Payout**

Now let’s introduce another layer of complexity, inching us closer to our ultimate goal of a whole life insurance policy. In this baby step, the financial institution is still promising to pay the man $1,000 when he reaches age 100. In this scenario, however, he is obligated to make a level stream of annual payments to the company from age 35 onward, in order to remain eligible for the $1,000 payout. We’ll further assume that initially the bond has zero value. So now the question is, what does the level payment need to be, at each of the hypothetical discount rates, in order to make the bond start at $0 at age 35, and end up at $1,000 by age 100?

By playing with an Excel spreadsheet, one can zoom in to find that the level payments are $7.28, $1.98, and 46 cents if we use discount rates of 2%, 5%, and 8%, respectively. Figure 2 shows the trajectories of their market values in this new setting.

![FIGURE 2: End-of-Period Value of $1000 Bond With Various Discount Rates and Implied Level Annual Payments](image)

Here too we can use either the prospective or retrospective method to calculate the market value at any particular age, though the calculations are trickier. The retrospective method is quite intuitive, since the asset in this case behaves just like a savings account with a conventional bank, which is growing at interest while the man continually pumps in more saving each year. For example, using the 5% discount rate, pumping $1.98 in at the beginning of each year to add to the previous year’s end-of-period market value, and then letting the whole sum grow 5% during the current year, will lead to an end-of-period value of $350.96 at age 80.

We can get the same result by forgetting the past, and just focusing on the future (i.e. by using the prospective approach). If the man at the end of his
80th year evaluates the future cash flows, he sees that he will receive $1,000 from the financial institution in 20 years (I assume the payment comes at the end of the year). Thus the benefit is worth $376.89—just as we reckoned in the earlier section, when calculating the PDV of a simple bond.

However, in our new scenario, this number would be overstating the value of the asset. In order to get his hands on that $1,000 payment when he is 100 years of age, the man must continue to make his level $1.98 contributions for the next twenty years, as well. From his vantage point at the end of his 80th year, the present value of that stream of contributions—discounting at 5%—is $25.93. Thus, the net value of the asset is only $376.89 - $25.93 = $350.96. As before, the retrospective and prospective approaches yield the same answer for the current value of the asset.

**Baby Step 3: Introducing the Risk of Death, But With Insurer Overcharging**

Now we’re ready to drop the unrealistic assumption that the man would necessarily live to age 100. To make our lives easier when doing the math, assume (quite unrealistically) that every year, there is a 1% probability the man will die. Thus his mortality risk stays exactly the same, throughout his whole life. Further assume that the asset now promises to pay the man $1,000 either upon death, or at the end of age 100, if he still happens to be alive at that point. As before, the man has to make level contributions to the financial institution, in order to remain eligible for these $1,000 payment possibilities.

At this point, the analysis is going to get more complicated so let’s drop the three different discount rates, and just work with a 5% rate to keep things simple on that score. Now, put yourself in the position of the financial institution—which at this point we might as well start calling “the insurance company.” If the man wants to pay a level premium, what do you charge him to make sure you cover yourself?

We already know from the previous section that if the man would be certain to live to age 100, then the break-even premium (using a 5% discount rate) is $1.98 per year. Essentially, the insurance company takes those $1.98 premiums and invests them in the marketplace earning 5% per year, and accumulates a fund that is exactly equal to $1,000 at the end of the man’s 100th year.

Yet if you the insurer only charged the man $1.98 in the new scenario, you’ll almost certainly lose money on him. Every period, there is a 1% chance that he’ll die. Such an outcome is a double whammy for you, the insurer. For example, if the man dies at age 75, not only do you have to pay the $1,000 twenty-five years earlier—which therefore represents a greater burden to you, since earlier dollars are worth more than later dollars—but you also miss out on twenty-five years’ worth of $1.98 premium payments. How should you, the insurer, deal with this tricky situation?

One way (which gives too high an answer, as we’ll see in a minute) is to have the insurer slap on a pure term insurance premium, in addition to the underlying $1.98 that is necessary to fund the payment at age 100. Every year, there is a 1% probability that the man will die, requiring $1,000 at that time. Thus, the actuarially fair pure term insurance premium each year is $10.

Therefore, you the insurer would certainly be covering yourself (disregarding overhead and other business expenses) on the pure financing of the contractual obligations, by charging the man a total premium of $1.98 + $10.00 = $11.98 each year. This way, if he dies you’re covered by the $10 term payments each year, and even if he survives to 100 then you’ve been collecting $1.98 and investing it on his behalf for sixty-five years. No matter what happens to the man, you will be covered and can pay him. (We are assuming of course that you have a large pool of similar customers, so that by charging each of the $10 per year in pure term premiums, you will have the cash flow to make the death benefit claims to the 1% of the pool who happen to die that year.)

But wait a second. The $11.98 premium is actually too high. You the insurer really only “break even” (again, disregarding other business expenses) on this arrangement if the man lives to 100. If he dies at any earlier point, you the insurer have strictly benefited from the deal, because you get to keep the
accumulating fund that had been earmarked for his possible attainment of age 100.

This fund has the same market value as depicted in the blue line in Figure 2 above. (Remember, each period $10 of the man’s gross premium is used to pay the death benefits of other people in his pool, who happened to die that year. That’s what the term premium is doing, from an actuarial accounting standpoint; that money is already spoken for.) For example, suppose our man dies at age 80. You the insurer can pay his beneficiary the $1,000 out of the $10 term premiums collected from everyone in the pool of customers that year, leaving the $350.96 (which had been accumulating from the $1.98 portion of the premiums since age 35) free and clear. The longer the man lives—and each year, he has a 99% probability of continuing on for another—the larger the fund grows.

So if $1.98 is too low a premium, and $11.98 is too high, how do you the insurer figure out the exact actuarially fair amount to charge the man, for what is now an ordinary whole life insurance policy that completes at age 100?

Baby Step 4: Introducing “Net Amount at Risk” (NAR) Approach

Actuaries have a very elegant solution to this pricing problem. The mistake we made in the previous section was to charge the break-even term premium for the full $1,000 every year. Instead, all you as the insurer need to do is charge the term premium on the current difference between the death benefit and the accumulating fund. In other words, in a given year you should charge the man (a) the $1.98 premium to continue growing the fund that endows at age 100, plus (b) the term premium for a one-year policy that has a death benefit equal to the “net amount at risk” (NAR), which is the difference between $1,000 and the fund’s present market value.

Table 1 below shows these calculations for the beginning and ending years of the man’s potential life, again assuming a 5% discount rate:

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<th>Age</th>
<th>Cash Value Before Mortality Charge (bop)</th>
<th>Net Amount at Risk (bop)</th>
<th>Premium Absorbed By Mortality Expense</th>
<th>Premium “Going Into Cash Value”</th>
<th>Cash Value After Mortality Charge and 5% Credited Interest (eop)</th>
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Table 1: Values at Various Ages Using Net Amount at Risk (NAR) Approach (premium=$11.22, bop=beginning of period, eop=end of period)

Let me offer some commentary to be sure you understand how to read Table 1. At the beginning of the policy at age 35, the man makes his level premium payment of $11.22. At this point, there is...
no fund to offset a death claim, so the entire $1,000 death benefit is “at risk.” Consequently, because there is a 1% chance of death this year, the insurer must devote $10 of the premium payment just to pure term insurance. This leaves only $1.22 available to invest on behalf of this particular client. Since the premium payment is collected upfront, and since cash values grow at 5% annually, by the end of age 35 the $1.22 has grown into $1.28. If the man for some reason decided to surrender the policy at this point, the insurer could hand him $1.28 and break even on the whole deal—again, unrealistically assuming away all of the other real-world expenses involved with issuing insurance policies.

At the beginning of age 36, the man again pays his level premium of $11.22. This time, however, the full $1,000 isn’t at risk—the insurer now has a dinky little fund of $1.28. Consequently, if the man happened to die this year, the insurer would only need a term policy with a face amount of $1,000 - $1.28 = $998.72 to pay the death claim. The actuarially fair premium for this term policy is (1% x $998.72) = $9.99 with rounding, which is one penny lower than the full $10 that was needed at age 35. The extra cent goes into the man’s accumulating fund, which grows at 5% again.

In case it’s not clear, I should explain that I set up an Excel spreadsheet with the above framework, and then simply experimented with the level premium payments until I got the age 100 end-of-period cash value to equal $1,000.00. That’s where the $11.22 level premium came from.

**At Last: Guaranteed Interest Rate vs. Internal Rate of Return**

We can now, at long last, easily see the distinction between the interest rate credited to the cash value of a permanent insurance policy, versus the calculated “internal rate of return” on the gross premiums associated with the policy.

By construction, the cash values in our hypothetical ordinary whole life policy in Table 1, grew at 5% throughout the life of the policyowner. If the man had called the insurer and asked, “How much am I earning on my policy, considered as an investment?” the representative could quite honestly tell him, “We are crediting your assets with a 5% annual growth.”

However, if the man completely disregarded the *insurance* aspect of his policy, and looked at its surrender cash values purely as a mutual fund, then he would be appalled at its performance. With the particular numbers I chose for our example, the calculated internal rate of return (IRR) on this policy is only 0.86% by age 100. In other words, if the man started at age 35 and put $11.22 each year into a savings account, such that his balance were $1,000 by the end of age 100, then the bank would only have to pay him a compounded annual rate of interest of 0.86%.

Since the market rate of interest in our example is 5%, the man would presumably be outraged by this result, *if he totally disregarded the insurance element*. But it would be completely inappropriate to treat his whole life policy as a mere mutual fund, since it is so much more than that. Yes, by making $11.22 annual contributions, the man is assured of a $1,000 payout at age 100—just as he would be assured, doing the same activity, with a bank paying 0.86% on its saving accounts. Yet with the insurance policy, if the man dies just after turning 36, he also gets the full $1,000. In contrast, he will only have $23 with the bank.

**Conclusion**

Although this article was long and heavy on the numbers, I hope it helped some readers to finally grasp exactly what is going on “under the hood” with cash value life insurance policies. Obviously my explanation left out many important real-world considerations, such as expense loading, changing mortality rates, and “adverse selection” based on changing insurability status. Even so, the above progression of scenarios should shed light on how actuaries use discount/interest rates to calculate the current cash value of a policy.

**Notes**

1If things do change, once the man begins moving down the trajectory, then economists would strictly prefer using the prospective approach, because “bygones are bygones” and all that matters right now when evaluating an asset, is
what the owner thinks it will do for him going forward. But so long as nothing important changes along the way, then these correct on-the-spot calculations have already been anticipated beforehand, and so the two approaches give the same answer.

For the purist who might actually try to replicate my results, I should mention that these assets are only worth $0 at the beginning of age 35. I am assuming that the man puts in his level premium payment in the beginning of the year, and so by the end of age 35, the premium payments have grown at the respective interest rates, giving market values of $7.42, $2.08, and 50 cents for the three rates.

The present discounted value stream of contributions looks like this: $1.98 + $1.89 + $1.80 + … + $0.82 + $0.78 = $25.93. Note that the age-81 contribution of $1.98 is not discounted by 5%, because the man reckoning at the end of age 80 is just about to make this particular payment.

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4 Reasons Why Socialism Is Becoming More Popular

by Alexander Zubatov

The newfound openness of large numbers of Americans to socialism is, by now, a well-documented phenomenon. According to a Gallup poll from earlier this year, 43% of Americans now believe that some form of socialism would be a good thing, in contrast to 51% who are still against it. A Harris poll found that four in ten Americans prefer socialism to capitalism. The trend is particular apparent in the young: another Gallup poll showed that as recently as 2010, 68% of people between 18 and 29 approved of capitalism, with only 51% approving of socialism, whereas in 2018, while the percentage among this age group favoring socialism was unchanged at 51%, those in favor of capitalism had dropped precipitously to 45%. The same poll showed that among Democrats, the popularity of socialism now stands at 57%, while capitalism is only at 47%, a marked departure from 2010 when the two were tried at 53%. A YouGov poll from earlier this year showed that unlike older generations, which still preferred capitalist candidates, 70% of millennials and 64% of gen-Zers would vote for a socialist.

The question is why socialism now? At a time when the American economy under Trump seems to be chugging along at a nice clip, why are so many hankering for an alternative? I would suggest four factors contributing to the situation.

Factor #1: Ignorance of History

The first cause of socialism’s popularity, especially among the young, is an obvious one: having grown up at a time after the end of the Cold War, the collapse of Europe’s Eastern Bloc and China’s transition to authoritarian capitalism, “these kids today” — those 18 to 29 year-olds who were born around the last decade of the 20th century — don’t know what socialism is all about. When they think socialism, they don’t think Stalin; they think Scandinavia.

Americans’ — and especially young Americans’ — ignorance of history is well-documented and profound. As of 2018, only one in three Americans could pass a basic citizenship test, and of test-takers under the age of 45, that number dropped to 19%. That included such lowlights as having no clue why American colonists fought the British and believing that Dwight Eisenhower led the troops during the Civil War. Speaking of the war during which he actually led the troops, many millennials don’t know much about that one either. They don’t know what Auschwitz was (66% of millennials in particular could not identify it). Twenty-two percent of them had not heard of the Holocaust itself. The Battle of the Bulge? Forget it. Go back further in time, and the cluelessness just keeps deepening.

Only 29% of seniors at U.S. News and World Report’s top 50 colleges in America — the precise demographic that purports to speak with authority about America’s alleged history of white supremacy — have any idea what Reconstruction was all about. Only 23% know who wrote the Constitution. So
much for any notion that this is the most educated generation ever.

Closer to the theme — socialism — the same compilation of survey results includes the attribution of The Communist Manifesto’s “from each according to his ability; to each according to his needs” to Thomas Paine, George Washington or Barrack Obama. Moreover, among college-aged Americans, though support for socialism is pretty high, when these same young adults are asked about their support for the actual definition of socialism — a government-managed economy — 72% turn out to be for a free-market economy and only 49% for the government-managed alternative (yes, it looks from those numbers like there are a lot of confused kids who are in favor of both of the mutually exclusive alternatives). As compared to about a third of Americans over 30, only 16% of millennials were able to define socialism, according to a 2010 CBS/New York Times poll. And though I haven’t seen polling on this, I’d be willing to bet that a good bunch of these same students, if asked to say what the Soviet Union was, would have no clue or peg it as some sort of vanquished competitor of Western Union.

Compounding the problem still further is that the history that students are being taught increasingly falls into the category of “woke” history, America’s history of oppression as imagined by the influential revisionist socialist historian Howard Zinn. When socialists are writing our history books, the end result is preordained.

Given such ignorance and systematic distortion of history, is it any surprise that millennials who never lived through very much of the 20th century don’t think socialism is all that bad?

**Factor #2: Government Bungling**

When we try to explain the socialist urge, we cannot lose sight of the fact that our government keeps interfering in the economy in ways that give people every reason to think the system is corrupt and needs to be trashed.

Take the skyrocketing cost of college, for instance. On the surface, this looks like greedy capitalist universities just keep on raising tuition, and since most college kids and their parents can’t pay the sticker price, almost 70% take out loans, saddling young people trying to start their careers with a mountain of debt (almost $30,000 on average). This results in all those socialist promises of free college or loan forgiveness sounding dandy. Underneath the surface, however, a huge part of the problem is federal grants and subsidized loans. If the government stopped footing a large part of their bill, more students and parents would be forced to pony up, which would mean, in turn, that colleges would not be able to keep hiking their prices without seeing a precipitous drop in enrollment. They would, instead, be forced to price themselves at some level that applicants could realistically pay, making college more affordable for a large segment of the American middle class.

Another simple example of the problem is Obama’s Emergency Economy Stabilization Act of 2008, colloquially known as the big bank “Bailout.” When kids grow up seeing government tossing out free lifelines to businesses that get themselves in dire straits, cause a massive financial crisis and, in the process, lose ordinary folks lots of jobs and homes, we can’t blame them for concluding that the system is rigged.

There are many more examples where these came from — our government frittering away trillions on foreign wars that increase instability throughout the world and end up costing us even more as we scramble to clean up our own messes is one expenditure that comes readily to mind — but the point is this: the more the government interferes in the economy to help out vested interests, the more reason many of us will see to ask government to interfere in the economy to help out the rest of us. The more reason we give anyone to think that capitalism means crony capitalism, the more they’ll clamor for socialism.

**Factor #3: Universities’ Ideological Monoculture**
The supporters of socialism are not simply the young, but rather, disproportionately those among the young who are college-educated. And the more college they have, the hotter for socialism they get. According to a 2015 poll, support for socialism grows from 48% among those with a high school diploma or less to 62% among college graduates to 78% among those with post-graduate degrees. Those on the left probably stop thinking hard about now and jump immediately to the conclusion that support for socialism is just a natural outgrowth of big brains and elite educations. But there is, in fact, a less obvious but ultimately far more compelling explanation that also manages to account for the general fact that more education correlates with more leftism: something — something bad — is happening at universities themselves to pull students toward the (far) left.

We have already seen above that what’s not happening at universities, even elite universities, today is a whole lot of education in important subjects like history. What we are getting instead is a lot of groupthink and indoctrination. Universities have always skewed a bit left. But beginning in the early to mid 1990s (for reasons I’ve explained in some detail elsewhere), ideological diversity began to vanish entirely, as the leftward deviation turned tidal. As documented in a 2005 paper from Stanley Rothman et al., as of 1984, 39% of university faculty were left/liberal, and 34% were right/conservative. By 1999, those numbers had undergone a seismic shift: faculty was now 72% left/liberal and 15% right/conservative. Since 1999, the imbalance has become starker still. A comprehensive National Association of Scholars report from April 2018 from Prof. Mitchell Langbert of Brooklyn College, tracking the political registrations of 8,688 tenure-track, Ph.D.-holding professors from 51 of U.S. News & World Report’s 66 top-ranked liberal arts colleges for 2017, found that “78.2 percent of the academic departments in [his] sample have either zero Republicans, or so few as to make no difference.” Predictably, given the composition of the professoriate, survey data also indicates that students’ political views drift further leftward between freshman and senior year.

In light of this data, it should not be a surprise to us that students who have gone to college in this age of ideological extremism have come out radicalized and … socialized.

**Factor #4: Coddled Kids**

The young have always been more inclined to embrace pipe dreams — a lack of familiarity with the complicated way in which the world actually works, coupled with the college fix described above, will do that to most anyone — but there is a reason the mindset of today’s young’uns is particularly susceptible to the red menace. In last year’s The Coddling of the American Mind, the prominent social psychologist Jonathan Haidt and FIRE’s Greg Lukianoff describe the species of overprotective parenting and instilling of baseless and uncritical self-esteem by parents and educators alike that came to prevail as kids were growing up in the 90s and 00s. When we are raised in the belief we are wonderful just as we are, we never learn the critical life skills of self-soothing, working through anxiety, facing obstacles and overcoming adversity. The predictable result, as Haidt and Lukianoff observe, is a demand to be safeguarded — safe spaces, free speech crackdowns and so on. The state appears to many as the appropriate institution to provide this sort of “safety.”

If these four are the primary causes of socialism’s rapid surge in our midst, then the next logical question is what to do about it. There is no easy answer, of course, but I would suggest that the radicalization of academia is the lynchpin issue. If we could succeed in reversing that tsunami, many dominoes would fall: we would be addressing the university monoculture that systematically distorts research, sends students veering hard left and graduates generations of left-orthodox clones who find their way into journalism, government, education, entertainment and other influential sectors driving public opinion and shaping the other three downstream issues factoring into socialism’s rise: government policy, educational philosophy and
Hardly. The “common property” approach killed off about half the settlers. Governor Bradford recorded in his diary that everybody was happy to claim their equal share of production, but production only shrunk. Slackers showed up late for work in the fields, and the hard workers resented it. It’s called “human nature.”

The disincentives of the socialist scheme bred impoverishment and conflict until, facing starvation and extinction, Bradford altered the system. He divided common property into private plots, and the new owners could produce what they wanted and then keep or trade it freely.

Communal socialist failure was transformed into private property/capitalist success, something that’s happened so often historically it’s almost monotonous. The “people over profits” mentality produced fewer people until profit—earned as a result of one’s care for his own property and his desire for improvement—saved the people.

Socialism Destroys

Over the centuries, socialism has crash-landed into lamentable bits and pieces too many times to keep count—no matter what shade of it you pick: central planning, welfare statism, or government ownership of the means of production. Then some measure of free markets and private property turned the wreckage into progress. I know of no instance in history when the reverse was true—that is, when free markets and private property produced a disaster that was cured by socialism. None.

A few of the many examples that echo the Pilgrims’ experience include Germany after World War II, Hong Kong after Japanese occupation, New Zealand in the 1980s, Scandinavia in recent decades, and even Lenin’s New Economic Policy of the 1920s.

Two hundred years after the Pilgrims, the Scottish cotton magnate Robert Owen thought he’d give socialism another spin, this time in New Harmony, Indiana. There he established a community he hoped would transcend such “evils” as individualism and self-interest. Everybody would be economically
equal in an altruistic, fairy-tale society. It collapsed utterly within just two years, just like all the other “Owenite” communes it briefly inspired. Fortunately, because Owen didn’t have guns and armies to glue it together, people just walked away from New Harmony in disgust. They learned from socialism, even if today’s socialists don’t. You can read all about it in this splendid 1976 article by Melvin D. Barger, “Robert Owen: The Wooly Minded Cotton Spinner.”

Socialism flops even when it’s the “pretend” or “voluntary” variety. Imagine the odds against it succeeding when it’s compulsory! The use of force prolongs the agony but doesn’t breed any less bitterness, resentment, or decline. It magnifies the calamity, in fact.

**Be Thankful for the Profit Motive**

Consider this as you feast at the Thanksgiving table this week: The people who raised the turkey didn’t do so because they wanted to help you out. The others who grew the cranberries and the yams didn’t go to the trouble and expense out of some altruistic impulse or because of some nebulous “sharing” fantasy.

Sacrificial rituals, even if they make you feel good, rarely bake a bigger pie. Charity is laudable, and I engage in it, too, but it’s not an engine of production or prosperity. For that, you need profit, incentive, and private property.

In North Korea and Venezuela, socialist regimes work to see that almost nobody makes a profit or owns a private business. There won’t be anything like widespread Thanksgiving dinners in either country this week, and that’s no coincidence. I wonder if that lesson is still taught in schools these days; polls that suggest young people are attracted to socialism suggest maybe it isn’t.

I’ll be offering gratitude for more than just good food on Thanksgiving Day. I’m going to give a prayerful thanks for private property and the profit motive that has made abundance possible. When God instilled a measure of peaceful, productive self-interest into the human mind, he knew what he was doing.

For additional information, see:

- The XYZs of Socialism
- "How Venezuelans Can Recover from the Sickness of Socialism"
- "Five Ideas at the Heart of Socialism"
- "Where are the Omelets?"

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**Why the Brightest Future Depends on Market Chaos**

by Maciek Chwalowski

Recently, a colleague disparaged my “reliance on markets” over his activist preference to use the government and its tax power to impose changes to technology and society. He berated me for believing that professionals should be at the forefront of changes that make lives better for fellow citizens. He derisively repeated the joke, how many conservatives does it take to change a light bulb? None, a free market will take care of it shortly.

**Market Chaos**

Here is a little thought experiment to support my views: Imagine a hot July day in 1900. You are standing on a street corner in Manhattan looking at horse manure-covered streets while flies are buzzing around your head and spreading various diseases. You are 60 years old, and you were born in 1840 in Western Europe to a father who was born in 1810. All your life, you lived in pre-modern, agrarian, and feudal societies. The technologies that surround you are primitive. The question is: What would have been the smartest and fastest way to get the society from 1900 to 2020 levels? Activists like my...
colleague using tax dollars or the unplanned chaos of self-interested tinkerers and dreamers in the marketplace?

Consider how hard it would have been in 1900 to decide on the best future technologies and trajectories to get there. Back then, 4,192 cars were accounted for in the United States, 40 percent of which were steam-propelled. Air conditioning would be invented two years later by Willis Carrier. The first controlled little puddle jump flight was three years out. A tractor would be invented in 1904. Penicillin would happen in 1928. Something as simple as a shipping container would wait until 1956. The structure of atoms and DNA were still mysteries. There would be many decades until widespread water fluoridation. It would take the imaginations of many insightful people to build the future.

Fast-forward to 2020, and let’s repeat the same exercise. You are standing on a street corner in Manhattan with your smartphone and watching Uber and Amazon delivery trucks. You just checked on your house because someone knocked on your door. A few minutes earlier, you spoke with your daughter who is studying in Europe, and so on; we can continue listing our civilization’s conveniences. If the trend continues, and at a vastly accelerated pace, another 120 years out, in 2140, our descendants will be living stepped-up lives much different than the distance between 1900 and 2020. The same question stands: “what is the smartest and fastest way between 2020 and 2140 amazing future?”

When comparing 1900 to 2020, we recognize the enormity of revolutionary and transformative changes to everything around us that has gotten us here. For example, the heart treatments, kidney transplants, smartphones, modern airplanes, and inexhaustible entertainment options that are common today required numerous inventions over many decades to eventually enable today’s products and services. These inventions happened mostly by happenstance and a great deal of imagination—not as a result of conscious planning. It would have been a fantasy for someone in 1900 to draw a plan for the smartphone market release in 2007 and decide what should have been done in each decade between then and now and by whom to come up with a smartphone.

The Effects of Economic Freedom

Still not sure? Thirty years after the collapse of the Berlin Wall, East and West Germany are still different. They are the same people, but the West has been much richer and better off due to economic freedoms.

Even technology predictions about short-term events are rarely accurate. Just ask people who recently shorted the Tesla stock waiting for it to collapse because they doubted the technology readiness. In late October, they must have felt silly when Tesla stock price shot up from $254 to $328 per share. Why do we expect an activist or a government planner to be more successful than people betting their own money?

The problem with my colleague is that he does not recognize how technologically primitive our world will be to those in 2140. He does not have skin in the game. He is not investing his money and does not consider trade-offs and alternatives. His blind spot is that while the single-technology focus may accelerate it, it is impossible to correctly optimize the economy with thousands of products and services over even a few years.

Notice how many economic activities, investments, and trials happen out there. These are people who use their resources or for which they are responsible to investors at their risk. Some win, some fail—but they all learn. However, it is unacceptable when the government taxes us and unspecialized activists with no accountability decide which technologies should be funded. These people waste money on rear-view mirror ideas instead of building the future. They have good intentions and itch to do “something,” but they destroy wealth.

In 2020, as was the case in 1900, there will be no virtual signposts for technologies to focus on, but there will be thousands of haphazard and necessary
John Adams on the Purpose of Government
by Gary M. Galles

John Adams, who has become “virtually an asterisk in history books today,” in one writer’s words, is inadequately celebrated. He played a leading role in our revolution and the beginnings of constitutional government. He wrote a Stamp Act protest that became a model for other protests. He outlined principles of liberty for Americans on the cusp of independence.

He helped write the resolutions of May 10, 1776, declaring America independent, and defended the Declaration of Independence before Congress. He composed most of the Massachusetts Constitution (the oldest still in use in the world), acclaimed for its bill of rights. His A Defense of the Constitutions of Government of the United States was often cited in the Constitutional Convention.

John Adams’s Advocacy

Given Adams’s importance in establishing our country on the basis of liberty, we should remember his advocacy of the rights, or property, that is the content of our liberty and whose defense is the central reason our government was instituted.

- "Liberties are not the grants of princes and parliaments."
- "[People have] rights...antecedent to all earthly governments—rights that cannot be repealed or restrained by human laws."
- "Each individual of the society has a right to be protected...in the enjoyment of his life, liberty, and property...no part of the property of any individual can, with justice, be taken from him, or applied to public uses, without his own consent."
- "In a free state, every man...ought to be his own governor."
- "To be commanded we do not consent." "Liberty is [government’s] end."
- "In order to have this liberty, it is requisite the government be so constituted...that one citizen need not be afraid of another citizen."
- "Property must be secured, or liberty cannot exist."
- "The end of...government is...the power of enjoying, in safety and tranquility, [individuals’] natural rights and the blessings of life."
- "[Government]...should be...for the preservation of internal peace, virtue, and good order, as well as the defense of their lives, liberties, and properties."
- "The moment the idea is admitted into society that property is not as sacred as the laws of God, and that there is not a force of law and public justice to protect it, anarchy and tyranny commence. If 'Thou shalt not covet' and 'Thou shalt not steal' were not commandments of heaven, they must be made inviolable precepts in every society before it can be civilized or made free."
- "Nip the shoots of arbitrary power in the bud is the only maxim which can ever preserve the liberties of any people."
- "Trust no man living with power to endanger the
"Liberty must at all hazards be supported." A free constitution of civil government cannot be purchased at too dear a rate, as there is nothing on this side of Jerusalem of equal importance to mankind."

"Be not…wheedled out of your liberty by…hypocrisy, chicanery, and cowardice."

John Adams, because he recognized “an enemy to liberty [as] an enemy to human nature” and that “nothing is so terrible as the loss of their liberties,” wrote that “It has ever been my hobby-horse to see rising in America an empire of liberty.”

A Monumental Debate

Reflecting the central importance of liberty, Adams called the debate over the Declaration of Independence “the greatest question…which ever was debated in America.” Thomas Jefferson described his defense as having “a power of thought and expression that moved us from our seats.”

Delegate Richard Stockton called him “the man to whom the country is most indebted…who…by the force of his reasoning demonstrated not only the justice, but the expediency of the measure.”

Adams also saw the importance of America’s revolution for the world:

Objects of the most stupendous magnitude and measure in which the lives and liberties of millions yet unborn are intimately interested, are now before us. We are in the very midst of a revolution the most complete, unexpected and remarkable of any in the history of nations.

And he made it clear why founding America on liberty was monumental: “Her cause is that of all nations and all men, and it needs nothing but to be explained and approved.” At a time when we often forget that liberty is both America’s rationale and its greatness, Americans would profit from Adams’s wisdom.

Gary M. Galles is a professor of economics at Pepperdine University. His recent books include Faulty Premises, Faulty Policies (2014) and Apostle of Peace (2013). He is a member of the FEE Faculty Network.

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Intellectual Property as the New Guild System

by Frank Hollenbeck

The standard justification for intellectual property — i.e., patents and copyrights and trademarks — is that the creative process would be significantly reduced if such protection did not exist. The underlying assumption is that the financial reward must be augmented by a grant of exclusivity enforced by the coercive power of government. Because we can freely copy an invention, innovation or other creative ideas, a financial reward is viewed as necessary for these intangible ideas unlike a tangible object sold in the marketplace.

But did inventors or artists starve before IP laws? The answer is no because they benefited from the first-to-market advantage. Boldrin and Levine explain how during the 19th century British authors with IP protection in the UK would sometimes make more money off their non-IP protected US sales by reaching an agreement (a contract) with a US publisher and then flooding the US market with cheap original copies.1 Since any potential copycat will wait to see if an idea is successful, the gains of being first-to-market could be substantial. Many drug makers retain important market share on a drug even though their patent protection has expired and the market is awash with cheaper generic alternatives. There are also many other indirect ways to profit from creative ideas. Many artists make more money off concerts and other appearances than from the original digital sales of their song.

Also, many other factors besides money enter the creative process, such as freedom of expression, enjoyment, reputation, and autonomy. Vincent Van Gogh created over 900 paintings but sold only one. While examining classical music of the eighteenth and nineteenth centuries, F. M. Scherer found that the imposition of IP protection had an indeterminate
impact on creativity. Although Bitcoin has been in existence for over ten years; its anonymous creator has yet to sell a single bitcoin or profit from his invention.2

We could provide a long list of historical examples3, but they would add little to our discussion. Since we cannot run a scientific experiment for a complex phenomenon such as inventions and innovations, it is impossible to distinguish between causation and association.4 In a recent study of 7198 important scientific events (innovations), Jonathan Huebner found they peaked in the 19th century and then rapidly declined.5 This drop-off could be due to IP laws or a multitude of other factors that affect innovations. It is even possible that without IP laws the drop-off could have been even more severe. Without the ability to run a scientific experiment on complex phenomena, we cannot determine causal links from historical or empirical evidence.

Yet, there is a reason that many past inventions like the electric motor, the sewing machine, photography, light bulb, telephone, or the airplane (flying machine) were discovered simultaneously by different people,6 often in different countries. The foundation of any great idea is built on an accumulation of ideas from other times and places. The airplane would not have been possible without the engine or the propeller. Leonardo Da Vinci had already drawn a prototype of the common airplane in the 15th century using a simple observation of the aerodynamics of birds in flight. Had lighter engines and propellers been available to him, he would probably have created the first functional airplane. The Wright brothers happened to be in the right place at the right time. Their 1906 patent was for a “flying machine” and the ensuing patent war greatly retarded aviation in the USA. So, was it justified to grant them a monopoly on all flying machines? What if other flying machines like the helicopters and drones had been created around the same time? WWI may have been lost if Germany had perfected these flying machines while US lawyers battled over ownership rights. The problem is that many times IP laws reward the entire idea and not just the value added by an inventor, author or songwriter.

If we reflect a moment, the intuitive logic behind IP laws is naïve. The purpose is to slow down the diffusion of new ideas in the hope that there will be more new ideas to diffuse later. It is to create a monopoly, hoping it will ultimately gently fade into the competitive woodwork. As expected, industries protected by IP laws have become more and more concentrated making it virtually impossible for individuals or small companies to incur the costs of both acquiring and defending a patent. Instead of being creative, these large oligopolistic firms have been using IP laws to limit any competition that might come from any tangential idea that is a little cheaper or better quality or to defend the status quo not to endanger royalties from existing patents or copyrights.

Creating Monopolies

The more things change the more they remain the same. The European guild system was created to ensure the status quo. Entry into a profession was strictly limited and monopoly privileges were given to a small minority who lived luxuriously while the bulk of the population lived in abject poverty. The goal was to strictly limit competition by using the coercive power of the king or government. How is our current economic system any different? Our living standards are higher, but IP laws have now created monopoly privileges for a different minority in practically all areas of business. This loss of general competitiveness is a direct result of the current trend to protect any and every idea.

The best evidence that intellectual property laws are counterproductive is the phenomenal growth of open source software which can be freely examined, modified and enhanced. Here programmers voluntarily relinquish intellectual monopoly rights to operate under conditions of free competition. The profits from being first to market are enough to induce programmers to voluntarily surrender future monopoly profits. A great deal of the websites or data you find on the internet was created or built
using open-sourced software. Another example is the widespread existence of patent pools, where private companies, generally within the same industry, share patents at no cost. A patent pool of all existing companies would be a world without patent protection. Patent pools reflect a market response to the constraints IP laws impose on the synthesis of ideas.7

**Extending IP Protections to Even Longer Time Horizons**

Even if one strongly believes that IP laws are essential for creativity, it is difficult to justify the expansion of IP protections that have taken place in recent decades. In fact, the length of time for protection should have been significantly reduced as markets expanded, increasing the profitability of first-to-market. The first IP law in the USA was the patent act of 1790 and was limited to workmen or artisans and was for 14 years. This is closer to what was intended in Article I, Section 8 of the Constitution, which provides, among other powers, “To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.”

The world population in 1790 was under 1 billion people. The potential market for an application or expression of an idea was limited to a small fraction of this population because of illiteracy rates, low living standards, language barriers, and a host of other factors. Today, the population is more than 7.7 billion. Advances in telecommunication, education, standards of living and cost of transportation have made the potential market for IP ideas a much larger percentage of the population; possibly a thousand times larger than in 1790. Of course, on the flip side, we have also seen improvements in re-engineering and copying technologies. The growth in market size for IP products should have led to a significant reduction in this initial 14-year protection period. But today, patent protection lasts 20 years.

Copyright protections last much longer. The Sonny Bono Copyright Term extension act of 1998 pushed copyright protection to the life of the author plus 70 years, or 95 years for work produced a corporate "author." This was an increase from life-plus-50-years for authors or 75 years for corporate authorship. The bill also allowed copyright protection to be imposed retroactively, covering many of Disney’s classic characters and films that were initially taken from the public pool: so much for quietly fading into the competitive woodwork.

What are possible solutions? One option is that intellectual property, as some early common laws on copyrights, is lost once it is released to the public. Another is greater use of contract law to replace IP laws. This is the more free-market solution since both parties to the contract are making voluntary choices. At the very least, the length of time for protection should be significantly reduced with no possibility for extensions. Let the market find a solution for drugs requiring large upfront investments in time and money. Just because it is hard to imagine a market solution, does not mean one does not exist.

3. There are books and articles, including Boldrin and Levine (2008), that cite historical evidence in support of, or against, IP protection. In general, the empirical results are mixed on the impact of IP laws on creativity.
4. A good discussion of the constraints of complex phenomena is Hayek’s Nobel lecture, “the Pretense of Knowledge.”
6. William F. Ogburn, Dorothy Thomas, "Are Inventions Inevitable? A Note on Social Evolution," Political Science Quarterly. Vol. 37, No. 1 (Mar., 1922), Ogburn and Thomas identified 148 major inventions and discoveries that were discovered simultaneously by two or more inventors.
7. The information in this paragraph is from Boldrin and Levine (2008). They point out that patent pools also reduce competition since they are essentially clubs with restricted club membership.

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Eighth in a monthly series of Nelson Nash’s personally written Becoming Your Own Banker lessons. We will continue these lessons until we have gone through the entire book.

PART 1 Lesson 8: The Problem (continued)

Content: Page 18, Becoming Your Own Banker Fifth Edition

There is an analogy from the airplane world that helps us to see the absurdity of what we saw in lesson 7 of how the average American handles his money.

I’ve been a pilot for over 56 years, and it was obvious to me from the start that you can’t fly an airplane through a vacuum. It must go through an environment.

You have seen the weather maps with the “highs” and “lows” on it. The best flying weather is in the “highs.” Bad weather is associated with the “lows.” In the northern hemisphere the “highs” turn clockwise, and they will move from west to east over the face of the earth.

Now, imagine this – there is a gigantic “high” that covers almost all of North America and the center is right over the middle of the country. You are located in Birmingham, AL, you have an airplane that will fly 100 miles per hour, and you want to fly to Chicago. The problem is that you have a headwind of 345 miles per hour! (notice the 3.45 to 1 ratio that we had in lesson 7). Guess which direction the airplane is moving! Right! Towards Miami at 245 miles per hour! Fantastic! This is a dramatic improvement over the first two situations. But, you see, it is much more dramatic than what most folks think.

Everything you do in the financial world is compared with what everyone else is doing. In America, most folks are doing the equivalent of flying with a 345 mile per hour headwind. Isn’t it obvious, if you have a 345 mile per hour tailwind, that the difference between you and them is 690 miles per hour? In all three examples the capability of the airplane is the same -- 100 miles per hour.

Translate this example into the financial world and it is pretty obvious what is really going on. Many financial gurus are concentrating on encouraging people to “get out of debt” and that is a wonderful thing to do. In our airplane analogy that is the equivalent of flying with no headwind. But, I have yet to hear one of these folks recognize that the most profitable thing one can do is to create the perpetual “tailwind” to everything that you do financially. It seems that this thought never registers in their consciousness.

But most financial gurus spend all their time “trying to make the airplane fly at 105 miles per hour” or something like that! Controlling the environment in which the airplane flies is far more effective.

You can’t do anything about the environment in the airplane world, but you can do it in the financial world. It must be done by creating a banking system that serves all your financial needs.

www.infinitebanking.org david@infinitebanking.org
This course is about how to create a perpetual tailwind to your financial world that will, eventually, serve everything you do. You can’t do it without getting in the banking business. In the next lesson we will see what it is like to get in that business.

Pleasant dreams! Use your imagination. It can be a wonderful world for you!

The following financial professionals joined or renewed their membership to our Authorized Infinite Banking Concepts Practitioners team this month:

- John Montoya - Dublin, California
- Sonda Frattini - Charlotte, North Carolina
- John Blalock - Birmingham, Alabama
- John Urbik - Gilbert, Arizona
- Kyle Fuller - Mesa, Arizona
- Harper Jones - Knoxville, Tennessee
- Patrick Eddins - St. Louis, Missouri

You can view the entire practitioner listing on our website using the Practitioner Finder.

IBC Practitioner’s have completed the IBC Practitioner’s Program and have passed the program exam to ensure that they possess a solid foundation in the theory and implementation of IBC, as well as an understanding of Austrian economics and its unique insights into our monetary and banking institutions. The IBC Practitioner has a broad base of knowledge to ensure a minimal level of competency in all of the areas a financial professional needs, in order to adequately discuss IBC with his or her clients.

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