

## Fiat Currencies

# Is Legal Tender the Problem?

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While most of us have heard the mention of 'legal tender', few probably have contemplated the meaning of it. It should hence come as no surprise that few seem to be aware of what not only legal tender means today but also what it used to mean. Consequently, you can also hear people saying that legal tender is the essence of the problem with fiat currencies. But is that really the case? Let's have a closer look at this question.

### What is Legal Tender?

Nowadays, in all places of the world, legal tender laws exist. According to my Oxford Dictionary of English, legal tender means 'coins or banknotes that must be accepted if offered in payment of a debt.' Thus, if a debt is denominated in US dollars, the creditor must accept US dollars as payment, if denominated in RMB the creditor must accept RMB, if a debt is denominated in the Swedish Krona the creditor must accept this Krona, and so on.

The words 'legal tender' indicates etymologically very little about the origin, but if we look at some Germanic languages we find a clue. In German it's called 'gesetzliches Zahlungsmittel' and in Swedish 'lagligt betalningsmedel', having the exact same meaning in the two languages. The first words simply mean 'legal' while the latter means 'means of payment'. So a clearer wording for 'legal tender' could be 'legal means of payment'.

But there's more to it than that. In her 1903 *Legal Tender, a Study in English and American Monetary History*, Sophonisba Preston Breckinridge made the following comment:

The idea of legal tender is a legal idea. It must be defined in legal terms. A definition which may be quoted is to the effect that "money is a legal tender when it may be used in payment of a debt." And it is from a plea in defense to the action of debt that the word "tender" comes. The law of tender is thus a portion of the law of contract, of the private law controlling the relation between individuals in their private capacity.

So there might be some importance to the words 'tender' after all. According to my Oxford Dictionary of English, a 'plea of tender' is 'a plea that the defendant has always been ready to satisfy the plaintiff's claim and now brings the sum into court'. In this way legal tender is simply a legal means of payment of a debt. But in what way is 'legal' defined? Breckinridge continues:

This law has, however, a close connection with the public law, in that the action of debt and plea of tender relate to the payment of money; and the authority to determine what was good and lawful money, which might be used in satisfaction of such obligation, was

a sovereign power, belonging to that group of powers which, in the terms of English constitutional law, constituted the prerogative of the Crown.

In other words, the king or government decided what lawful money was and thus also implicitly what was legal tender. Breckinridge also pointed out that:

[T]he quality of being a "tender in payment of debts" inhered in all lawful money. "Currency," being "current coin," meant coin or money which was full legal tender unless the contrary was expressed. If the coin was not to be an unlimited legal tender, current in respect to all transactions, whatever the amount involved, and to all persons, the limitation was clearly stated.

Hence, not all coins were legal tender, i.e. not all kinds of means of payment were legal tender, only the coins declared legal tender. This means that you could settle debt in other means of payment than the legal tender. It was a right of the law of contract between private persons and of no interest to the king or government. So why did the king or government bother at all?

One explanation could be that people had to settle their tax debt to the king or government. Historically, the tax payers might have wanted to pay in plain goods and often did. Still, there was a need to regulate how this debt was to be paid, what would be acceptable means of payment. Unlike private debt, where wealth is lent and repaid, this kind of tax debt was to a large extent a rather one-sided claim to property, i.e. wealth was transferred only in one direction. This means that it would be no natural means of settling the debt, as opposed to when you for example borrow a barrel of seed it seems quite natural to hand back a barrel of seed. So in order to avoid the tax payers to show up with this and that for tax payments, the king or government could simply declare that only some things were legal tender. Thus, not only coins but also other valuable things could from time-to-time be legal tender, and for example hemp, postage stamps and grains have all been legal tender. Later on in history, paper notes issued by the king or government were also legal tender, redeemable in legal tender coins.

Insofar as the king or government was involved in settling legal disputes, it might have been natural for such a court to declare that the legal tender should be used for settlement of debt. In this way legal tender might have had an impact also on private contracts.

However, it seems that originally, legal tender didn't imply that everyone had to accept it; only in relation to the king or government did you have to use the official coins and notes. There were definitely often other means of payment around for settlement of debt, but these were just not accepted for settlement of tax debt to the king or government.

Interestingly, Hayek noted in his *Denationalization of Money*<sup>ii</sup> that:

In its strictly legal meaning, 'legal tender' signifies no more than a kind of money a creditor cannot refuse in discharge of a debt due to him in the money issued by government.

Thus, if a private contract in the US is denominated in US dollars than the US dollar is legal tender. Thus, we shouldn't forget that even today you can sign private contracts that say that other means of payment should be used for settlement of debt. So maybe legal tender laws aren't of that great importance after all?

## An Historical Example

Many countries have gone from legal tender laws, precious metal standards, free issuing of redeemable bank notes to the monopolized legal tender fiat currencies of modern central banks. We could illustrate how this happened by the Swedish coin act of 1873<sup>iii</sup>. By it the previous silver standard was replaced by a gold standard in Sweden and it might serve well as an example of what legal tender laws looked like at that time:

§1 states that gold alone is the unit-of-account

§2 states that the weight for measurement is the French gram

§3 states that the currency is called 'krona' and that it's divided into 100 'öre'

§4 states that two gold coins should be struck, one at 20 kronor and one at 10 kronor. Out of 1 kilogram, 248 pieces of 10-kronor coins or 124 pieces of 20-kronor coins are struck. The coins come at 90% gold and 10% copper (weight %).

§5-7 states that the arbitration coins are of silver and copper and stipulate the denominations, alloys and weight.

§8 states that the discrepancy of the metal content cannot exceed 1.5 and 2 per mille for the 20- and 10-kronor coins, respectively, and somewhat higher for other coins. For every ten kilograms of new gold coins the discrepancy cannot exceed 0.5 per mille.

§9 states that anyone taking gold to the official mint can get new coins struck at a cost of ¼ per cent for the 20-kronor coin and 1/3 per cent for the 10-kronor coin.

§10 states that the official mint isn't open for anyone when it comes to the arbitration coins.

§11 states that the king will provide the details for the design etc of the coins.

§12 states that the gold coins are legal tender in relation to anyone and any amount. Some restrictions are in place for the arbitration coins.

§13 states that coins that have been damaged by accident or deliberately aren't legal tender

§14 states that gold coins that have been worn down and lost up to 2 per cent in weight still would be legal tender towards the king, while towards other only up to 0.5 per cent is allowed. For silver coins, additional wear is accepted.

§15 states that coins that have lost more than 4 per cent in wear and tear cannot be put back into circulation by the government.

§16 states that anyone can exchange used coins for newly struck coins or exchange for other coins at the Riksbank offices.

§17 states some relation to Danish coins (Norway and Sweden were in a currency union and Denmark joined a couple of years later).

In a brief appended law that stipulates how the transition from the previous silver standard should happen, it's clearly stated that the Riksbank's earlier mainly silver coins as well as silver-backed notes continue to be legal tender for debt denominated in the new gold standard.

The Riksbank was at this time very far away from being a central bank; it was rather the king's or perhaps the government's bank. One important thing in the transition into a central bank was later added when in 1897 a law was put in place giving the Riksbank a monopoly on note issuing, such that after a transition period, in 1904 the Riksbank notes were not only legal tender but also monopolized.

Later, as WWI had started, the gold redemption was temporarily suspended (May 18, 1915 - Feb 4 1916), and it was also the case after the war (Mar 18, 1920 – Mar 31, 1924). Since Sept 28, 1931, the gold redemption by the Riksbank has in practice been suspended and the Swedish krona has since been a pure legal tender fiat currency.

The story is pretty much the same for most major currencies, albeit with different dates and details.

## Legal Tender vis-à-vis Fiat Currency

If we summarize such a legal tender law, we have the following key characteristics:

1. A single unit-of-account (or sometimes two, called bimetallism)
2. Regulating the mint; (i) for each coin type, the mint has to follow a (a) fixed weight of metal and a (b) fixed fineness, (ii) the mint was open to anyone and a small premium was paid to cover the cost of coinage, (iii) the allowed discrepancies for the mint were specified for all coins, stricter the higher the value of the coins and the discrepancy was in the order of a few per mille for individual coins but less on volume, (iv) damaged coins aren't legal tender, (v) wear and tear is accepted up to a certain level by the government but to a less degree by the public, in the order of single per cents, and more worn coins cannot be put into circulation by the government, and (vi) worn down coins can at any time be exchanged for newly struck coins of the same or other kinds.
3. The government issued notes, redeemable in coins, are also legal tender, as opposed to privately issued notes

But we have to add two ingredients before we have the monopolized legal tender fiat currencies of today:

4. Giving legal monopoly on note issuing to a newly established central bank or existing government bank
5. Making notes irredeemable

## The Monopolies

Some believe that the monopolized legal tender fiat currencies of today are a serious problem, to put it mildly, and I agree on that. There are several monopolies involved:

1. One single unit-of-account
2. The mint has a monopoly on coinage
3. The mint is open only to the monopolist

## 4. Legal tender

## 5. The monopoly on note issuing

The first is of minor concern, since in practice you can use whatever you want as unit-of-account, except when it comes to filing the tax report. Granted, as the amount of taxes expands the official unit-of-account gains importance, so that nowadays few bother even consider using another unit-of-account, even if they actually can. When it comes to the second, the monopoly of the mint, there's really no real reason for it, although also the minting is open for contractors today in many countries. If we jump to the fourth, it is in a way of importance, but in practice you could stipulate other means of payment by contract, i.e. you can say you only accept this or that for payment, except when it comes to things like taxes.

Of these five, the by far most serious seem to be the third and the fifth.

Granted, in relation to the third, opening up the mint to the public makes no sense as long as only token coins are produced. Keeping it closed to the public is a means of ensuring that real precious metal coins are ruled out as an alternative to fiat currencies. Could we get around the monopoly on note issuing by opening up the mint to the public and for precious metals? Yes, and in many countries the mint still produces limited amounts of precious metal coins available for purchase by the public. But in most places the mints don't and even in the places they do, it's not open to free coinage. But who would pay with a 20-kronor gold coin when it's still legal to pay with a piece of paper? It seems Gresham's law would put an end to the use of precious metal coins since they wouldn't enter into circulation in the first place.

Moreover, and in relation to the fifth, there's no way of getting around the notes of the monopolized legal tender fiat currencies. Thus we have to accept the irredeemable notes. Thus we have to accept the token coins instead of valuable coins. Thus we have to accept the monopoly of the mint. Thus we have to accept the single unit-of-account.

## The Essence of the Problem

However, we should note that it isn't legal tender per se that has created the problems we see today with fiat currencies. It's rather the monopolization of note issuing that is the problem. It was only after that that we saw the rise of the problem with all the other things. So there is very little use in attacking legal tender laws, it seems rather that it's the monopolization of note issuing that should be the target.

The essence of the problem with fiat currencies isn't the legal tender laws. Neither is the fact that the mint isn't open to the public the essence of the problem. *The monopolization of note issuing seems to be the essence of the problem.*

Break that monopoly and the rest of the problems will vanish. (i) Gresham's law would reverse so that precious metal coins could enter into circulation again, (ii) there would be demand to open the mint to the public or import precious metal coins, (iii) people would consider using alternative unit-of-accounts, like precious metals, and (iv) the legal tender laws could more easily and naturally be circumvented by private contracts. Payments in relation to government could still be regulated by the legal tender laws, the official means of payment (coins and notes) in the unit-of-account of its choice. This was not a mere whim of an egocentric king or

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government. It really isn't strange to stipulate how other people should pay the debt they owe you (it's another issue if that claim itself is valid). The king or government would almost be on the same terms as the rest of us.

Amen to that.

## Endnotes

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<sup>i</sup> See <http://www.archive.org/download/legaltenderstudy00brecuoft/legaltenderstudy00brecuoft.pdf>.

<sup>ii</sup> See <http://mises.org/books/denationalisation.pdf>.

<sup>iii</sup> Available in Swedish <http://www.sedelmynt.se/litt/Lag1873-31.pdf>.