# CHAPTER XXXIV

## The Theory of Interest

I. Nature of interest
  1. Its meaning
  2. Some examples
  3. Why necessary:
    *a.* From the standpoint of saving
    *b.* From the standpoint of efficiency

II. What determines rate of interest
  1. Man's valuation of the future:
    *a.* Individual valuation
    *b.* Social valuation
    *c.* Why the rate is low or high
  2. Other considerations:
    *a.* Concerning supply of capital
    *b.* Concerning element of risk

III. Source of the interest fund
  1. The popular view
  2. The scientific view
  3. The summary

**Meaning and examples.**

**Nature of Interest.** — Capital is also a factor in production, and the share assigned to it in the general distribution of wealth is called interest. In other words, interest is the return on capital and represents capital's reward for engaging in production. If an individual permits his wealth to be used as capital, instead of consuming it unproductively, he will receive this interest for its use. Returns on investments, therefore, whether received as interest on deposits, or interest on mortgages, or dividends on stock, are all forms of interest. Therefore, interest is the sum paid for the use of capital.

The first question that naturally arises in considering interest is this: Why should it be necessary to pay interest for the use of capital? Why should not capital be universally employed without receiving any interest? The answer to this question may be found in a characteristic of human nature. Interest is necessary because man undervalues the future and, consequently, capital would soon disappear were no interest paid for its use.

**Why necessary:**

This payment of interest for the use of capital is necessary no matter whether we regard saving or efficiency as the prime factor in creating capital. When we view capital from the standpoint of saving, the necessity for the payment of interest is quite apparent. Because man undervalues the future he overvalues the present. The present enjoyment of one thousand dollars means much more to an individual than a contemplation of its enjoyment a year from now. This is true because the future is so uncertain. Dishonesty, accident, fire, or death may intervene to prevent the actual enjoyment of this wealth in the future. Therefore, man prefers to consume and enjoy it now. But should an individual resist this tendency and thus abstain from present consumption, he would be obliged, while saving, to make sacrifices. As an inducement, therefore, for him to save and as a reward for these sacrifices, he is offered more future value for his present wealth. Instead of a thousand dollars to-day, he receives a thousand and fifty dollars next year. This difference of fifty dollars offsets his undervaluation of the future and is a sufficient inducement for him to save and

***From the standpoint of saving.***

create capital. If such a premium in the form of interest were not offered, few would make present sacrifices, wealth would be immediately consumed, and little capital would be created.

*From the standpoint of efficiency.*

If we regard capital from the standpoint of efficiency, we find that the payment of interest is still necessary. When we regard capital as resulting from increased efficiency, rather than mere saving, interest must be paid, not as a reward for sacrifices, but as a means of preserving capital. For example, the millionaire's capital must be paid interest in order that it may be preserved. Man's undervaluation of the future still exists; and, should he not be offered a higher future value in order to offset this discount of the future, he would squander his wealth in present consumption. The spendthrift dissipates the fortune of his ancestors, and young men with large fortunes frequently enjoy the reputation of being "good spenders." While in these cases it would be an exaggeration to speak of interest as paid for rewarding sacrifices, it is equally evident that it must be paid for preserving capital. Should interest not be paid, the great accumulations of capital we now have would eventually be destroyed. Therefore, whether we regard capital as resulting from saving or from efficiency, the necessity for the payment of interest still exists.

**Rate of Interest.** — The next question that naturally arises is: What determines the rate of interest? From the previous discussion, it may readily be seen that this must likewise depend upon man's valuation of the future. Of course there is an individual and a social valuation. It need hardly be said that this latter is the determining factor in fixing the market rate of interest. If one individual values the future highly, his individual rate of interest would be low. He would not need much future promise to induce him to invest his wealth in a productive enterprise. If, however, the community's valuation should be low, the market rate of interest would be high. To offset this low regard for the future, a great premium would have to be offered in order to induce the community to refrain from present consumption. Under these circumstances, a particular individual, having a high valuation of the future, would profit by the higher market rate of a community with a low valuation. In any given community, however, the market rate of interest will be low or high according as to whether men in general put a high or low estimate on future values. In older and more civilized countries, because man values the future highly, the rate of interest is lower than in younger and less civilized countries where the future is greatly discounted.

**Man's valuation of the future.**

It is likewise apparent that when the community as a whole places a high valuation on the future, many people will abstain from present consumption and devote a large proportion of their wealth to productive purposes. This will cause the supply of capital to be plentiful, while the rate of interest will be low. On the other hand, when people place a low estimate on the future they will consume freely in the present and so reduce the amount of wealth devoted to productive enterprise. This situation will cause capital to become scarce, while at the same time the rate of interest will be high. Thus there develops a certain relation between the supply of capital and the rate of interest. When the supply of capital is great as compared with the demand for it, the rate of interest will be low; and, conversely, when the demand for

**Other considerations:** ***Supply and demand.***

capital is great as compared with its supply, the rate of interest will be high.

*Element of risk.*

Again, the element of risk is frequently spoken of in connection with interest. For example, it is often said that a high risk means a high rate of interest, and low risk a low rate of interest. This, however, is but another phase of man's valuation of the future. If an individual believes that the use to which his capital is put is accompanied by great risk, that is, if its future seems uncertain to him, he will demand a high rate of interest. The value of this wealth in the future looks so slight that a high rate of interest in the present is demanded. Generally speaking, however, the element of risk, to-day, is largely eliminated in the reckoning of pure interest. When, for example, money is deposited in a savings bank, there is practically no risk whatever involved in its investment.

**Source of the Interest Fund.** — There remains yet to be examined the source of the interest fund. Whence comes the fund from which interest is paid? We have just seen why it is necessary to pay interest and the factors involved in determining the rate of interest. But how does society secure the means with which to pay this sum necessary for the use of capital? Does capital get it by robbing labor? If so, labor is exploited by capital, and that which should go to the laborer in the form of wages the capitalist appropriates as interest. This view is popular with the laboring class. They are very willing to believe that the payment of interest deprives them of their full wages. Sometimes, too, there is little doubt but that this actually occurs. When large dividends are paid on "watered" stock and when, through monopoly,

**The popular view.**

an unfair advantage is taken of labor, there is every likelihood that interest is paid at the expense of wages.

As opposed to this popular belief, we have the scientific view that capital creates its own fund from which interest is paid just as labor produces the wealth from which wages is paid. Capital, to-day, plays as great and powerful a part in the productive process as the other requisites of production. Interest, then, may be paid without any infringement on the rights of labor from the extra fund of wealth that capital has created. If a merchant, for example, by making his store more attractive, that is, by adding to its capital and appointments, increases his business through the efficiency of capital, the extra return thus resulting furnishes the fund from which interest is paid. Thus, through increased output brought about by increased capital, interest is legitimately provided.

**The scientific view.**

This statement of the theory of interest brings forward its essential features. In the first place, the payment of interest for the use of capital is necessary, regardless of whether we consider saving or efficiency as the factor of prime importance in the development of capital. In the next place, the market rate of interest in any given community depends upon the social valuation of the future. Finally, the fund from which interest is paid is provided through the productive power of capital itself. Capital is thus entitled to its normal reward as much as is land or labor.

**The summary.**