

**THE FIVE EXPERIMENTS: a short essay<sup>1</sup>**

*By Fernando del Pino*

When I was kindly invited by our founder to make a presentation in our first meeting, I thought it would be interesting to bring out some global views on what I believe is a multi-generational decline of the Western civilization rather than talking about the very interesting but narrower field of investment. I must start with two disclaimers: the first is that I am not a historian, so I do not pretend all my data to be utterly accurate or exhaustive (although I have done my best). Secondly, I will use my right of freedom of speech to be completely politically incorrect: some data may surprise you the same way they surprised me when I came upon them.

My speech is titled “The Five Experiments”. According to the Webster dictionary an experiment is “something that is done as a test: something that you do to see how well or how badly it works “. It is also “a scientific test in which you perform a series of actions and carefully observe their effects in order to learn about something”. Western societies are undergoing five experiments – yet we are not aware that they are just that: experiments. All of them are fairly new and untested in the history of mankind, with the problem being that they are now taken for granted as if they were not experiments but an immutable reality, an axiomatic truth that cannot be changed. They are experiments – yet we are not carefully observing their effects in order to learn, we are not judging how well or how badly they work. Worse yet: they are all thought to be undeniable advances in civilization, protected by the iron fist, the tight grip of the tyranny of political correctness. Churchill said that “however beautiful the strategy, you should occasionally look at the results.” That is precisely what I intend to do.

The first experiment is universal suffrage and unlimited democracy, understood as a system where a simple majority of people, qualified to vote on a minimum age basis alone (pretty young, by the way), can decide on mostly anything – including to a large extent the rights of the minority. This is a pretty recent invention, which in most cases has taken place in the last 50 to 75 years.

We know that the goal of any political system should be liberty, order and justice under an ethical framework that promotes virtue. Democracy is just an instrument that is supposed to be the much better than others in achieving these goals, but it should not be considered a goal itself. In today’s world, however, democracy is confusingly considered a synonym of liberty, giving the wrong impression that all that matters is political freedom regardless of the level of the much broader, valuable and precious concept of personal freedom. In fact, a democracy can be perverted to the extent that it becomes an enemy of liberty and order, and its short history already provides quite a few sad examples of that. Hitler

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<sup>1</sup> Based on the author’s speech at Magallanes Value Investors 1<sup>st</sup> Advisory Board Meeting, which took place in Gloucestershire, England (June 2015).

was very democratically raised to power by the German people in the 1933 elections, despite the fact that he had not hidden his ideas at all. Venezuela's democratic tyranny is another recent example.

Most part of history man has lived under the rule of kings. Of course, even under absolutist regimes the king was not alone in the exercise of power. As Oxford historian Ronald Syme wrote in his book *The Roman Revolution*: "in all ages, whatever the form and name of government, be it monarchy, republic, or democracy, an oligarchy lurks behind the façade (...)". In fact, kings were subject to many theoretical and practical restraints, the first of which was their religious belief in a power above themselves and to whom they would unerringly have to respond in due time. Secondly, they were subject to a rule of law that was more or less immutable, based on religion and customs, as opposed to today's legislation, which changes very often and only responds to fads or the variable moods of the majority. Kings were dependent on nobles for both revenues and troops due to the fact that they had limited access to tax revenue and no way to effectively levy taxes, whereas conscription didn't exist (it was the 1789 French Revolution which brought it). Conscription, which we take for granted nowadays despite being an unquestionable dent to personal liberty, was an important development. Before conscription, soldiers were much more expensive and, thus, armies much smaller. Total wars were unconceivable, normal life was not as affected by what happened in a front that was quite narrow by definition, and the lines between the rulers and the ruled were not as blurred as they became afterwards -with the dire consequence of making possible the hatred between entire peoples through the extensive use of propaganda.

Between the 6<sup>th</sup> and the 3<sup>rd</sup> century BC, Ancient Greece is known for having become the first democracy in History, but it really had little to do with the unheard-of concept of universal suffrage. I will tell you later why it ended badly according to one great American specialist in Ancient Civilizations. Republican Rome lasted five centuries and had only some democratic scents. However, again, neither Greece nor Rome had universal suffrage and both even coexisted with the institution of slavery. Well, with only a couple exceptions, such as maybe the Republic of Venice or Switzerland, since the end of both the Greek democracy and the Roman Republic, and for the ensuing 1800 years, democracy, even in its most limited form of *a small group of* people being able to vote on *a few* issues, was not used as a political system roughly anywhere in the world. In the beginning of the 19<sup>th</sup> century only a small subset of the population was allowed to vote in those few countries where there were some timid traits of a democratic system. The mere thought of equalizing the voting power of a rookie youngster with that of an experienced, wise old man, or of literate and learned people with uneducated people, or of those who paid taxes to finance subsidies with those receiving those same subsidies, was considered weird, to say the least. In the UK, for instance, up until 1815 only 4% of the population 20 years old or older had voting rights (in 1832 it was ca 7%), and only 10% of Germans had the right to vote as late as 1871. In other countries it was similar. Indeed, universal suffrage was not embraced until the 20<sup>th</sup> century, between 1913 and 1928 in the case of the UK, Norway, Sweden, Denmark, Austria, Germany or the Netherlands, most of them after World War I. Taking into account that subsets of the general population were not

allowed to vote until much later (women and racial or religious minorities), we cannot talk about universal suffrage in other countries until the second half of the 20<sup>th</sup> century: Italy (1945), Canada (1960), Australia (1962), the United States (1965), Switzerland (1971), Portugal (1976) or Liechtenstein (1984). Illiterates in Brazil were banned from voting until 1988 and in Sweden, Catholics, which until 1871 were not allowed to vote, had to wait until 1950 to be eligible as members of the cabinet (by the way, only in 2013 were the members of the British royal family allowed to marry a Roman Catholic without losing their dynastic rights).

Arguably one of the best experiments in liberty in the History of mankind is the 1788 Constitution of the United States. However, it might surprise the reader (as it did surprise me) that some of the Founding Fathers didn't like democracy very much. They tended to define democratic systems as "two wolves and a sheep voting what to have for dinner", and were extremely worried that such a political system would soon become "mob rule", where the majority would become the new tyrant and abuse the minority – defined by religion, race or wealth (the poorest or the richest). Many common issues can be reexamined at the light of majority abuse in democracies: progressive taxation (the majority decides that the richer minority has to pay more than proportionally), rigid labor legislation that makes dismissal difficult and increases minimum wages (apparently "protecting" the majority current employed while undermining the possibilities of finding new jobs for the minority unemployed), and even abortion (the majority already born deprives the voiceless, defenseless minority which is still in the womb of their mothers from their right to exist). That is why these Founding Fathers created a Constitution difficult to overrule by any majority, clearly stating that the "inalienable" rights of the people were not decided or voted by fellow men but had been determined by a Superior Being, namely God. This Constitution was supposed to be the unconquerable fortress that would always defend the minorities against the whims of majorities. Further, numerous checks and balances were put in place. Throughout the world constitutions are indeed protected to prevent easy changes. In fact, it is so much of a hassle for politicians to legally change constitutions in their obsessive quest for arbitrary power that they have found an easier shortcut, which is to control the Court originally established to interpret the Constitution. Subsequently, constitutions everywhere have been slowly twisted to allow for a very broad range of legislation that would probably have been deemed profoundly unconstitutional by their original authors.

Therefore, people today rightfully consider the divine right of kings something weird but, strangely enough, happily accept the divine right of majorities (which is at least as weird) as the most natural thing in the world. In fact, today's governments, elected by majorities, have such power that absolutist kings would pale in envy. In most Western countries (not all) people do not fear the advent of a hostile majority, but in many countries around the world where there is a heterogeneous population, or where there are serious tensions between majorities and minorities, elections' results are often contemplated with anxiety by the prospective losers, as different outcomes bring vastly different scenarios that might even trigger a temporary exile in order to preserve one's wealth, freedom or life.

So much for the first experiment: never before in History has democracy been used on such a massive scale and never have majorities had so much unconstrained power.

The second experiment is Big Government & Welfare State is also a few decades old (again, maybe 50-75 years), and it is absolutely linked to the first. In democratic systems, politicians need to seduce the masses, and they usually do so by promising public money in exchange for votes. Taxes are the other side of promises, their natural consequence: first, you promise; then you tax. Thus, with the creation of boundless democracy, politicians started making promises at an increasing pace, and taxation had to follow suit (however, in one of those remarkable social phenomena, most voters still believe that promises bear no cost).

Up until the end of the 19th century, approximately 50% of public spending was military. In the old days, monarchies' public spending was estimated to range between 5 and 7% of GDP. Even in 1870, public spending in Western countries was around 10% of GDP; prior to WWI, in 1913, it was still below 13% of GDP. For the sake of giving some specific examples, public spending over GDP was 7% in the US and 12% in the UK at the time. In the Nordic countries, currently known for being paradigmatic Welfare State societies, public spending was ca 6% of GDP in 1870 and below 10% in 1913 (it seems they became rich and prosperous with limited government and then decided to squander everything as soon as they forgot the true origins of their wealth). These were the figures only 100 years ago, when our grandparents were already adults. Today, public spending in the EU is close to 50% of GDP.

Public debt was nearly non-existent at the beginning of the 20<sup>th</sup> century (in any case it was below 10% of GDP), and balanced budgets were considered the rule except in times of war. Government employment as a percentage of total labor force was miniscule, between 3 and 5% in 1900. In Spain, as late as 1975, public debt stood around 8% of GDP and public spending remained around 20% of GDP. Sidney Homer reminds us in his work *A History of Interest Rates* that back in the 14th century, for example, kings (governments) were required by their lenders to pay higher interest rates than commercial private borrowers, as they were considered less trustworthy. In just one hundred years, public debt has soared from 10% over GDP to the current 90-100% in many Western countries, and thanks to central banks, many governments actually get paid by their lenders for the privilege of lending to their near-bankrupt governments. I wonder whether societal wisdom has increased or decreased since the 14<sup>th</sup> century.

Permanent income taxes – the main source of funding or extractive capacity of the State – is another recent invention (as you can see, not all inventions are a progress for humankind). The first permanent tax took place in 1842 in Britain, followed by Austria, Italy or Japan in the second half of that same 19<sup>th</sup> century. Around 1900, the Netherlands and most of the European Nordic countries (Norway, Sweden and Denmark) followed suit. Between 1913 (close to the beginning of World War I) and 1925, the United States, France, Germany, Australia, Canada, Finland or Belgium joined the group. Switzerland did not enact a permanent income tax at the federal level until 1939 (when WWII started). It should be emphasized that

at the beginning tax rates used to be low single digit, ranging between 1 and 7% over annual income (nowadays it is not uncommon to find top tax rates between 40% and 50%).

Afterwards, the always astute politicians have found many ways to increase taxation. Progressive tax rates, deemed unconstitutional in the US until 1913, that unlucky year when the Fed was created (both events taking place on the same year may well be the origin of number 13's bad reputation), were soon adopted. Indeed, through progressive taxation, politicians disguise and soften the inevitable voter's annoyance caused by tax hikes using the always powerful feeling of envy as a masterly softener: "the rich will pay even more", they say. "Oh, I feel better", the voter responds. "Tax me, please". In fact, progressive taxation should be seen as a long term destroyer of the principle of private property. If the political system allows majorities to decide without restrictions regarding the wealthy tiny minority, it seems logical to think that abusively high income taxes will be followed by wealth taxes, then by legal expropriation (garnished by beautiful words such as "social justice", for instance) and, finally, by arbitrary illegal confiscation before the whole system explodes in total chaos.

Another trick used by politicians is to call "Social Security" what is merely another huge tax. Social Security sounds better, of course: it even sounds like a pension contract, except for the little detail that there is no contract whatsoever (just the promise of a politician, which I wouldn't rate AAA). Yet another trick is withholding taxes, which divide the tax payments through the year with the goal of reducing the pain of a single payment on a certain date. Finally, politicians have invented a myriad of little taxes, so that the overall abusive level of taxation goes unnoticed, and also that great stealth concept called indirect taxation. The Value Added Tax (VAT), invented by a French bureaucrat as late as 1954, is the mother of all indirect taxes. Of course, all temporary taxes remain in place forever, and people seem to sheepishly accept whichever new form of taxation is created regardless how eccentric and outrageous it might have regarded just one generation ago – let alone two.

In any boundless democracy, a Welfare State is simply a symptom of aging. The healthier the democratic system, the longer it takes for it to degenerate into a Welfare State. In this sense, it is taking much longer in the Anglo Saxon countries than in the European continent. In a Welfare State, politicians promise Peter that he will be subsidized at the expense of Paul, and then they run to convince every single voter that they are all Peters (except the obvious minorities, which don't count anyway). The politician's principle is simple: you earn, I redistribute. He takes with one hand and redelivers with the other (with some unfortunate midway loss). In my view, any society that aspires to call itself civilized has the moral duty of taking care of the weakest, of those who cannot take care of themselves, temporarily or permanently. The State should only have a subsidiary role, though, with the family (currently under a most vicious attack) representing the main support of these weakest, followed by the voluntary action of fellow men through charity aid. However, the weakest, by definition, are a minority, and minorities are of little interest to the Welfare State, which is a political concept. That's the reason why the Welfare State has failed to provide protection to those it should, while spoiling (controlling) those it should not.

Politicians promise a nonexistent, fraudulent, completely imaginary security in exchange for a very real and precious value called liberty, and people end up without both. That was the trap of Communism, but the temptation to accept such poisonous deal is as old as man. In the Bible we can see how the Jewish people bitterly blamed Moses for all their adversities in the desert just weeks after having been saved by him from slavery: “Why did we not die at Yahweh's hand in Egypt, where we used to sit round the flesh pots and could eat to our heart's content!.” They'd happily trade their recently recovered freedom, naturally full of uncertainties, for the “security” of a full stomach. We definitely cannot take for granted the value placed by the average man on his own freedom, because freedom bears responsibility, effort, taking the right choices, erring and falling, and standing up again after every fall. In reality, true freedom can be scary. That's why a Spanish comedian of the 70s and 80s famously said: “We will be free! And those who don't want to be free, we will force them to become free!”

Welfare States create the illusion that money grows in trees: “free” highways and high-speed railway infrastructures, “free” health systems, “free” public education systems. Bizarre “rights” start growing like mushrooms in a humid forest –rights without duties. Personal responsibility, on the other hand, is killed on the altar of universal rights and political power: the State will provide no matter what, so there's no need to save, no need to have children to support you at an old age, no need to search for a job, no need to keep healthy. This is Europe: a citizenship completely dependent on the State (of course, a free, independent citizen has always been a nuisance for any power junkie). Social Security, disguised as State-sponsored savings, becomes a Ponzi scheme. Voters are openly bribed with ever more subsidies and a set of absurd, tyrannical and overwhelming regulations seem to bring totalitarianism through the back door. They distract us with political liberty while stealthily robbing personal liberty at an accelerating pace. The huge danger is that we may end up living in a totalitarian society disguised as a democracy, where people would just carelessly choose the next tyrant for the next few years with nobody bothering who he might be.

Politicians first promise, then tax. When they run out of tax revenues, they borrow. A gigantic indebtedness is the third experiment. The trend is particularly noteworthy in the last 35 years. Historically speaking, governments only borrowed heavily in times of war and particulars were wary of getting too much into debt. Today, both private and public debt levels remain at historical records in most world regions. It seems that today's societies have lost the due respect that debt deserves. Etymologically, debt is having without having; it means bread today and hunger tomorrow, as we say in Spain. As it usually allows living beyond one's means, it also brings some sort of reality loss. Debt doesn't add to wealth and becomes dangerous, because our assets change in value, as does our income, but debt remains merciless constant regardless of what assets or income may do. As a wise Spanish businessman once said, “debt is the only thing real”.

In the good old days, debt had two natural deterrents: interest rates and the obligation of repayment. Interest rates have been suppressed by the world's Great Helmsmen (central

bankers), and rolling debt at maturity has become the norm, as overleveraged lenders do not want to realize how stinky their loan book really is and keep kicking the can down the road in the belief that better times will come along to save them from disaster. To pretend is the name of the game. The problem with these reckless policies is that the world has become addicted to debt and has already consumed tomorrow's wealth - today. As with all addictions, the only cure implies going through the pain of withdrawal, but in our teenager, spoiled, egocentric societies, pain is no longer acceptable (it may well become illegal). Sooner or later, the day of reckoning will come due, however, and the longer we postpone it, the more vicious the final collapse will be.

Finally, the fractional reserve system, based on trust, is very dangerous. If we have huge debts and a false sense of security through deposit "insurance" (who insures the insurer?) that guarantees up to a certain amount of deposits (who guarantees the guarantor?), we take responsibility off people's shoulders in the moment of choosing which entity is safe enough to keep their hard earned savings. The fractional reserve system bears with it the fear of a bank run: if deposits were real (or at least more real), a bank failure would be like any other bankruptcy, with its shareholders and bondholders taking the burden of human error. There would be nothing like systemic risk, and both managers and depositors would have to behave more prudently, more responsibly (like adults?). What we are seeing everywhere is an abuse of trust, where the system has been allowed to become extremely fragile. Fragility is a treacherous concept: for a long time, nothing seems to happen and prudence resembles stupidity, until suddenly, apparently out of the blue, all hell breaks loose.

The fourth experiment has to do with crazy central bankers and fiat currencies, and it goes back to 1971, when US President Nixon unilaterally cancelled the convertibility of the US dollar into gold. Nixon literally stated: *"I have directed Secretary Connally to suspend temporarily the convertibility of the dollar into gold"*. Please note the word "temporarily", read 44 years later.

As we have already seen, the history of fiat currencies is quite simple: powerholders first promise, then tax; there comes a moment when there are more promises than money (the very definition of today's Welfare State), so powerholders have no option but to borrow. Then, when no lender in his right mind would lend them a single dime, powerholders just print. It's easy and for a while it seems harmless. We can find examples in China as far back as in the 10<sup>th</sup> century or in the Roman Empire prior to its demise. The end is predictable: currency destruction. Money has a limited, finite demand; if you create an infinite supply, its value will go down to zero. Of course, fiat currencies have both pros and cons. The problem with the pros is that they rely too much on powerholders' common sense, good judgement and right morals, turning a blind eye to the ever present pathology of power which, with very few exceptions, appears every time man starts believing he's is God – forgetting that he unfortunately lacks His other attributes. Extreme power without extreme virtue is not a good idea.



Subject to a false sense of security which is nothing but an illusion of control, central bankers have tried to eliminate economic cycles, which naturally occur at least since the times of the Bible, with the seven fat years followed by the seven lean years. However, cycles are indispensable, rewarding vision, intelligence and rightful behavior (and luck, to be sure) and punishing recklessness, excessive greed, shortsightedness or stupidity. Cycles bring pain, and pain brings necessary change. That's how human nature works: because of man's fallen nature, incentives are essential for righting the wrong in the long term. The financial repression of centrally planned zero interest rate policies (ZIRP) will be viewed in the future with dismay and judged as yet another example of human hubris. The price mechanism has been destroyed, asset values distorted; we have run away from reality and created a fantasy where mistakes are not corrected, addictions are not healed and problems are not solved. On the contrary, problems are extended and amplified. The innocent victims of ZIRP have so far been ignored by public opinion: retirees, insurance companies, pension funds, endowments, etc. All these have been forced to climb the ladder of risk desperately trying to grab the yield leftovers. Unfortunately, we will pay the price as certainly as night follows day – although central bankers themselves will comfortably retire, find some scapegoat for the next meltdown and quietly tiptoe out of stage without assuming any responsibility whatsoever.

If you think I've been too harsh on central bankers and you still believe they are a bunch of wise, benefic men sitting around crystal balls, equipped with supernatural intelligence and specially gifted and destined to rule the world since birth, let me give you a recent example so you can judge for yourself. Haruhiko Kuroda, governor of the Bank of Japan, said on June 4<sup>th</sup> 2015: "I trust that many of you are familiar with the story of Peter Pan, in which it says that the moment you doubt whether you can fly, you cease forever to be able to do it. Yes, what we need is a positive attitude and conviction". Wow, that's all we need.

I recall from that same movie another character: Tick-Tock Croc. I believe that what the crocodile had eaten were these arrogant, reckless monetary policies, that is: central bankers' ticking bomb. The fuse's length is uncertain, but you can bet on one thing: it's finite.

The fifth and final experiment is much more profound and has deeper and longer lasting consequences. It is the experiment of living without God, particularly acute in developed, formerly Christian Western countries, and is really recent, arguably two of three decades old in most cases. This is a huge issue: for the first time in nearly two millennia, Western countries live as if God didn't exist. There are no longer Ten Commandments, no natural law, no inalienable rights, no right or wrong. Rules and rights are decided, nearly without exception, by fellow men, by the deified majority accountable to no one, subject to no limits at all. When you take God out, you take human dignity out: we are no longer sons of God, with our own indestructible rights. If fellow men can decide what our rights are, then they are not rights, because a right cannot depend on the opinion of others. Relativism, one of the most dangerous philosophical currents ever, defends that absolute truth does not exist (except this very statement, of course). Under the relativist ideology, it all depends on subjective views, on the latest fad or on the ever changing whims of the majority. We have



forgotten something extremely important: when power is not subject to a higher rule, those in power become gods, although not saint, infinitely merciful, just and good gods, but somber tyrants in waiting. Also, when we take God out of our lives, something has to occupy the empty space. Therefore those who think they have killed God are wrong: they have just substituted Him for other gods, like power, sex, money, popularity or mother Earth, gods who are inferior to us instead of vastly superior, gods that enslave us instead of having the ability to set us free. In our quest for a misunderstood freedom we have become slaves. Worse yet, we have become slaves who remain oblivious to their state of slavery.

I worry that we might be blindly participating in the decline of our own civilization in the name of progress, that we might be losing our freedom in the very name of freedom. Our deified democracies are degenerating into a race where majorities vote for themselves with largesse ever increasing rights and ever decreasing duties. Freedom without responsibility and without moral constraints is not freedom, but barbarism. Indeed, once morals are sufficiently corrupted by the anesthesia of conscience and the passage of time, the sovereign masses, unconstrained by any rules at all, having already kidnapped truth and redefined right and wrong, will become ruthless arbitrary tyrants. This moment is looming in the horizon.

I mentioned at the beginning that Ancient Greece was the pioneer of democracy 2,500 years ago and the first society in which a sizable part of its people could proudly call themselves free citizens. How did democracy in Greece come to an end? One of the foremost authorities in this period of History, the late Edith Hamilton, clearly explained the reason of Greece's decline in her wonderful book *The Echo of Greece* (1957). This quote belongs to the chapter called Athens' Failure:

"What the people wanted was a government which would provide a comfortable life for them, and with this as the foremost object, ideas of freedom and self-reliance and service to the community were obscured to the point of disappearing. Athens was more and more looked on as a co-operative business possessed of great wealth in which all citizens had a right to share. The larger and larger funds demanded made heavier and heavier taxation necessary, but that troubled only the well-to-do, always a minority, and no one gave a thought to the possibility that the source might be taxed out of existence. Politics was now closely connected with money, quite as much as with voting. Indeed, the one meant the other. Votes were for sale as well as officials.

The whole process was clear to Plato. Athens had reached the point of rejecting independence, and the freedom she now wanted was freedom from responsibility. There could be only one result. "The excess of liberty in states or individuals," he said, "seems to pass into excess of slavery." If men insisted on being free from the burden of a life that was self-dependent and also responsible for the common good, they would cease to be free at all.

Responsibility was the price every man must pay for freedom. It was to be had on no other terms. (...)

But, by the time, Athens had reached the end of freedom and was never to have it again.”

Enough said. Thank you very much.

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