

## What is Interest?

BY RAYMOND V. McNALLY

**I**NTEREST is commonly referred to in much the same way as the terms "money" and "property"—glibly, without any definite understanding of what it really is and what causes it. Interest is the return for the use of capital," people say, believing that with this simple assertion they have completely disposed of the matter. If pressed to explain the cause of interest, they amiably accept any plausible theory with the comment that interest is of no great importance anyway. Many Georgeists, confident that they know the whole truth because of their acceptance of Henry George's correlation of the law of rent and the law of wages, also assume this unscientific attitude, without realizing that such complacency is dangerous in the light of the confusion relating to economic matters that pervades the world today. As George insisted upon treating economics as a science, they are actually violating the trust that he reposed in those who followed him to carry further the application of the general principles that he laid down, wherever necessary. To many people, the Marxists particularly, the question of interest is highly important and any unscientific explanation of it tends to discredit in their minds even the law of rent and the law of wages.

Some Georgeists blindly accept George's law of interest without fully understanding it, as one might a religious tenet. Others profess belief in it but under pressure of discussion, reveal a belief in something entirely different. Still others, while frankly rejecting his theory, are seen to hold various other ideas that fail to stand up under examination. Is it not significant that while there is a general agreement among economists on the law of rent, there is none on the question of interest? The interest problem has plagued the human race from ancient times right down to the present day, and although an enormous amount of literature has been written on the subject, it has not yet been satisfactorily solved. Obviously the failure to agree is due largely to a confusion of terminology and a misuse of words. Now, I am well aware of the fact that the subject of interest cannot be treated thoroughly in the limited space of a single article, and it may be that I shall not do full justice to the different theories and the various phases of each that have been advanced by many different economists. Yet all of these theories cannot be correct. While each is based on a different principle, in some respects they are quite similar. Therefore, I shall confine myself to a discussion of a few of the more prominent theories, disclosing the errors that are peculiar to each and pointing out the fundamental error that is common to all of them.

Let us begin by stating what economists mean by interest. It is the income that accrues to all capital in the production of wealth, regardless of its nature, above

its replacement value. It includes all returns from the use of capital, whether the capital is used by the owner or borrower, but excludes compensation for risk and for wear and tear obsolescence. We are not seeking the cause of any particular rate of interest but of the *general* rate of interest. Thus, we must view capital in the general sense, that is, as it relates to the community and not to an individual, for the income that an individual may acquire from the use of his capital might not add to the sum total of wealth. Wealth consists of tangible goods produced by labor when applied to land, and capital represents that part of wealth that is not consumed immediately but that is employed by labor in order to obtain more wealth. We must be careful to avoid at the same time any reference to whether interest is right or wrong until after we have reached our conclusions, for economic science is not concerned with the question of morals.

The phenomenon of barren capital yielding a return to the lender who rendered no service for it first engaged the attention of philosophers—Plato, Aristotle, Cicero and others—who condemned it as unjust. After the collapse of Rome, the Roman Catholic Church continued the attack on it and so strong was its authority that legislation outlawing it was passed throughout all Christendom. Not concerning themselves in the least with any logical analysis of interest nor with determining the exact cause of it, the protest of the canonists, like that of the ancient philosophers, was steeped entirely in considerations of justice and benevolence, for they were aroused by what they considered the injustice of inanimate things enjoying a continuous existence and in addition yielding an increase to those who did nothing to earn it.

During all of this time, however, in spite of the ecclesiastical denunciation and the civil laws, the phenomenon of interest persisted in industrial life, because it was a natural part of the economic organism and could not be abolished by men. The canonists found it imperative, therefore, to support their hostility with something more than appeals to the sacred writings of the New Testament and those of the famous philosophers. Thomas Aquinas was probably the first of the Church fathers to take a theoretical approach to the problem by refuting the idea that there was an independent use of capital, that deserved a reward, aside from its actual consumption. But like those who followed him, his pronouncements were little more than an appeal to the moral aspects of the problem, for he did not explain the phenomenon of interest. Despite the inadequacies of the canonists' arguments, however, they seemed to be strong enough to hold their opponents in check. Calvin, the reformer, one of these opponents, justified interest on the grounds that the lender could put his money into land which would yield him an income, overlooking the fact that the interest rate would first have to be determined before the selling value of the land could be computed. Weak as the arguments of the opposition were, they did influence



thought and encouraged others to carry on the work of criticism.

The persistence of the phenomenon of interest in economic life and the lessening of the authority of the Church that resulted from the religious and political upheavals during the middle ages, permitted economists to write freely on the subject purely from the economic angle. Very few of them approached the problem, however, with entirely open minds. Most of them accepted interest as a fact, and their inquiries (with the exception of the Rodbertus and Karl Marx school of writers) consisted in strenuous efforts to justify it. None of them thought of questioning its reality—not even the socialist.

The simple claim that interest is the reward for the use of capital has been developed by some economists into very elaborate theories that have been achieved through a process of mental acrobatics, and any attempt to follow their long-winded and tortuous dialectics leaves one well nigh exhausted and almost incapable of further thought on the subject. The Say-Hermann school assumed in the case of the loan of capital that what was transferred to the borrower was not the capital itself but an independent use of the capital. The payment for the use of the capital was said to be interest. For instance, if A lent B a plow for a year and at the end of that time received back a new plow to replace the one that was worn out and part of B's crops as well, it was assumed that A received back the same plow he had lent and that the crops represented interest or payment for the use of that plow. But it can readily be seen that B had not only the use of the plow but the plow itself, and that what he returned to A was not the same plow but another equally as good. In other words, B wore the plow out during the year by using it and paid for the use of it by returning a new plow to A. What then can we regard the payment of part of his crops to represent? Surely we cannot assume that there are two distinct uses attaching to the loan of the plow. The using of it is the same thing as its consumption. If B instead of borrowing had bought the plow, he would have paid A at once a value that was equivalent to a new plow equally as good; but when he borrowed he paid A not only a new plow of equal value but part of his crops as well. Why? If it is said that this additional payment was for the delay in replacing the plow, then we are attributing interest, not to the use of the plow, but to the element of time, which is an entirely different matter. But inadequate as the use theory obviously is, as an explanation of interest, it leads us directly and indirectly into other theories.

One of them is the Abstinence theory of which N. W. Senior appears to be the originator. According to it, interest is the reward for abstaining from the immediate consumption of the results of one's labor. But abstinence in itself is not productive. It is a negative quality. If a man saves the fruits of his labor in the form of money

and keeps it locked up in a tin box, he has exercised as much abstinence as though he had lent it, yet he will expect no increase from it. It is said that when a man accumulates capital and lends it to another, he has rendered a service. But does not the second man render a service also by keeping it safely and returning it intact? In fact, the second service may be greater than the first. If the first man retained his capital, he would have the trouble of caring for it. It would deteriorate otherwise and eventually disappear. Capital, therefore, to be maintained must be used, and the borrower pays his debt in full when he replenishes or replaces the capital and returns it to the lender. The use is offset by the replacement. If the borrower must pay an additional sum as interest, is he not robbed? So the Marxist believes, who insists that interest accrues at the expense of labor. In my opinion, those who hold the Abstinence theory do not sufficiently meet the arguments of the Marxist.

Senior claimed that abstinence was a factor in production and that indemnification for the sacrifice involved in it was an element in the cost of production. In other words, capital is the result of two kinds of sacrifice—one involved in the labor directed to its production and one involved in the postponement of present enjoyment. This is obviously a double calculation. To make this point clearer, let us suppose an owner of capital uses it himself to produce more wealth. Out of the wealth produced, he pays himself wages for his labor and compensation for the effort he exerted in making the capital, which consists merely of its replacement value. Now, if he claims an additional sum for having abstained in the first place from immediately consuming his wealth instead of accumulating it in the form of wealth, he is overlooking the fact that without the aid of the capital his wages would not have been so great. He can include one or the other sacrifice in the cost of production but he cannot include both.

Our contemporary, Prof. Harry Gunnison Brown, in a discussion of interest in his "Economic Basis of Tax Reform" unfortunately falls into a similar error. He states on page 32 that an added annual output of industry is made possible by that person or persons "whose saving, whose excess of production over consumption, brought the capital into existence." He recognizes that savings of the individual are the result of an excess of production over consumption—in other words, that savings and excess production are one and the same thing. Yet he seems to overlook this fact when he insists that the individual receive not only wages for that excess production but also compensation or interest for the savings. Now, savings of course explain the existence of capital but they do not explain how interest arises. It is true, as Prof. Brown points out, that labor can produce more with capital than without it, but to insist that the increase

or any part of it is due to the owner of capital, is to assume that the person who uses it is not capable himself of saving part of the results of his own labor; that saving is the result of superior qualities or of a superior technique. This then would make the question one of wages and not of interest. If it is claimed that some people cannot afford to save, that they are forced to consume all that they produce and that, therefore, those who are in a more fortunate position render a real service by making their savings available for use in production, then what we are discussing is not capital but monopoly. It is only fair to point out here that Prof. Brown admits in his earlier book, "Economic Science and the Common Welfare," that saving is not limited to one class but is open to all and that those who use capital can save themselves and become the owners of their own capital. He concedes that some people would save even though there were no prospect of reaping a reward—for their old age and future security. He knows, too, that some people find it easy to save, while others find it hard, regardless of whether they are rich or poor. Yet those who find it hard to save receive no greater return on their capital. The millionaire does not suffer as much pain as the poor man when he saves—in fact saving might be a real pleasure—and realizing that the phrase "pain of saving" is rather too strong to apply generally, Prof. Brown chooses to use the expression "impatience" or "time-preference." At the same time, he perceives that "impatience" or "time-preference" varies with different people and that because of its lack of universality, it cannot serve as a reliable basis of interest. Consequently, he narrows the element of "impatience" down to that of the "marginal" saver—that is, the person who will not save unless he receives a compensation for so doing—and assumes that if it were not for this "marginal" saving, there would not be sufficient capital furnished for profitable enterprise. This is an arbitrary assumption, for it can be claimed with equal assurance that this "marginal" saving furnished rather too much capital. Interest then is regarded here as being caused not by all abstinence but only by that of the "marginal" saver; and although he has tried to avoid making the question one of monopoly, he has gone right around in a circle and met himself coming back, so to speak. In other words, the "marginal" saver holds the balance of power and the socialist's claim of exploitation, according to this reasoning, is sustained.

Realizing the weakness of his position because of the negative character of abstinence, Prof. Brown has sought to save himself by attributing interest directly to the productivity of capital. By the productivity of capital he does not mean that capital possesses the power to reproduce itself plus an increase but that labor can produce more with the aid of capital than without it, and this increase is interest. This is merely an assertion, for

although Prof. Brown has devoted 36 pages in his "Economic Science and the Common Welfare" to a discussion of the cause of interest, he has succeeded only in showing how capital is accumulated and how capital aids labor. But although he has not proved interest, he proceeds to show how various psychological factors influence the rate of interest to such an extent that the whole increase in production due to the use of capital might not necessarily go to capital. Here he brings in another element—the element of time—by estimating the desirability of present goods (which could be bought with one's savings) as compared with future goods (the product obtained with the use of capital). And although he is aware that no two men necessarily act alike under similar circumstances, he attempts to draw a general principle from probabilities, clearly revealing the influence exerted on him by Jevons and the Austrian economists. Thus his theory of interest appears to be a curious, eclectic blending of the Abstinence, Productivity and Time theories.

The Time theory, as developed by Eugen V. Böhm-Bawerk, briefly is this: Present goods are valued more highly than future goods. For instance, \$100 now is equivalent to say \$105 a year hence, the difference being interest. But it is not at all conclusive that present goods are always valued higher than future goods. It depends entirely on individual feelings. \$100 a year hence might seem to me to be much more desirable than \$100 now, if I had no immediate use for it but did contemplate a very important use for it in the future. If I did require an additional \$5, it would be because I wished to be compensated for the risk involved in waiting a year before I used my money, but this would not be interest. This Time theory is based on the utility theory of value which means that a thing derives its value from the intensity of individual desire measured by its marginal or lowest degree of usefulness. But marginal utility differs in the case of individuals. No matter how strenuously Böhm-Bawerk strives to make his value theory stand on its own feet, he is forced time and again to admit that the marginal utility of a thing depends in the last analysis on its scarcity which involves, as we know, human exertion. Human exertion stands supreme in this case, for while utility may be measured by exertion, exertion is never measured by utility. Desire cannot be measured in itself but only by the resistance it will overcome and this resistance to the gratification of desire is the pain of exertion. Therefore, the value of a thing depends not on its marginal utility but on the amount of exertion necessary to produce a similar thing. The futility of trying to draw a general principle from psychological probabilities is clearly shown in both the Abstinence and Time theories of interest. This probably explains why Böhm-Bawerk used so much space in his "Positive Theory of Capital" in his attempt to prove his point, for his book reads more



like a treatise on psychology than a discussion of economics. But while psychology might aid us in explaining certain relative economic phenomena (such as why one occupation will pay a higher wage than another), economic science has nothing to do with the purely subjective feelings and desires of individuals, from which no absolute laws can be deduced.

The Productivity theory, which we shall now consider, has always been a popular one because at first glance it appears so plausible. That labor can produce more with capital than without it seems self-evident and so its adherents ascribe the increase to the power that resides in capital. As to just what this power is or where it comes from there is no clear idea. Before proceeding, it might be well to determine what the "productive power" of capital means. There are two possible meanings. It may mean that capital aids labor to produce more goods and that such goods have more value than the capital consumed in their production, the increase being interest. There is no denying the fact that labor can produce more goods with the aid of capital than without it, but in order to prove interest, we must show that the value of these goods is greater than the capital consumed in their making. It does not necessarily follow that a greater quantity of goods is more valuable than a smaller quantity. Such a claim would have to be demonstrated. Let us suppose that A can catch 3 fish a day with his bare hands but finally decides to spend a day to make himself a fishing pole which will last the five days of a six-day working week. With this pole he can catch 10 fish a day, so that at the end of the five days when the pole will be worn out, he will have 50 fish and will take the last day to make himself a new pole. Without the pole he could only catch 15 fish and so he has gained an increase of 35. The productivity theorists assume that this increase is interest, and if the 50 fish represent a value greater than that of the 15 fish caught with the bare hands, this would be true. But no more exertion was required of A to catch 50 fish with the pole than to catch 15 with his bare hands. As value is measured by exertion and nothing else, the 50 fish is equivalent in value to the 15 fish and there is nothing left for interest. But it may be said that if A had lent his pole, he could have procured an increase from it. Let us assume then that A lends his pole to B for a week instead of using it himself. At the end of the five days, B will have 50 fish and will take the last day to make a new pole to return to A. Has B gained at the expense of A by this transaction? A in the meantime has taken the first day to make himself another pole which would last five days. At the end of the week he will stand in the same position as though he had not lent his pole—namely, 50 fish and a new pole which he received from B. B, on the other hand, if he had borrowed, could have made a pole for himself. It must be assumed of course that B is able

to make a pole as well as A, for otherwise our illustration would be one of superior skill and not of capital, and the question would be one of wages and not of interest. He would use the pole for the five days it would last and have 50 fish, exactly the same number he would have had if he had borrowed. Thus, B has gained nothing to the loss of A and need not pay any interest and A has gained no increase from lending. Where and how does interest arise then?

The other meaning of the "productive power" of capital is this: Capital possesses a power in itself of producing more value than it has in itself. Capital of course is productive because it enables labor to produce goods more efficiently, but that is a different thing from asserting that capital enables labor to produce more value. Capital in the physical sense, being the product of land and labor, consists of both natural and human powers. What gives rise to the value of capital, however, is not the natural power but the human power therein which manifests itself through actual exertion when the capital is used. For that reason then and despite the fact that George Gunton in his "Wealth and Progress" ridiculed the idea that capital was "stored-up labor" (human energy could only be stored up in a human being, he said), we are safe in saying, in the value sense, that capital formulation is the storing up of labor in concrete form. But by no stretch of the imagination can we say that when this energy is released through the use of the capital a value is created greater than its own value, and, therefore, we cannot explain interest by adopting this particular meaning of "productive capital."

If Henry George had attacked Bastiat's celebrated illustration of the plane in "Progress and Poverty" from the standpoint of natural interest instead of loan interest, he might never have chosen the reproductive forces of nature as constituting the cause of interest, thus avoiding the violation of some of his own fundamental concepts. In the first place, he had insisted time and again that capital was not an independent factor but the product of labor and that labor was the only active factor. Secondly, he had overlooked the fact that he had definitely named labor as the only source of value and that to attribute any value creation to the natural powers was a contradiction. Furthermore, in his illustration of the calf growing into a cow, he appeared to assume that the borrower was not in a position also to avail himself of the natural forces, making the illustration, therefore, one of monopoly and not one of capital. If the borrower had free access to nature, he could have produced a calf as well as the lender and cared for it until it had reached maturity, so that any increase due to nature would have been absorbed and freed him of the necessity of paying interest. His statement that if wine were put away, at the end of the year it would have increased in value because of the improved quality unfortunately confused



economic value with use value. He pointed out in his "The Science of Political Economy" that the value of a thing was not intrinsic—that is, it had nothing to do with its substance—but was due to the amount of exertion that would be required to reproduce it. The increase in the value of the wine was not due to its improved quality but to the labor expended in its production, for if a man makes wine and puts it away, his production has not stopped but continues—for waiting is a part of human exertion—until the end of the year. And even though the natural forces were capable of creating a value, George did not prove that the cow was any more valuable than the calf plus the action of nature, plus the labor expended in caring for it. It was merely an assertion. He was arbitrary also in assuming that the plane in Bastiat's illustration contained no vital force of nature, which helps man to produce. What is the difference between the reproductive force of nature in plant and animal life and the chemical and geologic forces in such things as poles, concrete, planes and machines? Isn't water power, for instance, a force outside of man himself even though it is not reproductive in character?

The error in all of this, however, is akin to the error of the Austrian economists in bringing psychological factors into economics. Economic science is not concerned with how nature helps man to produce wealth, for it has nothing to do with the physical laws of production. It is interested only in the laws of distribution which are based on a fundamental law of human nature, that men seek to satisfy their desires with the least amount of exertion. But while it may be said that this law is psychological and physiological, it is not peculiar to these sciences but is a universal law—the law that motion tends to seek a straight line or the line of least resistance—and is, therefore, common to all of the sciences, such as mathematics, chemistry, physics, geology, and biology.

The various schools of thought regarding interest have attempted to deduce a general law from a relative concept. Capital is not an independent factor like land and labor, for it can be received into both of these. Land and labor are absolute concepts and the returns that they yield must necessarily yield absolute returns. On the other hand, capital, being a relative concept and representing only a use to which wealth is put, must necessarily yield relative returns. As absolute returns and relative returns cannot logically stand on a parity with one another, it is incorrect to say that wealth is distributed into rent, wages and interest. Strictly speaking, wealth is distributed only in two ways, namely, rent and wages, and the only laws with which economic science is concerned then are those of rent and wages. We can no more deduce a general law of interest than we can deduce a general law of particular wages. The phenomenon in economic life that appears to be interest but which economic science is not able to locate is very likely nothing

else but compensation for risk, a relative return to capital analogous to the return that equalizes the hazards and disagreeableness of various kinds of labor. When a man locks his money up, he does so because he fears the risk involved in lending it. When he lends it, he demands not interest in the economic sense but compensation for risk. It is interesting to note that Böhm-Bawerk on page 423 says that "the greater security of the investment, again, and the prospect of future rise in value, keeps the rate of interest in immovables low; and considerations closely akin to this account for the present lower return of interest on state bonds, preferences, etc. payable in gold as compared with those payable in silver or paper," so that it seems in spite of the fact that he believes there is such a thing as interest, he is forced to link it up with the compensation for risk, and that compensation for risk varies according to the different employments of capital appears to support the conclusion that the return to capital is not absolute but relative. The burden of proving that there is such a thing as interest in the economic sense, therefore, and that it is unjust, rests entirely with the Marxist and other opponents of interest.

## Chicago vs. New York in the Henry George School

AT this writing the score of classes seems to favor the Big Town. Considering the time advantage—New York started two years before Chicago—the Windy City should really be given all the hosannahs. This, the New Yorkers are quite willing to do, since in this game of starting and conducting classes, the loser is as much a winner as is the winner.

A full report of the classes started in various parts of the country should be given in this issue of LAND AND FREEDOM, for the school year closes July 1. But the clerical force at headquarters has been so busy planning and doing that the record of things done has suffered. We hope to have a complete report for the next issue.

But a picture of what can be done in every city is seen in the attached lists of classes now operating in our two big cities and environs. Wherever there is a Georgeist who wants to do it a class can be organized. The telephone book is as good a list of possible students as any. Some place can be located for holding the class. The class announcements are furnished by school headquarters. A Teachers Manual, some classroom helps—and away we go. It's just as simple as that.

NEW YORK CLASSES NOW OPERATING AT  
NATIONAL HEADQUARTERS, 211 WEST 79TH  
STREET, NEW YORK

(These are classes in "Progress and Poverty" only.