A Theory of Interest

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THE INTEREST QUESTION

FOR centuries the interest question has been a subject of discussion among philosophers, economists, and reformers of all shades of opinion, yet it has never been settled. No general agreement has ever been reached as to what interest is, what causes it, how it is determined, and whether or not it is equitable.

The feeling that interest is unethical is perhaps as old as interest itself. Long before Christ was born, the taking of interest was denounced as unjustifiable by philosophers like Plato, Cicero and Aristotle. Later the Roman Catholic Church condemned the practice and laws were passed forbidding it; but in spite of all efforts at suppression, interest persisted. This is no doubt the reason why it came to be regarded as a natural economic fact by all economists, who have tried ever since to justify interest as the legitimate reward of those whose industry and thrift (?) have enabled them to accumulate capital.

Today interest is more firmly established than ever. It has become an integral part of our economic system and is regarded by rich and poor alike as a beneficial and necessary institution. Interest, we are told, is the reward of thrift, and thrift is a virtue; could a virtue bear evil fruits?

Yet, even today, there are thinkers who, like the ancient philosophers, look upon interest as but a form of privilege and a tribute upon labor. It seems to me that such views are not without justification. In fact I believe such feeling to be the logical reaction in any one possessed of a sense of justice, whose judgment has not been warped by the incongruous teachings of our plutocratic civilization.

No one can possibly question the right of the man who has produced and accumulated wealth, to live without working as long as it takes him to consume the wealth he has accumulated; to be told however, that he should be able to live without working for an indefinite period, and his children, grandchildren and their descendants after him, without even taking from his accumulation, but entirely from the interest thereon, is somewhat disturbing to the minds of those who are convinced of the righteousness of the command: "By the sweat of thy brow thou shalt eat bread."

*I wish to say that my views on interest, as expressed in this article, in no wise affect my adaptation of "Progress and Poverty" in a forthcoming work, "The Philosophy of Freedom" (advertised elsewhere in this issue). In that book, I have adhered scrupulously to the views of Henry George.

However, some prominent Georgeists have suggested that the above article be printed as an appendix to the aforesaid book, not only to present students with a new angle on the moot question of interest, but also to impress upon them that one may disagree with George on interest and yet fully accept his fundamental philosophy. —G. H.

HENRY GEORGE'S THEORY OF INTEREST

In "Progress and Poverty" Henry George attempts to explain and justify interest in a unique theory, in which he bases interest on the reproductive forces of nature. He tells us ("Progress and Poverty," Book III, Chapter III) that capital, when used in the reproductive modes, receives a natural increase over and above that due to labor, and while capital has to yield a certain portion of this increase to labor, it retains the other portion, which is interest. George then goes on to say that any one possessing capital can demand and receive this increase (interest) even though his capital is used in other modes. For the same reason, he who has money which could buy seeds or breeding stock will exact from the borrower the interest he could thus secure from nature.

This is a logical deduction from the premise that nature gives an increase to capital apart from the return to labor. If, however, the premise is false, as I believe it is, then the conclusion is not valid.

It cannot be denied that the reproductive forces of nature give an increase. A small cabbage seed buried in the ground will become a cabbage weighing several pounds. A calf turned out in the pasture will in time grow into a cow, and it is evident that such amazing results are due mostly to nature and not to the labor of man. But it does not follow that this work of nature increases the capital of the farmer.

The ultimate purpose of all production is the satisfaction of human wants, and this is obtained by an increase in quality or usefulness as well as by an increase in quantity. The power of shoes to satisfy human wants over that of skin and hides is not less than the power of the wheat crop to satisfy human wants over that of seeds. In either case the return to labor and capital is based on the value created whether it be quality or quantity.

When the farmer takes his wheat or his cattle to market, he exchanges something which is partly his work and partly the work of nature. *But does he get anything in exchange for the work of nature? He does not, for the effect of the cooperation of nature is to give more produce for the same amount of labor, hence, not to increase his return as a producer but to lower the exchange value of his product.*

And the same is true of the increased productivity due to the use of capital in non-reproductive modes. If the shoemaker has used machinery which has enabled him to produce more shoes with a given amount of labor, the effect of this greater productivity will be to lower the price of shoes. Barring monopoly, he cannot sell the added productivity due to the use of capital any more than the farmer can sell the added productivity due to nature.

Henry George has clearly demonstrated that the power which exists in tools to increase the productiveness of labor cannot be the cause of interest, and to this I add that neither can the reproductive power of nature. In this connection I wish to formulate an economic principle which I deem of importance, inasmuch as it bears on the foregoing discussion. It is this:

Those forces, outside of man himself, which increase the productiveness of labor, when such are used to increase production, never benefit the producer as such but always the consumer as such, unless these forces are monopolized, in which case the benefit will accrue, not to capital or to labor but to monopoly in the form of extraordinary profits or in the form of rent.

If this principle is economically sound, it will serve to prove that the reproductive forces of nature cannot be the basis of interest, for interest is unquestionably a production cost and cannot benefit the consumer as such; and if the reproductive forces of nature do benefit the consumer by lowering the value of the product, they cannot give any increase to the labor or the capital of the producers.

But is it not a fact that capital generally obtains a return over and above its replacement and compensation for risk? This is an absolute fact in the case of money, though not always a fact in the case of real capital; but whenever capital can command such a return, it is certainly not due to the reproductive forces of nature.

THE NATURE AND FUNCTION OF CAPITAL

The failure to reach an agreement as to the cause of interest is simply a consequence of the failure to agree as to what interest is, and this in turn is due to the confusion that exists concerning the nature and function of capital and its true relation to labor.

What is capital and what is its purpose? Capital is wealth, i. e., labor products made or accumulated for the purpose of aiding labor in production. As production includes making, transporting and exchanging, capital has been properly defined as wealth in the course of exchange, i. e., wealth which has not as yet reached the ultimate consumer.

In the field of agriculture it consists of: seeds, breeding stock, tools, machinery, buildings, produce for sale, etc.

In the field of manufacturing, mining or transportation, it consists of: buildings, machinery, materials, equipment, finished goods, etc.

In the field of commerce it consists of: buildings, equipment, stocks of merchandise, etc.

When we see the huge and expensive machinery used in a modern mill or factory, we are apt to think of it as having nothing in common with the simple tools of the old fashioned cobbler or journeyman mason or carpenter. Yet, though the difference is enormous, it is but a difference in degree, not a difference in kind, and for the purpose of our discussion we might just as well think of capital as a simple tool such as a spade or a carpenter's plane.

A tool, which is the most characteristic form of capital, is nothing more than a contraption conceived, produced, and utilized by labor to produce wealth more efficiently; it is, so to speak, an artificial amplification of man's physical power by man himself. It is labor's own brain child, and what is true of tools is true of all other forms of wealth used as productive instruments.

And now that labor has produced wealth with the aid of this thing called capital, we are confronted with the task of determining how much of the produce shall go to capital in interest and how much to labor in wages. Justice demands that each shall receive what it produces, but what has capital produced?

Capital itself, whatever its form, has no productive power. What we might term "live capital," of which domestic animals, cultivated plants and trees are good examples, has a power of growth but this should not be confused with productive power, which is essentially a human power. The power of growth is a natural power altogether independent of man's effort. It is not an attribute of capital but a characteristic of all living things under any condition.

As for "inanimate capital" such as tools, machinery, etc., it is as dead as a door nail and has no more productive power in itself than would a man's arm cut off from his body. Not that man's limbs have in themselves any productive power, for man's arms and hands are but natural tools which can operate only through man's mind. We speak of physical labor as one thing and of mental labor as another, but this distinction is not a fundamental one. There is no such thing as purely physical labor, i. e., labor dissociated from the exercise of the mental faculties. Even in what we call physical labor, it is not the hand that produces, it is the mind which directs the hand. Likewise it is not the tool that produces, it is the mind which directs the hand that guides the tool.

No matter how much capital existed and no matter how rich the field of production, not one iota of wealth could they bring forth without labor. It is only by labor that capital is produced; it is only in the hands of labor that it can be utilized productively; how then, can we think of capital earning anything to which labor is not entitled?

The fact is that capital itself produces nothing and is not entitled to any part of the product as a factor of production, and this for the simple reason that *capital is not a factor of production.*

Here I beg to take issue with all economists, past and present, who consider capital a factor of production apart from labor. This, in my opinion, is the economic fallacy which is responsible for the failure to arrive at a satisfactory conclusion concerning interest.

Capital is not a factor of production, it is merely a factor (instrumentality) of labor.

Nature provides all animals with such natural implements as enable them to secure sustenance and protection, together with the instinct to use them to the best advantage. Nature has not been quite so generous with man as regards physical assets, but on the other hand nature has gifted man with that which no animal possesses, viz., the power of reason. Vested with this power, man can produce tools and weapons so superior to anything which nature can provide, that they have enabled him not only to gain dominion over the animal kingdom but to harness nature itself to do his work.

Bearing in mind that capital is anything external to man which he has secured through conscious effort and which he uses to aid in production, was there ever a time when men produced without capital? Never, for if there ever was a time when human beings lived by producing all their needs entirely with their bare hands, such human beings could hardly be called "men." The most primitive savage we know of made use of objects external to him, fashioned or secured by him, were it nothing more than sticks and stones.

The use of capital by man is therefore as natural as the use of his own powers. Labor alone needs capital, labor alone can produce it, and labor alone can utilize it. It is an integral part of labor. How can we think of it as a separate factor? It is just as natural for a laborer to have capital to work with as it is for a buffalo to have horns or for a tiger to have claws. We expect a laborer to own his clothes—why not his tools?

THE NATURE OF INTEREST

But, since capital can produce nothing without labor, and labor can produce hardly anything without capital, it is utterly impossible to determine their respective contribution to a given result on the basis of what each could have produced alone. How, then, is interest, which is supposed to represent the contribution of capital in aid of labor, determined?

To this question there is but one answer and one explanation. What we call interest does not represent the contribution of capital in aid of labor; it represents that part of labor's produce which labor agrees to surrender for the loan of capital. It is determined by supply and demand in the loan market.

It is not until borrowed capital is used in production that a division between labor and capital is necessary. The producer who uses his own capital has no concern in ascertaining what he would have produced without it, any more than he is interested to know how much less he would have produced were he stupid instead of intelligent or sickly instead of healthy.

Had laborers always owned their tools and whatever other labor products they needed to work with, how could such a thing as interest ever have been thought of?

If there were, in general, an advantage to labor in borrowing capital rather than owning it, this might be some justification for interest, but the cases where borrowing is more advantageous than the use of one's own capital are exceptions and not the rule. It cannot be said that laborers do not own their capital because it is more profitable to borrow it. The incentive to accumulate capital cannot be greater for the lender who receives interest than it is for the borrower who pays it. If laborers do not accumulate capital, it cannot be that they find accumulation unprofitable, it must be that they find it impossible.

That we have today a class known as "labor" who use capital and another class known as "capital" who supply it, is but the result of economic injustice which, by depriving the laborers of the fruits of their toil, makes it impossible for them to accumulate capital and compels them to borrow their own production.

Capital is, as we have seen, an integral part of what in political economy is called "labor." Accordingly what man produces with or without the aid of capital is (excluding rent) a return to labor and can only come under the head of "wages."

Land and labor (including capital) are economic facts essential to the production of wealth, but while the use of capital is necessary to production, the borrowing of capital is not. Borrowing and lending are not economic processes but purely social phenomena. Therefore, interest, which is nothing more than the price of a loan and the only cause of which is the need for borrowing, is not an economic fact and has no place in distribution.

After allowance is made for the replacement of capital, wealth is divided, not into three parts but only two, viz., rent and wages.

Having established the fact that interest is not a return to capital as a factor (since capital is not a factor of production), nor a return to the use of capital (the return to which is wages), but only to the loan of capital, it remains to be seen how interest is determined.

We hear of borrowing capital and paying interest at a certain rate or percentage, but what does it mean? When a man goes into the printing business, for example, does he borrow printing presses, linotypes, paper, ink, etc. from those who manufacture these products, and does he pay them interest? Of course not. Those who produce capital goods are not lenders of capital; they produce them for sale just as the farmer produces and sells potatoes. Those who need capital goods buy them from those who produce them and whose return is therefore wages and not interest.

But if capital goods are purchased and not borrowed, what is borrowed? It is the medium of exchange, money or its equivalent, i. e., purchasing power.

If actual capital were borrowed, we would have an independent rate of interest for each form of capital, which would be based on the supply and demand, for loaning purposes, of each particular commodity. But since all commodities may be secured through the medium of money, it stands to reason that the rate of interest will be that at which money or purchasing power may be borrowed. Therefore, interest being a return to lending, it is the return to money lending, and the interest rate is determined by supply and demand in the money loan market.

Money or loan interest is therefore pure interest, i. e., the only real interest, and must not be confused with the returns of producing capitalists, manufacturers, merchants, and other business men, for though the return to their capital may be affected to some extent by what they could have secured in the money loan market, it is on the whole nothing more than wages of superintendence and compensation for risk commonly known as "profits." It is only when business is good that such profits include real interest, for when business is bad and competition keen, the average business man is lucky if he can maintain his capital and in addition receive a fair compensation for his work and risk.

In money lending there is no replacement; risk is covered by collateral and the return is fixed in advance by contract. But the business man cannot thus fix the rate of return on his capital, for the price at which he sells his goods is determined by the market and consequently his profits are always subject to market and business conditions. Furthermore, the supply of capital goods in productive use cannot affect interest since it is not part of the supply of loanable capital. Neither are new capital goods for sale a factor in determining interest, for the supply of such can only affect their market price, not the interest rate, which is essentially a loan rate.

It is hardly necessary to point out that, inasmuch as money loans are secured by collateral, and there being no depreciation or labor involved, allowing only for any possible insurance against loss, the return to money lending, viz., interest, is an unearned increment, a form of privilege to which too little attention has been paid by economists and social reformers.

CONCLUSION

In the light of the foregoing discussion we may give answer to the questions involved in the interest problem, i. e., what is interest? what causes interest? how is interest determined? is interest equitable?

Interest is the return to the loan of money or its equivalent in actual wealth. It is caused by the need for borrowing, due in the main to poverty. It is determined by supply and demand in the money loan market.

As for the question: Is interest equitable? this depends on whether we are considering interest as a private business transaction or as an institution. The former is equitable because it is a contract freely entered into by two parties, both of whom, under the prevailing circumstances, derive a benefit from the transaction. The latter is inequitable because it is forced upon the people as a result of a condition of social and economic injustice which creates debts and which deprives men of the opportunity to receive and accumulate the wealth which their labor brings into existence.

It is not likely that the borrowing of money shall ever cease altogether. Life will always have its ups and downs, and men, whether in private life or in business, may at times be forced or induced by circumstances to call on others for financial assistance and be willing to pay for a service thus rendered them. But given just social conditions and an equitable distribution of wealth, the equation between the number of those able and willing to lend and the number of those forced to borrow will be such that loans will be obtainable at very low rates. Such loans will be but temporary burdens easily borne.

On the other hand, interest as an institution is but the evil fruit of an evil economic system. It has its roots in land monopoly and the resultant exploitation of labor. It will tend to disappear with an equitable distribution of wealth. Public debts will be unnecessary when the world goes to work instead of going to war and governments subsist on their legitimate and natural income, the rent of land. Mortgages and other private debts will vanish when land is free and wages high. Capital invested together with labor will bring handsome returns, but capital or money seeking investment without labor will find little or no market.

This is not to say that there will be no savings to provide for man's needs in sickness and old age, nor accumulations for future consumption or future productive undertakings, but the system which enables an individual to lend his money at interest and watch his fortune grow while he lives in luxury without doing a stroke of work, will be a thing of the past.

To the A.A.A.

On Reading "The Grapes of Wrath"

IF we must buy our right to live on Earth,
What are your favors to the migrants worth?
If Joad be penniless, must he not live
As Ishmael did — a locked-out fugitive?
Your loans are no relief, although well meant;
What's Interest but another kind of Rent
With Taxes added? . . . As for good intentions,
They are the paving stones the cynic mentions!
Can Friday be made free from Slavery's toil,
If Crusoe still is master of the soil?
Not being bird, he could not reach the sky;
And Friday was no fish, the sea to try . . .
Unless you free the Earth, call off your quacks--
They'll only pile more burdens on our backs!

—HORATIO

. . .

P M, New York City's latest daily newspaper, has carried some articles on land speculation. One is a story of Muscle Shoals, which, after two decades, is still a hotbed of speculation. Lots of 20 by 100 feet are being sold for $1000 and $5000. More than $20 millions have been "poured down the sink" by credulous buyers. Another is a story of the new Zoning Ordinance of New York City. Land owners and speculators have fought the bill, since it limits the blighting of residential areas. P M praised Harold S. Buttenheim and the City Housing Council for backing up the Ordinance.