What Americans Used To Know About the Declaration of Independence

by Thomas J. DiLorenzo

"During the weeks following the [1860] election, [Northern newspaper] editors of all parties assumed that secession as a constitutional right was not in question . . . . On the contrary, the southern claim to a right of peaceable withdrawal was countenanced out of reverence for the natural law principle of government by consent of the governed."

~ Howard Cecil Perkins, editor, Northern Editorials on Secession, p. 10

The first several generations of Americans understood that the Declaration of Independence was the ultimate states’ rights document. The citizens of the states would delegate certain powers to a central government in their Constitution, and these powers (mostly for national defense and foreign policy purposes) would hopefully be exercised for the benefit of the citizens of the "free and independent" states, as they are called in the Declaration.

The understanding was that if American citizens were in fact to be the masters rather than the servants of government, they themselves would have to police the national government that was created by them for their mutual benefit. If the day ever came that the national government became the sole arbiter of the limits of its own powers, then Americans would live under a tyranny as bad or worse than the one the colonists fought a revolution against. As the above quotation denotes, the ultimate natural law principle behind this thinking was Jefferson’s famous dictum in the Declaration of Independence that governments derive their just powers from the consent of the governed, and that whenever that consent is withdrawn the people of the free and independent states, as sovereigns, have a duty to abolish that government and replace it with a new one if they wish.

This was the fundamental understanding of the meaning of the Declaration of Independence – that it was a Declaration of Secession from the British empire – of the first several generations of Americans. As the 1, 107-page book, Northern Editorials on Secession shows, this view was held just as widely in the Northern states as in the Southern states in 1860-1861. Among the lone dissenters was Abe Lincoln, a corporate lawyer/lobbyist/politician with less than a year of formal education who probably never even read The Federalist Papers.

The following are some illustrations of how various Northern-state newspaper editors thought of the meaning of the Declaration of Independence in 1860-1861:

On November 21, 1860, he Cincinnati Daily Press wrote that:

We believe that the right of any member of this Confederacy [the United States] to dissolve its political relations with the others and assume an independent position is absolute – that, in other words, if South Carolina wants to go out of the Union, she has the right to do so, and no party or power may justly say her nay. This we suppose to be the doctrine of the Declaration of Independence when it affirms that governments are instituted for the protection of men in their lives, liberties, and the pursuit of happiness; and that ‘whenever any form of government becomes
Destructive of these ends, it is the right of the people to alter or abolish it, and to institute new government..."

On December 17, 1860 the New York Daily Tribune editorialized that "We have repeatedly asked those who dissent from our view of this matter [the legality of peaceful secession] to tell us frankly whether they do or do not assent to Mr. Jefferson’s statement in the Declaration of Independence that governments ‘derive their just powers from the consent of the governed...’. We do heartily accept this doctrine, believing it intrinsically sound, beneficent, and one that, universally accepted, is calculated to prevent the shedding of seas of human blood." Furthermore, the Tribune wrote, "[I]t justified the secession from the British Empire of Three Millions of colonists in 1776, we do not see it would not justify the secession of Five Millions of Southrons from the Federal Union in 1861."

The Kenosha, Wisconsin Democrat editorialized on January 11, 1861, that "The founders of our government were constant secessionists. They not only claimed the right for themselves, but conceded it to others. They were not only secessionists in theory, but in practice. The old confederation between the states [the Articles of Confederation and Perpetual Union] was especially declared perpetual by the instrument itself. Yet Jefferson, Madison, Monroe and the hosts of heroes and statesman of that day seceded from it." And, "The Constitution provides no means of coercing a state in the Union; nor any punishment for secession."

Again on February 23, 1861, the New York Daily Tribune reiterated its view that "We must not, in behalf of either of the Union of Freedom, trample down the great truth that ‘governments derive their just power from the consent of the governed.’"

The Washington, D.C. States and Union newspaper editorialized on March 21, 1861, that "The people are the ruling judges, the States independent sovereigns. Where the people chose to change their political condition, as our own Declaration of Independence first promulgated, they have a right to do so. If the doctrine was good then, it is good now. Call that right by whatever name you please, secession or revolution, it makes no sort of difference."

This last sentence was a response to the Republican Party propaganda machine of the day that invented the theory that the Declaration allows for a "right of revolution" but not a right of "secession." The States and Union recognized immediately that this non-distinction was nothing more than a rhetorical flimflam designed to deceive the public about the meaning of their own Declaration of Independence. It is a piece of lying propaganda that is repeated to this day by apologists for the American welfare/warfare/police state, especially the Lincoln-worshipping neocons at National Review, the Claremont Institute, and other appendages of the Republican Party.

On the eve of the war the Providence, Rhode Island Evening Press warned that "the employment of [military] force" against citizens who no longer consented to being governed by Washington, D.C., "can have no other result than to make the revolution itself complete and lasting, at the expense of thousands of lives, hundreds of millions of dollars, and amount of wretchedness fearful to contemplate, and the humiliation of the American name."

The Evening Press then reminded its readers that in the American Revolution the colonists rejected "the Divine right of Kings" to do whatever they wanted to their subjects. "Our forefathers disputed this dictum," they wrote, and "rose against it, fought against it, and by successful revolution accomplished their independence of it. In its place they substituted the doctrine that ‘to secure human happiness, governments are instituted among men, deriving their just powers from the consent of the governed...’"

On this Fourth of July most Americans will not be celebrating or commemorating these founding, natural law principles. To the extent that they are celebrating anything but a day off work to overeat and overdrink, they will be celebrating the imperial warfare/police state with hundreds of parades featuring marching soldiers in camouflage, flags galore, military vehicles, jet fighter fly-overs, "patriotic"/warmongering
musical anthems, etc. The symbol of all of this is King Lincoln himself, who rejected every single principle of the Declaration of Independence. His successors have reinterpreted the document to "justify" endless military interventionism all over the globe in the name of "making all men everywhere equal." To the neocons, this means perpetual wars for "democracy." This of course has nothing whatsoever to do with the real meaning of the Declaration of Independence and is in fact the exact opposite. No people in any country that has been invaded and occupied by the U.S. military have ever consented to being governed as such by Washington, D.C. As such, they can all be thought of as Neo-Confederates.

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Annual Night of Clarity Event

The Night of Clarity this year will be held at the downtown Nashville Sheraton on August 23 and 24. The theme is the 100th anniversary of the Federal Reserve. On the first day, which is a Friday, the event will start at 1pm. In addition to Carlos Lara and Bob Murphy, the event will feature speeches from Foundation for Economic Education (FEE) President Larry Reed, Nelson Nash, Tom Woods, and Ron Paul. This program will focus on “the problem,” namely government intervention in money and banking. We are expecting a crowd of about 600 people for this general session.

After Dr. Paul’s speech ends (around 6:45pm), the main crowd will disperse while those staying for the whole event will have a private reception and then a dinner, with Ron Paul giving us a Q&A.

On Saturday we will have an IBC workshop, dedicated to “the solution.” This will run from 9am – 4pm, with a large break in the middle for lunch. The lecturers will include Carlos Lara, Bob Murphy and Nelson Nash, with possibly others that are yet to be determined.

This workshop will be ideal for clients who have been introduced to IBC but have lingering doubts, or who want to hear it described from different perspectives. In the first session we will explain the “big picture” of IBC, and then over the course of the day we will walk step by step through its applications to the household and business owner.

We will explain how whole life insurance and policy loans work from an economic and actuarial perspective, we will explain that IBC isn’t tax evasion or some other scheme, we will explain how the growing practice of IBC will minimize the very problem we diagnosed the night before, we will explain the function of the IBC Practitioner’s Program in helping the public locate insurance professionals who are familiar with Nelson’s ideas, we will defuse common objections/myths, and we will field questions from the audience.

The Saturday workshop will prove quite useful even to the veteran IBC producer, for help in clarifying some of the finer points and perhaps bringing up new considerations, but we want to stress that we are designing it for the general public who are interested in IBC but need more details.

For just the Friday afternoon/evening lectures, students pay $35 while others pay $75. (We expect many Nashville residents will want to see Ron Paul.)

A second package gets the Friday lectures, AND the Friday cocktail reception, the Friday dinner, and the Saturday lunch and workshop, for $650.

However, for IBC Practitioners and those currently enrolled in the Program (but who have not yet taken the final exam), there is a 10% discount code, which you can obtain by emailing Carlos, usatrust@comcast.net which would make your actual price $585.

You will need to make your hotel reservations
yourself, at the downtown Nashville Sheraton. You can either call them directly or use the dedicated link at our event website. There is a generous group discount rate available for two days before and after our event dates, so be sure to either use our dedicated link or to say you are with the “Night of Clarity” if you call. However, there are only a limited number of rooms that the Sheraton can guarantee us at this special rate, so please make your reservations as soon as possible, before we begin our marketing wave to a broader Austrian/libertarian audience.

Please go to the event website for the pricing packages: http://nightofclarity.com.

Please let us know if you have any questions or concerns. Thank you again for your support in helping us build the ten percent!

Sincerely,
Nelson, David, Carlos and Bob

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**Why Political Correctness and Economics Don't Mix**

By Doug French

Why learn economics? To know economics is to understand how the world works. Multitudes of people know nothing about the subject, and that is very sad. Economics relates to everything we do. Without that understanding, much of the operation of society will remain mysterious.

Not only do you want to be the smartest person at the cocktail party, but your health and happiness are at stake. Maybe you've cracked open a few economics books, but quickly dozed off as the author sedated you with theory.

What you need is a book that combines solid theory applied to today's real-life problems. That book is Kel Kelly's The Case for Legalizing Capitalism.

Mr. Kelly is not an academic preaching from atop the ivory tower. He works in the real world. He spent over 15 years as a Wall Street trader, a corporate finance analyst, and a research director for a Fortune 500 management consulting firm.

Kelly is a devotee of Austrian economists like Ludwig von Mises, F.A. Hayek, and especially Mises student George Reisman. Reisman has the rare distinction of having studied directly under Mises and philosopher and author Ayn Rand. The value that Kelly brings to the reader is analyzing today's issues using theory from the great thinkers of the Austrian tradition.

This is not a book you have to read cover to cover. If you are interested in a particular topic, you can simply head to a particular self-contained section. It's the type of book that allows you to skip around.

If you do wish to take on the book in linear fashion, Part 1 starts with "The Foundations of Our Economy," which is divided into chapters on labor and trade. Part 2 has chapters on inflation and regulation. Next, Kelly explores "Government Control Versus Free Markets," and so on.

Kelly doesn't sidestep any issue, and he is not politically correct. For instance, Hurricane Katrina didn't flood New Orleans; the government's levees broke. The author points out that the Big Easy should be a small port, except that the government subsidized flood insurance, stepped in with FEMA, and constructed, but didn't maintain, a large levee system that private enterprise would never pursue.

The author tells us in Chapter 1 that sweatshops and child labor should be embraced. To intervene with government is to make these workers poorer. Groups like Press for Change denounce athletic-wear company Nike for making lots of money and paying low wages in Asia. Nike CEO Phil Knight was called a "corporate criminal" by filmmaker Michael Moore.

However, Kelly makes the point that whatever we in America think, Nike's working conditions are an...
 improvement for these workers.

"In fact," writes Kelly, "the supposedly greedy and exploitive multinational companies we hear that conduct sweatshop operations in undeveloped countries usually pay about double the local wage."

Child labor is needed in developing countries. People forget that once upon a time, America was developing and child labor was common. As more families prospered, children didn't have to work to support the family anymore. Child labor only became terrible when unions sought to ban child labor for competitive reasons.

Kelly devotes a chapter to demystifying banking and inflation. The author writes that virtually every problem in the modern economy can be traced back to the government's printing of money. Government is the primary beneficiary of inflation, because it receives the money first and can spend it before prices rise.

Writing in the wake of the 2008 meltdown, the author explains that government could not finance its deficit without central bank money creation. He probably couldn't imagine to what level the Fed would take its debt purchases. As Ben Bernanke tries valiantly to revive the economy doing the only thing he knows how, the Fed is now buying 90% of newly issued Treasury debt.

Bernanke is buying every bond in sight because the thought of deflation keeps him and other Keynesians up at night. Kelly explains that this fear is "misguided." The money supply must collapse for there to be deflation. In reality, if price inflation is zero, as Kelly notes, there is actually inflation. Prices would fall due to efficiencies and competition if excess money wasn't being created. "Therefore, the amount of money that is printed in order to keep prices unchanged still has the same negative effects on the business cycles and financial markets..."

For those sympathetic to government regulation, Kelly's chapter on regulation will give you pause. Always and everywhere, government claims that business is regulated to help and protect customers. Unfortunately, it never works out that way. Kelly leans on the work of Dominick Armentano to point out that in the "55 most famous antitrust cases in U.S. history, in every single one, the firms accused of monopolistic behavior were lowering prices, expanding production, innovating, and typically benefiting customers."

No good deed goes unpunished.

I heard a couple friends saying recently that they are worried Google and Amazon may become monopolies. Kelly lays that myth to rest, pointing out that the only monopolies are government-sanctioned monopolies. There are no such things as "natural monopolies," where single providers are more efficient.

The author relates how RCA Corp. was prohibited from charging royalties to American licensees and instead licensed to Japanese companies. This gave rise to the Japanese electronics industry that ended up outcompeting American companies. There might be a Pan American World Airways (Pan Am) if the government would have allowed the international airline to obtain domestic routes. Instead, with no domestic flights feeding its overseas flights, the company went bankrupt.

And as we prepare to descend into the brave new world of Obamacare, it will be useful to read through Kelly's considerable section on health care. While America does just the opposite, the author explains that only the free market can solve the health care crisis. If costs and access are the problem, more supply is the answer, along with having patients pay for medical services, rather than third parties. Nobody controls costs that they never see.

People are living longer and healthier than ever, and the reason is, where it is allowed to thrive, capitalism. We hear plenty about evil corporations and exploited workers. Some academics claim that businesses are gaining at the expense of customers. However, where there has been some semblance of capitalism, it has "prevented starvation, eradicated diseases, led to the development of sanitation systems and products, made us stronger, healthier, and longer-living, built cities with all the modern conveniences and luxuries.
we enjoy, and continues to do so to this day."

When gas prices spiked in 2011, President Obama criticized oil company profits because they were affecting his business. "My poll numbers go up and down depending on the latest crisis, and right now gas prices are weighing heavily on people," said Obama.

Just last week, Congress hauled in Apple CEO Tim Cook and berated him for his company's legal tax avoidance. Never mind that Apple is America's largest taxpayer, paying $2.5 billion in federal taxes in 2011 and $6 billion in 2012.

Today, corporations are supposed to be kinder, gentler, and socially responsible, forgetting the bottom line and accommodating the needs of stakeholders (whoever they are!) and the environment. However, profits are the only real measure of success that matters. Profits are dictated by customer satisfaction. Profits provide capital. Capital is needed for further investment. Investment leads to prosperity.

If Apple and the oil companies are earning big profits, they must be satisfying customers. In fact, during the Apple questioning, when it was Sen. John McCain's turn to ask a question, all he wanted to know was how to upgrade the apps on his iPhone.

Kelly lays waste to the irritating bromide that the successful should "give back to society." The rich and successful already pay the most in taxes, and besides, these are the people who create the products we love and the jobs we need. "It is the rest of society who should give back to the rich," writes Kelly.

The author has lengthy chapters questioning environmentalism and the war on terror. He ends the book with a complete critique of Keynesian economics and addresses provocative political quotes and news items in an interesting final chapter.

The sweep of Mr. Kelly's book is massive. At the same time, his pithy writing style and the book's organization make it a pleasure to read. It is more than an economics book. The Case for Legalizing Capitalism is a book that mows down common misconceptions and will help you see the world a little more clearly.

**Understanding Interest Rates in Cash Value Life Insurance**

*Robert P. Murphy, PhD*

*May 2012*

*This Lara-Murphy Report (LMR) article was reprinted with permission. This and many more articles related to IBC and Austrian Economics are published monthly in the LMR. Subscriptions are available at www.usatrustonline.com*

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)

Figure 1 shows three different trajectories for the “present discounted value” of the $1,000 bond, as the owner of the bond ages. At a 2% discount rate, that future $1,000 payment is valued more highly in earlier time periods—it is discounted less than in the other scenarios. That’s why the red line is consistently higher over the man’s life, until finally in the 100th year the other lines finally catch up to it.

Notice that if we fix the ultimate payout, then there is 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^1.  

**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 35^2 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.

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^1. While we used an annual discount rate of 2% for simplicity, you can use any rate you wish. The numbers will be different, but the same calculations can be done. For example, using a 5% discount rate, the calculations are similar but the values will be different.  

^2. We use a hypothetical age of 35 to illustrate the example. In practice, the age when payments begin will depend on the specific life insurance policy and the age at which the policyholder wants to receive the payout.
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 $25.93³. 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 &quot;Going Into Cash Value&quot;</th>
<th>Cash Value After Mortality Charge and 5% Credited Interest (eop)</th>
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**TABLE 1: Values at Various Ages Using**
BankNotes - Nelson Nash’s Monthly Newsletter - July 2013

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.

2For 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.

3The 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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Nelson’s Favorite Quotes

“Americans buy things they don’t need – with money they don’t have – to impress folks they don’t know – who could care less.” - Bill Bonner

When the government fears the people, there is liberty. When the people fear the government, there is tyranny. - Thomas Jefferson

“They that can give up essential liberty to purchase a little temporary safety, deserve neither liberty nor safety.” - Ben Franklin

Number Thirty-Eight in a monthly series of Nelson’s lessons, right out of Becoming Your Own Banker®. We will continue until we have gone through the entire book.

PART V, Lesson 38: Capitalizing Your System and Implementation

Content: Page 65, Becoming Your Own Banker: The Infinite Banking Concept® Fifth Edition, Sixth Printing

By this time in the course you may be motivated to do something about it by putting these principles into practice in your own life. First comes desire – unless it is strong enough to see you through good times and bad ones, let’s face it, you will probably never get it done. You will remain one who is paying 35 cents out of every dollar left over after paying your income taxes, for interest alone, to the banking business for the things in life that you have just “got to have.” I suggest that you go back and read – several times – Parkinson’s Law, located on page 28. Unless you can overcome this law you might as well give up, dig a hole and crawl in and ask someone to cover you up. You are hopeless! But, remember, if you can whip Parkinson’s Law you will win by default in comparison with your peers!

Next, would be conviction that this concept is without flaw. There are a large number of people out there who have no earthly idea of the truth of this message and you are going to probably face their ridicule. You must not let these folks influence you. Why listen to an incompetent? Having someone else in your life that is very familiar with this concept is a necessity. You are going to need a coach. Find a life insurance agent who knows, and understands it thoroughly. If you don’t know one, then look on my website infinitebanking.org and click on the Authorized IBC Practitioner Finder.
Another thing to consider is to recognize the value of moral support by joining a “wealth club” -- a group of people with similar interests who get together periodically to discuss the process of building wealth through whole life insurance and other strategies. Or, even better, maybe you should organize one yourself. Discussing each of the five parts of my book, *Becoming Your Own Banker* could be very profitable activity. There are many persons who have been through my seminar over a dozen times and they testify that they learn something new on each occasion.

Still another possibility is to have such a group to purchase Robert Kiyosaki’s board games, *Cashflow 101*, and *Cashflow 202* and play them regularly. These are not cheap “toys” – they are great teaching tools that can help you understand what is really going on in the financial world. You can get these games by going to www.richdad.com. I highly recommend these games.

Basically, it is a matter of rearranging what you are now spending. After all, Parkinson’s Law applies – “Expenses rise to equal income” – and “a luxury, once enjoyed becomes a necessity.” All of us feel that we are already spending all our money on necessities – that is, until critical analysis proves otherwise. So, you have to become brutally honest with yourself and reorganize your priorities in life to answer the question, “Do I really want to get out of the financial prison of my own making?” Honest introspection will usually find some premium dollars with which to start. At least, that was my own experience and I don’t think I’m all that different from everyone else.

A significant source of funding could be your current contributions to tax-qualified retirement plans. I know this is probably an untouchable subject in your mind, so let’s conduct an exercise:

Would you go into business with your best friend…

(1) If he demanded that you put up all the money.

(2) If he required you to let him make all decisions as to percentage of ownership, when money was split, etc.

(3) And he reserved the right to change anything, any time, without your consent?

I don’t think anyone in his right mind would do so – yet that is exactly what you are doing if you participate in any tax-qualified plan, such as a 401-K, IRA, Pension Plan, etc. and you are dealing with a “partner” that has a perfect record of lying to you.

There is a way to begin receiving income from such plans without having to pay a penalty. You will, of course, have to pay income taxes on the withdrawals but you can certainly use this chain of payments to start up new life insurance policies.

We will deal with this subject at length in the next lesson, so try to prepare yourself mentally for a great challenge.

[Nelson’s Newly Added Book Recommendations](http://infinitebanking.org/reading-list/)

*Pound Foolish* by Helaine Olen