

## CHAPTER IX

### THE NATURE AND THE RATE OF INTEREST

INTEREST denotes that part of the product of industry which goes to the capitalist. As the ownership of land commands rent, so the ownership of capital commands interest; as rent is a price paid for the use of land, so interest is a price paid for the use of capital.

However, the term capital is less definite and unambiguous, both in popular and in economic usage, than the word land. The farmer, the merchant, and the manufacturer often speak of their land, buildings and chattels as their capital, and reckon the returns from all these sources as equivalent to a certain per cent of interest or profit. This is not technically correct; when we use the terms capital and interest we should exclude the notions of land and rent.

#### *Meaning of Capital and Capitalist*

Capital is ordinarily defined as, wealth employed directly for the production of new wealth. According as it is considered in the abstract or the concrete, it is capital-value or capital-instruments. For example, the owner of a wagon factory may describe his capital as having a value of \$100,000, or as consisting of certain buildings, machines, tools, office furniture, etc. In the former case he thinks of his capital as so much abstract value which, through a sale, he could take out of the factory, and put into other concrete capital forms, such as a railroad or a jobbing house. In the latter case he has in mind the particular instruments in which his capital is at present embodied. The capital-value concept is the more convenient,

and is usually intended when the word capital is used without qualification. It is also the basis upon which interest is reckoned; for the capitalist does not measure his share of the product as so many dollars of rent on his capital-instruments, but as so many per cent on his capital-value.

Capitalists are of two principal kinds: those who employ their own money in their own enterprises; and those who lend their money to others for use in industry. The former may be called active capitalists, the latter loan-capitalists. Perhaps a majority of active capitalists use some borrowed money in their business. To the lenders of this borrowed money or capital they turn over a part of the product in the form of interest. When, therefore, interest is defined as the share of the product that goes to the capitalist, it is the owner of capital-value rather than of capital-instruments that is meant. For the man who has loaned \$50,000 at five per cent to the wagon manufacturer is not, except hypothetically, the owner of the buildings which have been erected with that money. These are owned (subject possibly to a mortgage) by the borrower, the active capitalist. But the abstract value which has gone into them continues to be the property of the lender. As owner thereof, he, instead of the active capitalist, receives the interest that is assigned to this portion of the total capital. Hence interest is the share of the product that is taken by the owner of capital, whether he employs it himself or lends it to some one else. While the fundamental reason of interest is the fact that certain concrete instruments are necessary for making product, interest is always *reckoned* on capital-value, and goes to the owner of the capital-value. It goes to the man whose money has been put into the instruments, whether or not he is their owner.

#### *Meaning of Interest*

Interest is the share of the capitalist as capitalist. The man who employs his own capital in his own business

receives therefrom in addition to interest other returns. Let us suppose that some one has invested \$100,000 of borrowed money and \$100,000 of his own money in a wholesale grocery business. At the end of the year, after defraying the cost of labor, materials, rent, repairs and replacement, his gross returns are \$15,000. Out of this sum he must pay five thousand dollars as interest on the money that he has borrowed. This leaves him a total amount of ten thousand dollars as his share of the product of the industry. Since he could command a salary of three thousand dollars if he worked for some one else, he regards his labor of directing his own business as worth at least this sum. Deducting it from ten thousand dollars, he has left seven thousand dollars, which must in some sense be accredited as payment for the use of his own capital. However, it is not all pure interest; for he runs the risk of losing his capital, and also of failing to get the normal rate of interest on it during future unprosperous years. Hence he will require a part of the seven thousand dollars as insurance against these two contingencies. Two per cent of his capital, or two thousand dollars, is not an excessive allowance. If the business did not provide him with this amount of insurance he would probably regard it as unsafe, and would sell it and invest his money elsewhere. Subtracting two thousand dollars from seven thousand, we have five thousand left as pure interest on the director's own capital. This is equivalent to five per cent, which is the rate that he is paying on the capital that he has borrowed. If he could not get this rate on his own money he would probably prefer to become a lender himself, a loan capitalist instead of an active capitalist. This part of his total share, then, and only this part, is pure interest. The other two sums that he receives, the three thousand dollars and the two thousand dollars, are respectively wages for his labor and insurance against his risks. Sometimes they are classified together under the general name of profits.

Let us suppose, however, that the gross returns are not \$15,000 but \$17,000. How is the additional sum to be denominated? In strict economic language it would probably be called net profits, as distinguished from normal or necessary profits, which comprise wages of direction and insurance against loss. Sometimes it is called interest. In that case the owner of the store would receive seven instead of five per cent on his own capital. Whether the extra two per cent be called net profits or surplus interest, is mainly a matter of terminology. The important thing is to indicate clearly that these terms designate the surplus which goes to the active capitalist in addition to necessary profits and necessary interest.

At the risk of wearisome repetition, one more example will be given to illustrate the distinction between interest and the other returns that are received in connection with capital. The annual income from a railway bond is interest on lender's capital, and consequently pure interest. Ordinarily the bondholder is adequately protected against the loss of his capital by a mortgage on the railroad. On the other hand, the holder of a share of railway stock is a part owner of the railroad, and consequently incurs the risk of losing his property. Hence the dividend that he receives on his stock comprises interest on capital plus insurance against loss. It is usually one or two per cent higher than the rate on the bonds. Since the officers and directors are the only shareholders who perform any labor in the management of the railroad, only they receive wages of management. Consequently the gross profits are divided into interest and dividends at fixed rates, and fixed salaries. When a surplus exists above these requirements it is not, as a rule, distributed among the stockholders annually. In railroads, therefore, and many other corporations, interest is easily distinguished from those other returns with which it is frequently confused in partnerships and enterprises carried on by individuals.

*The Rate of Interest*

Is there a single rate of interest throughout industry? At first sight this question would seem to demand a negative answer. United States bonds pay about three per cent; banks three or four per cent; municipal bonds about four per cent; railway bonds about five per cent; the stocks of stable industrial corporations about six per cent net; real estate mortgages from six to seven per cent; promissory notes somewhat higher rates; and pawnbrokers' loans from twelve per cent upward. Moreover, the same kind of loans brings different rates in different places. For example, money lent on the security of farm mortgages yields only about six per cent in the states of the East, but seven or eight per cent on the Pacific coast.

These and similar variations are differences not so much of interest as of security, cost of negotiation, and mental attitude. The farm mortgage pays a higher rate than the government bond partly because it is less secure, partly because it involves greater trouble of investment, and partly because it does not run for so long a time. For the same reasons a higher rate of interest is charged on a promissory note than on a bank deposit certificate. Again, the lower rates on government bonds and bank deposits are due in some degree to the peculiar attitude of that class of investors whose savings are small in amount, who are not well aware of the range of investment opportunities, and to whom security and convenience are exceptionally important considerations. If such persons did not exist the rates on government bonds and savings deposits would be higher than they actually are. The higher rates in a new country on, say, farm mortgages are likewise due in part to psychical peculiarities. Where men are more speculative and more eager to borrow money for industrial purposes, the demand for loans is greater relatively to the supply than in long established and more conservative com-

munities. Therefore, the price of the loans, the rate of interest, is higher.

In one sense it would seem that the lowest of the rates cited above, namely, that on United States bonds, represents pure interest, and that all the other rates are interest plus something else. Nevertheless, the sums invested in these bonds form but a very small part of the whole amount of money and capital drawing interest, and they come from persons who do not display the average degree either of business ability or of willingness to take risks. Hence it is more convenient and more correct to regard as the standard rate of interest in any community that which is obtained on first class industrial security, such as the bonds of railroads and other stable corporations, and mortgages on real estate. Loans to these enterprises are subject to what may properly be called the average or prevailing industrial risks, are negotiated in average psychological conditions, and embrace by far the greater part of all money drawing interest; consequently the rate that they command may be looked upon as in a very real and practical sense normal. While this conception of the normal rate is in a measure conventional, it accords with popular usage. It is what most men have in mind when they speak of the prevailing rate of interest.

The prevailing or standard rate in any community can usually be stated with a sufficient approach to precision to be satisfactory for all practical purposes. In all the Eastern States it is now about six per cent; in the Middle West it is somewhere between five and six per cent; on the Pacific coast it is between six and eight per cent. The Supreme Court of Minnesota decided in 1896 that, in view of the actual rates of interest then obtaining, five per cent on the reproduction cost of railroads was a fairly liberal return, and could be adopted by the state authorities in fixing charges for carrying freight and passengers.<sup>1</sup> A few years later the Michigan tax commission allowed the railroads

<sup>1</sup> "Final Report of the Industrial Commission," pp. 410, 411.

four per cent on the reproduction cost of their property, on the ground that investments which yielded that rate in addition to the usual tax of one per cent or five per cent before the deduction of the tax, stood at par on the stock market.<sup>1</sup> In other words, the prevailing rate was five per cent. At the beginning of the year 1907, the railroad commission of Wisconsin fixed six per cent as the return to which the stockholders of railroads were entitled, because this was about the return which investors generally were able to get on that kind of security. In the view of the Commission, the current rate of interest on railroad *bonds*, and similar investments, was about five per cent.<sup>2</sup> The significance of these decisions by the public authorities of three states is found not so much in the particular rates which they sanctioned as in the fact that they were able to determine a standard or prevailing rate. Therefore a standard rate exists.

What causes the rate to be five per cent, or six per cent, or any other per cent? Briefly stated, it is the interplay of supply and demand. Since interest is a price paid for the use of a thing, *i.e.*, capital, its rate or level is determined by the same general forces that govern the price of wheat, or shoes, or hats, or any other commodity that is brought and sold in the market. The rate is five or six per cent because at that rate the amount of money offered by lenders equals the amount demanded by borrowers. Should the amount offered at that rate increase without a corresponding increase in the amount demanded, the rate would fall, just as it would rise under opposite conditions.

Supply and demand, however, are merely the immediate forces. They are themselves the outcome or resultant of factors more remote. On the side of supply, the principal remote forces which regulate the rate of interest are: the industrial resources of the community, and the relative

<sup>1</sup> "Report of the Industrial Commission," vol. IX, p. 380.

<sup>2</sup> "Publication No. 32 of the Railroad Commission of Wisconsin," pp. 165, 166.

strength of its habits of saving and spending. On the side of demand, the chief ultimate factors are: the productivity of capital-instruments, the comparative intensity of the social desires of investing and lending, and the supplies of land, business ability and labor. Each of these factors exercises upon the rate of interest an influence of its own, and each of them may be assisted or counteracted by one or more of the others. Precisely what rate will result from any given condition of the factors cannot be stated beforehand, for the factors cannot be measured in such a way as to provide a basis for this kind of forecast. All that can be said is that, when changes occur on the side of either demand or supply, there will be a corresponding change in the rate of interest, provided that no neutralizing change takes place on the other side.