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INTEREST

A Survey of Theory and Practice

From Earliest Times to the Present Day

by

Arthur Leopold Blakeslee, Jr.

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of the University of Richmond

in candidacy

for the degree of

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PREFACE

The phenomenon of lending at interest has intrigued men for thousands of years. It has been the subject of controversy for centuries. The list of antagonists and protagonists stretches interminably into the past. Philosophers and economists, scholastics and sovereigns, have found, and still find, the interest problem an ever-stimulating question.

Interest-getters and their defenders would have it appear that interest is inevitable. They point out that it has existed since earliest times, that it exists now, and will, in their opinion, continue to exist in the future. Being thus inevitable, it must be just and proper, an equitable demand, a righteous requirement.

On the other hand, those who condemn interest-taking find it essentially unjust and unrighteous, a wholesale exploitation of the weak by the strong. Many have lived handsomely upon the interest from their investments. Some have had no other end in life than to spend their unearned incomes.

Much thought has been given to the questions - Whence interest upon capital? What is the justification for interest? What is a fair and reasonable rate of interest which should accrue to the possessor of capital? Great minds and keen intellects have sought the answers; but, like Omar Khayyam of Naishapur, they

> . . . . did eagerly frequent
> Doctor and Saint, and heard great argument
> About it and about: but ever more
> Came out by the same door where in they went.

Writings on the theory and practice of lending at interest offer much data relating to legal rates, but little information concerning the rates actually charged. What were the rates charged by lenders which stimulated repeated attempts to lighten the interest burden for borrowers? It was to develop this aspect of interest-taking that this study was undertaken.

The practice of interest-taking has influenced, and been influenced by, the theories advanced to justify or condemn it. Therefore, a brief survey of the more important theories has been included. It can be said with justice that much has been omitted. The intention has been to consider only those theories which best illustrate the principal currents of thought.

Arthur Leopold Blakeslee, Jr.

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CHAPTER I

Origin of the Concept of Interest

Ages before man developed even the simplest of civilizations, there was necessity for borrowing and lending. In those early times, when men were but little removed from animals, the matter of existence was constantly at stake.

In climes where nature dealt harshly with her progeny, life was to be preserved only at the cost of great effort and privation. The aged, the weak, and the sick, were left to die that they might not consume food and warmth needed for the existence of the young and healthy. Even in those regions blessed with almost unlimited food to be had for the taking, there were recurring years of drought, or disasters which destroyed even the earth from whence came subsistence. In such periods of torment, those who could not secure for themselves what was needed to sustain life were allowed to perish. Heartless as this may seem, it was necessary in order to perpetuate the race.

As men climbed slowly and painfully from the depths of savagery, a sense of responsibility for the less fortunate gradually developed. At first, only those in an immediate family were objects of solicitude; later, members of a small group of families would be included. Eventually, the idea was expanded to embrace entire tribes.

For centuries the idea of responsibility for the welfare of others was revolved in the mind of primitive man. Occasionally, it was applied to individuals in a limited way. Ultimately, it became part of family and tribal custom. As centuries passed, these customs became the force which regulated individual and group behavior. When government evolved, customs were endowed with the attributes of law, and in theocracies were enforced in the name of deity.

At some point during those timeless eons, there was born the idea of expressing gratitude by returning to a benefactor more than had been received during a period of misfortune. A prehistoric man might spend much time and effort seeking just the right piece of flint and chipping into shape a particularly nice arrowhead, in gratitude to one who had sustained and protected him and his family while he was recovering from an injury or severe illness. Or he would share with his benefactor the rewards of his hunting or husbandric fortunes. In a nomadic society there might be a gift of cattle, sheep, or goats. An agrarian might give grain, wine, or other produce. An article of clothing upon which more than usual care had been lavished in selection, preparation, and decoration, might be given by a woman skilled in household arts.

This practice led to a form of exchange of gift and return gift in some primitive societies. An article was presented by one individual to another with the understanding that the recipient was obligated to make some form of return in due course. The return gift was ordinarily more lavish than its predecessor. Custom prescribed that the generosity displayed in the original gift should be repaid with still greater generosity. Some have professed to see in this practice a similarity to lending at interest. Such an explanation seems highly improbable

as a possible origin of the idea of interest. What was observed, it would seem, was a social standard of generous conduct, rather than anything in the nature of interest on a loan.[1]

When man began to conquer nature, some time could be devoted to cultural pursuits of a simple sort, and to accumulate surpluses of weapons, tools, food, and clothing. Under suitable circumstances, these would be made available to the needy with the understanding that the same or equivalent items or amounts be returned when the borrower was in a position to do so.

In gratitude for the loan of an article of value, some form of increment over and above return of the article or its equivalent, was generally repaid by the borrower. If grain were loaned to one whose crop had been ruined, or who had been prevented from sowing by injury or illness, or if a hunting weapon had been borrowed, it seemed only fitting that part of the crop raised or the game killed should be given to the lender in addition to return of the borrowed item.

As time went on, lenders began to expect a share in the increment which bountiful nature bestowed upon the borrower, in recognition of the fact that their loan had made the increment possible, even though they had not helped with the actual labor which produced it. This viewpoint came to be sanctioned by patriarchal and tribal custom which dictated that a portion of the increment should be given to the lender in addition to the amount loaned. The proportion of the increment which should be given depended upon a number of factors. The value of the article or commodity loaned; the size of the increment; the needs of borrower and lender at the time of repayment; the social position of the parties; all had a bearing upon the amount to be paid to the

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1. Edmund Whittaker, <u>A History of Economic Ideas</u>, p. 516

lender. What had been in primitive times an expression of gratitude, in later times was distorted by mens' greed until a share in the increment was not only expected but demanded as a condition of a loan.

It is human nature to feel entitled to part of the increment resulting from the loan of a good created by ones own time and effort. When a man fashioned tools or weapons, or raised grain, he felt that he should receive some of the game killed or crop raised when the product of his labor was loaned to another. Even today, if a man loans his gun to another, not only does he expect it to be returned in good condition, but he expects a share of the game killed. Should the hunting trip be unproductive, return of the gun in good condition will satisfy all the obligations of the borrower. He would not be expected to go to market and purchase game to be given the owner of the gun. This would be necessary if the concept of interest were applied. The lender would be entitled to an increment regardless of the fortunes of the borrower. It seems obvious, therefore, that since earliest times the payment of an increment in addition to return of a loan has been looked upon as sharing in the profits of the venture.

It is probable that many of the early civilizations were well developed before the idea of interest appeared as a requirement for a loan. Once this concept gained widespread acceptance, the amounts demanded by lenders increased with the passage of time until conditions became so onerous that efforts were made by borrowers to reduce the increment repaid in relation to the amount borrowed. They felt that all the profit belonged by right to them, since their labor and skill had produced the increment.

Lenders took the opposite view, contending that they were entitled to a substantial part of the increment, because without their willing-

ness to make the loan there would be no increment, no matter how much labor and skill were at the command of the borrower. Over the centuries these conflicting viewpoints were in bitter struggle for the ascendancy. Finally, the social implications of the controversy were recognized. Wise counsellors sought to establish a compromise which would compensate each fairly for their contribution to the betterment of the social group of which both were members.

CHAPTER II

Interest Among the Ancients

Babylon

The earliest record yet brought to light which recognizes the right of lenders to a part of the profit accruing to borrowers, would seem to be the famous code of laws promulgated by the Babylonian monarch Hammurabi, who reigned circa 2150 - 2100 B. C. Excavations during the past century have unearthed much documentary evidence to substantiate the view that this king was a wise and beneficent ruler who realized that lenders were entitled to a proportion of the increment derived from their loan and the labor of borrowers, but that the share they received should be fair and equitable to both. Exhorbitant charges for loans would reduce to slavery too many freemen, and jeopardize the greatness and wealth of his empire.

That justice might be dispensed equally to all throughout his kingdom, he called together a group of the wisest and ablest men in the realm. They were instructed to compile a code of laws to promote the welfare and happiness of his subjects. When the code was completed and accepted by the monarch, he caused its terms and provisions to be carved on huge blocks of stone which were set up in the central market places of the principal cities of the Empire. One has been found almost intact where it stood for forty centuries under the sands of the desert. From it has been reconstructed in large measure, the legal, economic, and social, aspects of life in the great and departed Kingdom of Babylon.

Almost three hundred laws were listed. Several had reference to contracts between lenders and borrowers. They recognized various circumstances affecting the payment of interest on loans, refer to legally established rates, and set forth conditions under which borrowers were absolved from payment of interest even though stipulated in the contracts. These regulations must have constituted a great advance over conditions previously obtaining, else there would have been no need for incorporating any reference to the subject in such an important undertaking. That charging interest for loans was widely practiced is indicated by the inclusion of such laws and their being given prominence through distribution in permanent form throughout the realm. It was considered important that all should be informed of the conditions under which lenders were permitted to receive interest.

Discovery of the monolith bearing the Code of Hammurabi was an event of great interest to all who sought information on ancient legal practices. To economists it was of particular value for the light it threw upon the nature of interest as practiced by a people exempt from the prejudices which influenced later thinking on the subject.

Among the Babylonians, the idea of interest was defined by the term SIBTU which was used to designate it. SIBTU meant an increase, an increment of capital. The term was very general; the Babylonians did not distinguish between interest and profit. SIBTU was used to identify not only the increment accruing to capital, but to designate also that increment which resulted from the activities of the owner of capital.

The Babylonians looked upon a loan as a contract in accordance with which one of the parties gave the other a certain quantity of things with the understanding that the borrower would return to the lender at a stipulated time an equal quantity of things of the same

kind and quality, or an equivalent quantity of things of another kind. Under this concept, the notion of a loan was wide in scope. A loan of money could be repaid in grain, onions, or bricks. A loan of wheat or peas was repayable in money. Ordinarily, loans were of grain or money. Loans involving the more usual products of Babylonian agriculture and industry, such as dates, onions, wheat, peas, wool, or bricks, were common. Loans of money or wool were measured in terms of weight. Other commodities were measured by volume, usually a standard size vessel or basket of fixed capacity, such as our gallon or bushel.

Following are examples of entries in the Code of Hammurabi which relate to payment of interest on loans:

> If any owe a debt upon which he pays interest, and a storm devastate his field and destroy the grain, or, owing to a scarcity of water, the grain have not grown in the field: in that year he need not give any grain to the creditor: he shall moisten his contract tablet in water, and need pay no interest this year. (Contract tablets were made of clay. To moisten the tablet in water was symbolical of voiding the contract. Tablets were also destroyed.)[1]

> If a man have borrowed money from a merchant, and have given the merchant a lien on an arable field as security, the field to be planted in grain or sesame, and have said to him (by the merchant) 'Plant grain or sesame in the field and take the crop': if the cultivator produce grain or sesame in the field, then at the harvest the grain or sesame that the field has produced shall be the property of the owner of the field, and he shall pay grain for the money he received from the merchant, and for the interest and for the support of the renter.[2]

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1. W. W. Davies, The Codes of Hammurabi and Moses, p. 42.

2. Ibid., p. 43.

> If the field of grain or the field of sesame were already planted when he gave it as security, the grain or sesame in that field shall belong to the owner of that field, and he shall return the money with interest to the merchant.[3]

> If he have no money to pay back, he shall give the merchant grain or sesame according to the current price, for the money, and also interest according to the royal tariff.[4]

Under King Hammurabi, an annual interest rate of 33 1/3 per cent was permitted on loans of grain, while only 20 per cent was allowed on loans of money. A thousand years later, during the Second Dynasty of Ur, these rates were brought closer together. A rate of 30 per cent per annum was sanctioned for loans of grain, while loans of money could be made at 25 per cent. As in modern times, the state took advantage of its position and paid only 12 1/2 to 16 2/3 per cent.[5]

Much prominence having been given to the regulation of interest even at that early date, it would seem reasonable to assume that the rates charged previous to the promulgation of King Hammurabi's code were much higher than those subsequently permitted, since the purpose of the codification, as set forth in the preamble, was to benefit his people and insure continued prosperity for his realm. None of the tablets so far deciphered tell what rates were charged prior to promulgation of the Code. But only a few of the more than 150,000 tablets unearthed have been deciphered, so there is hope that before many years have passed some more positive information on this point will be available.

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3. Ibid., p. 44.

4. Ibid., p. 45.

5. Ed. Colas de la Noue, Du Pret a Interet, p. 15.

The Babylonians apparently felt that the lender was entitled to a share in the profit resulting from the use of his capital, without which no increment would have been possible. Too large a share was recognized as being unfair to the borrower. Therefore, they adopted regulatory measures which would limit the rate of interest by setting maximum legal rates. Similar measures were taken by the Assyrians who ruled Western Asia for a thousand years between the First and Second Dynasties of Ur.

Recognition by the Babylonians of the great importance of the phenomenon of lending at interest, and the promulgation of regulations limiting the rates which could lawfully be charged, was a great forward step in the legal, economic, and social history of the world. The effects of this accomplishment have been felt in all the great civilizations which arose after the cities of Babylonia and Assyria were but curious mounds in the deserted river valleys of Western Asia.

Judea

A narrow strip of land lying between the Arabian Desert and the Mediterranean Sea was the home of the Hebrews. Through this corridor for centuries flowed the trade and military power of the world's great empires. Enslaved alternately by the Babylonians and Egyptians, with only a brief period of political power and splendor under Saul and David, the Hebrews were oppressed and despised for centuries on end. Finally, the Roman Titus destroyed Jerusalem in 70 A. D. and scattered the survivors.

During their periods of captivity, the Jews observed closely the commercial practices which made Babylonia and Egypt rich and prosperous. Their position along the trade route between Asia and Africa brought them into close contact with the commerce of many lands. It was only natural, therefore, that they would examine the social and economic

practices of other races and nations. What they observed was submitted to the scrutiny and analysis of a people whom oppression had welded into a unified group, and a philosophy was evolved which was peculiarly adapted to their modes of thinking and acting. The history of the Jewish people thus provides a logical explanation of the similarities and dissimilarities between the Hebraic attitude toward interest-taking, as set down in the Old Testament and the Talmud, and the Babylonian viewpoint exemplified by the Code of Hammurabi.

When Moses wrote the laws which were to regulate the lives of the Isrealites, he placed the charging of interest to the poor in the same category as theft and other trespasses. "If thou lend money to any of my people that is poor, that dwelleth with thee, thou shalt not be hard upon them as an extortioner, nor oppress them with usuries."[6] And again: "If thy brother be impoverished, and weak of hand, and thou receive him as a stranger and sojourner, and he live with thee, Take not usury of him, nor more than thou gavest; fear thy God, that thy brother may live with thee. Thou shalt not give him thy money on usury, nor exact of him any increase of fruits."[7]

The first of these passages merely prohibits usury being charged to the poor. Tribal loyalty is evident in the second which bans usury between "brothers." That it was permissible to charge interest to those not members of the Jewish faith seems evident from the following: "Thou shalt not lend to thy brother money at usury, nor corn, nor any other thing: But to the stranger. To thy brother thou shalt lend that which he wanteth, without usury . . ."[8]

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6. Exodus, 22, v. 25.

7. Leviticus, 25, vv. 35-37.

8. Deuteronomy, 23, vv. 19-20.

No hint is given as to the level of interest rates which it was permissable to charge others than Hebrews, though it may be assumed that the Jews were allowed to conduct commercial transactions and enter into contracts with traders of other nations on their terms. They would then be able to carry on trade and commerce with neighboring tribes and nations on even terms, insofar as negotiating loans at interest was concerned.

The text of the Talmud, that book which contains the whole body of Jewish law and tradition, bases its prohibition of interest on the Pentateuch. Any kind of interest, no matter how trivial, is forbidden. Again it would appear that this stipulation applies only to fellow Jews. Usury in the Talmud is defined as lending a sela (four denars) for five denars, an interest rate of 25 per cent, or lending two seahs of wheat for three, an increment of 50 per cent.[9]

As was to be expected, the Mosaic injunction against usury was not always observed to the letter of the law. Nehemiah ordered restitution to Jewish debtors of lands on which money had been advanced by Jews at the rate of one per cent per month,[10] and Ezechiel accused his brethren: "Thou hast taken usury and increase, and hast covetously oppressed thy neighbors."[11]

Greece

The Greeks, geographically situated between the East and the West, devoted their attention to the development of a sea-borne commerce. Although the plains of Macedon and Greece had been but the grazing grounds for nomadic tribes during the long centuries that the civil-

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9. H. E. Goldin, Text of the Talmud, passim.

10. Nehemiah, 5, v. 7.

11. Ezechiel, 22, v. 12.

izations of Babylon and Egypt were developing, agriculture did not retain its favor among the Greeks as it did among the Hebrews, an eminently pastoral people. Concentration of the people of the Greek peninsula in their city-states necessitated laws prohibiting the export of wheat because not enough was raised to feed the population. Furthermore, in order that the supply might be equitably distributed throughout the land at a fair price to all, it was forbidden for anyone to buy more than fifty basketfuls. This attitude was quite in contrast to that of the Carthaginians who stimulated the export of grain and cereals, and who, having conquered Sardinia, forced its inhabitants to raise grain and send it to Carthage.

The Greeks, divided between Athenians and Spartans, were subjected to two distinct sets of laws and regulations. The Spartans had little intercourse with neighboring peoples. Lycurgis, a King of Sparta, flattered himself that he had improved human nature in his realm, that he had created a nation in which progress and intellectual activities could proceed unhindered by hostile influences. Possession of gold or silver was prohibited under pain of death. Iron was the only metal used in coining money, and it was heated and dipped in vinegar to make it unfit for any other use. Lending at interest was forbidden, and what little commerce there was, employed a system of barter for the exchange of goods.

The laws were broken, nevertheless, upon occasion. One king of Sparta is said to have restored respect for his authority by having the tables of the money-lenders and bankers carried to a public square where he set fire to them and reduced them to ashes. "Never," said he ironically, "have flames cast a richer glow."[12]

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12. Quo igne nullum clarius lumen se vidisse.

Similar ideas were held by the Persians, whose attitude toward interest was as strict as that of the Spartans.

The Athenians, on the other hand, held quite different views toward interest. They were a commercial people, carrying on extensive trade with Egypt, Phoenicia, and other nations along Eastern Mediterranean shores. Silver mines in the mountains of Attica added to their store of wealth. Athenian law did not prohibit interest-taking, but was content to see that the practice was carried on with moderation. The regulations were endowed with a protective character.

Restrictions on the export of grain were rigidly enforced. Demosthenes tells us that any citizen of Athens who loaned money on a ship to be used to transport grain to any port other than Athens, forfeited his rights to legal protection. In spite of this onerous restriction, loans were made freely at high rates of interest, at times up to 30 per cent. We read in Xenophon that capital was generally tripled in a year by the addition of interest. "With respect to a most numerous class of people," says this historian, "I have noticed that they double their capital in a year, because, according to my calculations, those among them who have made advances have required in return almost twice as much interest, and so, without leaving the city (Athens) receive a most certain and lasting form of income."[13]

Such rates, regarded as reasonable when applied to a maritime loan, were considered usurious and oppressive when applied to a civil loan. In the former case, the perils of the sea greatly increased the risk and might easily eliminate any possible profit from the venture.

Greed being universal, we see the Athenians exacting up to 16 per

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13. de la Noue, op. cit., p. 20.

cent. How could borrowers pay such rates in a period when most loans were made to the necessitous for consumptive, not productive, purposes? Their lands were generally mortgaged, providing barely enough to cover their debts. In addition, under the terms of loan contracts, they were obliged to pay creditors one-sixth of the income from their lands. Furthermore, the law permitted a debtor, his wife, and his children, to be sold into slavery if his goods and chattels were insufficient to satisfy his debts. These penalties, long borne under duress, finally roused the people to action. They revolted and chose Solon as their leader. He was considered a disinterested party, neither greedy and unscrupulous like the rich, nor necessitous, as were the poor.

Solon proposed to distribute the land among the people and cancel their debts while continuing the loan contracts in effect. Accomplishment of these proposals appeared quite difficult. But Solon had recourse to a procedure that many nations in debt have used to their advantage. He debased the coinage. The silver mina had been valued at 73 drachmas. He proclaimed it to be worth 100 drachmas. Thus, by payment of a revalued mina, a debtor could satisfy a debt of 100 drachmas where before he would have been obliged to pay one and one-fourth minas. At the same time, the laws permitting imprisonment for debt were abolished, at least insofar as this penalty could be meted out for non-payment of interest on loans. By these measures all debts were immediately reduced by more than one-fifth and the burden of borrowers was lightened. Lenders, denied the right of appeal, were too few in numbers to contest the new arrangement.

When we seek to discover what was the usual rate of interest among the Greeks, we find that it varied widely. Rates on overseas commerce were as high as 20 to 30 per cent, but general purpose loans could be had for around 12 per cent. Interest was calculated on the

basis of 100. When one drachma was required as interest on a loan of 100 drachmas, the rate was said to be one per cent. The time interval for calculating interest being one month, not one year, money-lenders were said to resemble the infernal powers which each month, at the new moon, afflicted men with attacks of epilepsy.[14]

Although the laws permitted interest-taking, the philosophers and poets were opposed to lending money at interest. They felt that money had been invented to serve as a medium of exchange, and that it was a glaring error to use it to produce more money. Plato, for example, taught that laws were devised that men "should be as happy as possible, and as friendly as possible to one another."[15] Since the rich are not good, they are not happy; and as riches breed lawsuits, men who are always at law with one another can never be friends. Therefore, "gold and silver ought not to be allowed in the city, nor much of the vulgar sort of trade which is carried on by lending money."[16] Again he says, "no one shall . . . lend money upon interest."[17]

Some have professed to see in another passage a sort of left-handed approval of interest when he says: "And let him who, having already received the work in exchange, does not pay the price in the time agreed, pay double the price; and if a year has elapsed, although interest is not to be taken on loans, yet for every drachma which he owes to the contractor let him pay a monthly interest of an obol."[18]

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14. Similes demonibus qui, recurrente luna, morbo comitiali homines quosdam afflictant.

15. Plato, "Laws," <u>Dialogues of Plato</u>, 5, p. 124.

16. <u>Ibid.</u>

17. <u>Ibid.</u>

18. <u>Ibid.</u>, p. 308-309.

An obol was one-sixth of a drachma, so that this would be equivalent to an interest rate of 200 per cent yearly. This was obviously a penalty for non-fulfillment of an obligation and in no sense interest on the loan, since if paid when due no interest would accrue to the lender.

Aristotle's condemnation of interest is well-known:

> There are two sorts of wealth-getting, as I have said; one is a part of household management, the other is retail trade: the former is necessary and honorable, while that which consists in exchange is justly censured; for it is unnatural, and a mode by which men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest (tokos, offspring), which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefor of all modes of getting wealth, this is the most unnatural.[19]

As transactions in money for its own sake increased, teachers such as Aristotle realized that it would become more and more difficult to engender a dislike for inordinate gain, and kindle in the breasts of the people a feeling of generosity toward their fellow men. Accordingly, they made it a practice to flay and deride the money-getting instinct at every opportunity. Aristotle himself went so far as to say that he could see no difference between an usurer and a highway robber, and to him a merchant was only a little less culpable than the former.

Aristophenes, in his celebrated play The Clouds, holds up to ridicule the practice of interest-taking. "Do you believe," says a debtor to his creditor, "that the ocean is any larger than it used to be?" To which the creditor replied that he was certain the ocean had always been as large. "What, you rascal," continued the debtor, "You say that the ocean, into which all the rivers of the world empty, is

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19. Aristotle, "Politics," 1258b, Introduction to Aristotle, p. 571.

no larger than formerly, and yet you claim your money should grow day by day!"[20]

The Greeks applauded this bit of comedy as they had many times applauded the teachings of Socrates; but they changed neither their moral principles nor their habits. Philosophers such as Cleanthe might turn a mill in order to live rather than resort to borrowing, but the people thought this only showed the impracticability of the doctrines they taught. They simply laughed at this sincere moralist who, having spent his life thundering against usurers, was obliged to labor as a slave rather than borrow money and recoup his fallen fortunes through commercial activities.

The discourses of the philosophers against the practice of lending money at interest may have served only to lessen the opposition to, and increased the number of usurers, because according to Plutarch, they "made the palace where justice was dispensed a hell for the poor debtors, and fleeced and devoured them with beak and claw, until only their whitened bones remained, as the flesh is picked off a skeleton by starving vultures."[21]

Although there was probably no feeling more deeply implanted in the Greek mind than that retail trade was "vulgar" and money-lending "usury," they were, nonetheless, among the keenest traders and merchants of their day. They expelled the Phoenicians from their trading stations in the Mediterranean; they went to Tartassus for silver and other metals; to the shores of the Baltic for amber; to the steppes of Scythia for grain. They sailed to Britain and "farthest Thule" in search of new products and openings for commerce. Perhaps the scale

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20. de la Noue, _op. cit._, p. 32.

21. _Ibid._, p. 35.

of operations made a difference in the manner in which they were regarded. The wealthy aristocrat might employ his slaves in a workshop, or let them out to hire as artisans or mechanics; he could not himself, without social degradation, to use Plato's humorous language, "open a shop or keep a tavern." Moreover, there appears to have been current then, even as there is in some countries today, a distinction between the trader who has retired with a fortune, and the man who is actually engaged in trade and commerce. At least, Aristotle asserts that it was not uncommon in oligarchies to allow only those to hold office who had left business for a period of ten years or more.[22]

And so it seems that interest-getting, while roundly condemned by the acknowledged leaders of Greek thinking, was widely practiced by the people themselves at rates which enriched the few and impoverished the many. There were probably a number of reasons for the decline of the Greek city-states of antiquity. Perhaps the universal urge toward money-getting was one. In any event, their commercial and financial influence is no more. Sic transit gloria mundi!

Rome

The practice of lending at interest greatly influenced the political history of Rome. Debtors became so numerous, and their determination to secure relief from oppression reached such proportions, that they overcame the government and effected reforms which became part of Roman law for centuries. Many nations have based their codes of jurisprudence upon that of the Romans.

Seven kings reigned in the early days over the City of the Seven Hills, counting Romulus, its mythical founder, as the first. One of these, Servius, was known as the "commons' king" because he was a

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22. Aristotle, "Politics," 1278a, Introduction to Aristotle, p. 588.

champion of the common people against the nobility. He had been a servant of a previous king, and may also have been a stranger in the city. All strangers in early Rome were classified as "plebeians" to differentiate them from the descendants of the first inhabitants who were known as "patricians." Only the latter had full rights of citizenship and could vote in the public assemblies.

These early kings of Rome extended the power of the city by conquering neighboring tribes, destroying their cities, and bringing the inhabitants to Rome. They became servants and slaves, and did not share in the divisions of public wealth which were the spoils of so many successful wars. The plebeians had small chance of growing rich. In later years they gradually acquired the rights of citizens, so that the original distinction between the two classes disappeared, but the names continued in use to signify the rich and the poor.

The quarrels between these two economic groups of citizens of Rome make up the early history of the city. Servius, having been a servant himself, did all he could to change the old laws so as to ease the lot of the poor and give them more political power. Noticing that silver coins seemed to leave the city in a continuous stream, he introduced the innovation of coins made of copper, so as to keep them in circulation among the poor people of Rome. In spite of determined opposition from the rich, some improvements were made in the laws and others undoubtedly would have been made had he not been murdered.

Under the early kings of Rome there was no standing army. Whenever the city was threatened with attack, or a campaign was launched against some foreign peoples, the citizens were forced to leave their homes and farms, equip themselves at their own expense, and hurry to the arena of defense or conquest. They returned from these periodic

convulsions to find their patrimony ruined, their homes destroyed, and a huge debt facing them for rebuilding their homes and restoring the fertility of their fields, lost through neglect during the years of war. The only source to which they could turn for help was to the rich patricians who loaned them the needed funds on extremely harsh terms. But agriculture is not a prodigal calling, so the interest accumulated; the debtor could not pay when due, so the hand of the creditor stretched forth, took the last farthing of his estate, locked him in prison, and, if necessary to satisfy the debt, sold him, his wife, and his children, into slavery. Creditors were even permitted to divide the body of the wretched debtor among them, though it is difficult to see what they would gain by doing so.

It is said that one of the bravest officers of the Roman army, whose praises were on every tongue because of his patriotic deeds, had been thrown into prison because he could not pay the debts incurred during his years of service to his country. One day he broke out of prison and rushed to the Forum where he proclaimed his mistreatment to the amazed listeners.

Now it happened that almost at the same moment the alarm sounded at the approach of the hostile Volsci. The authorities called the people to arms to protect the city. Sullen and incensed by the consciousness of their wrongs, the plebeians refused to enlist and defied their masters. The crisis was so threatening that the consuls yielded for the moment and promised to right their wrongs. So the sufferers marched against the enemy and helped defeat them. When the campaign was over, however, and the people had returned to their homes, the Senate refused to keep the promises made by the consuls and threatened to appoint a dictator. The plebeians then united and left the city, withdrawing to an adjoining elevation some three miles away known as

the Mons Sacer (Sacred Mountain). Upon being assured that the Senate would fulfill the promises made to alleviate their sufferings, they returned to Rome.

The poor were still the victims of many wrongs and there could be no lasting peace or security for the city until these were righted. One of their major complaints was that there was no regular code of laws in existence. Accordingly, in 450 B.C. a Council of Ten, hence called Decemvirs, was appointed to prepare a code of laws, much as had been done seventeen centuries earlier by King Hammurabi of Babylonia. Of this, however, the Romans most probably were quite ignorant. The Decemvirs framed a code based on the Greek laws and known as the Laws of the Twelve Tables. The maximum legal rate of interest was fixed at 1 per cent a month or 12 per cent per year.

The Laws of the Twelve Tables confirmed creditors in their right to reduce to slavery any debtor who was unable to pay his indebtedness within thirty days after the due date. Debtors enslaved by their creditors were generally treated with unnecessary harshness and severity. Often they were not given the amounts of food required by law for their subsistence. When several creditors had claims against the same debtor, they still had the right to divide his body amongst them in proportion to his debt to each. Cruel as was this provision, its impracticality rendered its actual consummation a dead letter, although the principle that the body of the debtor became the property of the creditor remained.

The disgraceful excesses indulged in by the rich creditors became notorious and caused great resentment among the people. In 429 B. C. one of them dared to demand "the flower of adolscence" in payment of a loan. The debtor sought sanctuary in a temple to keep the creditor from laying impious hands upon his daughter. The Forum resounded with

the cries of his family and friends. The people took up the cry. The consuls, fearing another uprising, called the Senate into session. The furious crowd swarmed into the Capitol and demanded abolition of the odious law. The Senate bowed to the will of the people and promised justice. The law was amended to provide that only the debt had to be paid. The body of the debtor was held to be as inalienable as his liberty. Thus was defined one of the great principles of Roman law. The common people were elevated to a new level of dignity in the state.

This victory encouraged the people to continue their efforts to improve their economic condition. The interest rate of 1 per cent a month permitted by the Law of the Twelve Tables bore heavily on the poor. It was considered so oppressive that popular demand for reform was heeded and in 398 B. C. a committee was appointed to recommend ways in which this plague preying on their vitals could be alleviated. It is without doubt due to the suggestions of this committee that the following year the tribunes of the people proposed a law which would reduce the interest rate to one-half per cent per month or 6 per cent per annum. The people acclaimed this reform with enthusiasm, but their joy was short-lived. Within a few years the Gauls swept down from the north, captured the city, and left it a burning ruin.

Hardly had a new city been erected upon the ruins of the old, when the patricians again asserted their claims, and demanded a revival of the fearful severities of the acts governing debtor and creditor. The plebeians had been reduced to the greatest poverty and distress during the years of the Gallic invasion, and the measures proposed by the patricians, if carried out, would crush them into abject slavery.

The quarrel was bitter and came to a head in 376 B. C. when two of the ablest tribunes of the people advanced a plan for settlement of the troubles. To remedy the unbearable political inequality, they

demanded that the consuls should be restored as the chief magistrates of the city and that one of the two annually chosen should be a plebeian. To improve the grinding poverty of the plebeians, the new plan provided that the interest already paid on debts should be deducted from the principal, and the remainder of the debt should be paid in three equal annual payments. Public lands, hitherto held almost entirely by the rich, were to be redistributed so that no patrician should have more than about three hundred acres. The remainder was to be divided into small tracts for the plebeians.

The new plan, called Licinian Rogations after Licinius Stolo, one of its sponsors, was fiercely fought by the patricians. The plebeians were equally resolute, and their tribunes prevented the election of officers and military levies. The patricians were helpless, and the plan as proposed became Roman law in 367 B. C. Lucius Sextus, the other sponsor of the plan, was elected consul the following year. All other offices, of whatever nature, were thrown open to plebeians and political equality was at last established in Rome. The aristocratic republic which had lasted for a century and a half after expulsion of the kings had now become a truly democratic republic or government by the People. Having overcome its external foes and settled its domestic difficulties, Rome now stood forth a young giant, politically strong, morally self-confident, and economically healthy. It stood poised to conquer the world.

The consuls, eager to fulfill their mandate to improve the lot of the plebeians, vigorously prosecuted the bankers who loaned money at more than the legal rate of interest. They were subpoenaed by the officers of the law, imprisoned, and forced to pay off the public debt incurred during the last war. The fines levied against the culprits

were metamorphosed into four-horse golden chariots in honor of Jupiter, the guardian god of Rome.

The Licinian Rogations were the law of the land, insofar as the legal rate of interest was concerned, for the next 800 years. During these centuries the Romans extended their power over the then known world. Rome ceased to be a Nation and became an Empire. A steadily increasing number of foreigners was absorbed. The sturdy ancient Roman - the perfection of manly vigor and strength - disappeared. His place was taken by a debauched, effeminate, luxury-loving people, wholly abandoned to self-indulgence. The wealthy lived for pleasure alone.

Their downfall drew near with the surety of the tread of doom. The death-blow was dealt by northern barbarians, who, magnificent specimens of manhood, inured to hardship and physical suffering, swept over them like great bulls, ramming their walls with lowered horns until they trembled. Their savage cries made the Romans quake with dread as they braced themselves against the tottering gates in a vain attempt to keep out the invaders.

Rome was captured and sacked by Alaric the Visigoth in the year 410 A. D. He accomplished what Pyrrhus and Hannibal, the Greek and the Carthaginian, had failed to do. For the first time in eight hundred years Rome saw a foreign master within her gates. The following year most of the Roman laws were abolished and the regulations governing lending at interest became but a memory.

A hundred years or so later the Empire achieved a brief span of life under the Emperor Justinian, whose chief claim to renown is his work as a legislator. Upon his accession in 527 A. D. he set about collecting the vast mass of previous legislative enactments which were still nominally in force. It took several years for this great

project to be completed. In the new code formulated by Justinian, the legal rate of interest was set at 1/3 per cent per month, or 4 per cent per annum on loans to distinguished personages and agriculturalists; at 6 per cent per annum for persons not in business; at 8 per cent on loans to businessmen and merchants; and at 12 per cent for bottomry on ships and cargoes. The latter had been unlimited in former times. Compound interest was not permitted, and the penalty for usury was four times the interest taken.

The graduation of the rate of interest according to the rank of the borrower, or the type of use to which the loan was to be put, presumably upon some hypothetical ability to pay, was an innovation which is met for the first time in the history of lending at interest. The complete system of Justinian, known as the Civil Law, formed the ground-work of the law for nearly all the nations of Europe, the most notable exception being England.

There was little opportunity for Justinian's graduated rates of interest to become widely accepted. A few years after promulgation of the new code, Italy was overrun by the Lombards, the third and last of the Teutonic invaders. The fall of the Roman Empire was complete.

Out of the hideous turmoil of blood and flame the power of Christianity rose indestructible and triumphant. It was the sole influence that had remained strong and unsullied amid the corruption and decay of the Empire. With its ascendancy to a position of importance in the affairs of nations, a new viewpoint toward commercialism and interest-getting began to supplant the accepted practices of more than a thousand years.

CHAPTER III

Interest During The Middle Ages

Early Medieval Period

The early Christian Church looked with disfavor upon the practice of usury, by which was meant any interest on loans. Early in the fourth century, the Council of Elvira, a provincial gathering, had issued a decree against usury. Later, the great Council of Nicae, convened by the Emperor Constantine in 325 A. D., laid down the principle that lending at interest was an un-Christian practice. It was formally forbidden to the clergy, subject to the penalty of loss of office, but at that early period no definite ban was promulgated with respect to the laity. The doctrine that all interest-taking was sinful was largely the result of the teachings of three great doctors of the Church: Basil, Bishop of Caesarea; his brother, Gregory, Bishop of Nyssa; and Ambrose, Bishop of Milan. Other great leaders of the early Christian Church who opposed interest were Chrysostom and Tertullian.

Reasons for their attitude toward interest are not hard to find. Disintegration of the Empire meant that the central authority was no longer able to enforce its will throughout the vast reaches of the world. Local kings and barons took the law into their own hands to an ever greater extent. The centuries which followed the Lombard invasion saw the gradual spread of anarchy and chaos, the almost complete disappearance of trade and commerce. A system developed under which each community or petty principality was practically self-contained, having little intercourse with neighboring towns except to

wage war, burn, pillage, and steal each others belongings. Under such conditions there was little opportunity for loans to be made for productive purposes. Most of the loans were made to kings and barons to meet expenses of their military exploits and for the luxurious living of their households and retainers. Since both warfare and high living were contrary to the principles of the Church, the early Fathers considered lending at interest a bad practice and condemned it.

The question might be asked, Why did not the early teachers of the Church forbid borrowing instead of forbidding the taking of interest? The reason appears to be that so long as lenders were permitted to make loans, people would borrow. Under the economic conditions then existing, the purposes for which they borrowed added nothing to their earning capacity. They were in no better position to save money after borrowing than they had been before. Had they been able to save it would not have been necessary to borrow.

Inability to save was taken to be conclusive evidence that the debt would not be paid. Borrowers therefore put themselves in the hands of usurers. So instead of forbidding short-sighted borrowing, as all borrowing for consumptive purposes was regarded, the early teachers went to the root of the matter and tried to make it unprofitable for the usurers by forbidding interest-taking.

As the influence of Rome waned, the Church stepped into the breach and became the most potent factor in determining the course of medieval thought. Prior to the thirteenth century, the Fathers of the Church gave more consideration to religious and moral concepts and little thought to economic matters. They introduced elements which were at variance with the ideas of antiquity and in which Roman jurisprudence was defficient. The dignity of labor was emphasized; slavery was condemned; the family and family life were extolled; charity and

almsgiving were among the cardinal virtues; the rich were their poor brothers' keepers; agriculture was praised; manufacture did not displease God; but trade could not be pleasing to the Deity because by it men made a profit out of the necessities of others. Furthermore, value is independent of price, so exchange was just or unjust in proportion to the equality of the absolute values. Usury was forbidden on the premise that in taking interest, a greater value would be exacted than given, which would be an injustice to the borrower.

Scholasticism

For long periods the subject of interest received little attention, probably because social life was too disturbed for lending to occur on any considerable scale. From the twelfth century, however, the situation changed. The Church began to take active measures against the practice of lending at rates of interest which were oppressive and unconscionable. The growth of monasteries, towns and guilds, the revival of trade and commerce, the increasing use of money, had introduced new problems.

Medieval thought was greatly influenced by the introduction into Western Europe of the first Latin translations of Aristotle's works direct from the Greek. The younger teachers of the Church seized upon Aristotle with avidity, much as their earlier predecessors, such as Augustine, had adopted Plato. Their problem was one of welding the seemingly incompatible teachings of the Bible and of Aristotle into one harmonious body of thought. The accomplishment of this apparently impossible feat is known as Scholasticism.

For the beginnings of this philosophical movement, we must go back to Charlemagne. Conscious of the evil plight of learning, he encouraged study and invited the monasteries to open their schools

to outsiders in addition to their own members. As the fame of teachers spread, they were invited to join the staffs of the cathedral schools which were thus seupplied with competently trained professors or Scholastics, as they were called. These schools were usually located in a town, and with the guilds which came into being about the same time, provided a nucleus for a semi-university life.

Probably the greatest of the teachers was Thomas of Aquino. Son of a Lombard Count of Aquino, he spent his early years in the nearby Benedictine Abbey of Monte Cassino. When yet a young man, he defied parental objections and became a Dominican friar. At the first opportunity he went to the University of Paris and had the good fortune to have Albertus Magnus for his teacher. Albertus was already an admirer of Aristotle and was enthusiastically engaged in winning others to this system. Thomas Aquinas became his disciple and the outstanding exponent of Aristotelianism.

The Crusades had brought back booty for the mind as well as for the body. Arabian and Jewish ideas were gaining ground in the universities. In the ferment of old and new, younger minds were showing a precocity which was alarming. The Church had stamped out a number of heresies, but it was not so easy to check and control movements of thought which accompanied rapid and enthusiastic acquisition of new knowledge. To hold the balance between the philosophy of nature and of religion was difficult. Some form of alliance was necessary now that civilization was Christian.

The philosophy which encouraged these tendencies was Aristotelian. The Church at first did not realize the service which that system could render because of its Arabian associations. Albertus Magnus and Thomas Aquinas proved by deed that the suspicions were unfounded, and the Church became a convert. Thus it came about that, just at a time when

it was most needed, a system of philosophy came into favor which joined harmoniously the physical and spiritual worlds. Aristotelianism became the successful rival of Platonism. The synthesis accomplished by Thomas Aquinas impressed itself upon the age as the complete Christian interpretation of the world.

Two of the fundamental teachings of Scholasticism which have influenced economic thought even to the present day, are the concepts of value and price. An independent domestic economy and the idea of production for use only, were sufficiently prevalent - and competition sufficiently absent - to make a freely determined market value seem unnatural. Labor was the chief factor in production, little capital being involved, so the value of a thing tended to be expressed in terms of the amount of labor required to produce it. As formulated by Albertus Magnus and Thomas Aquinas, value should equal the expenditure of labor and other costs. The labor element was weighted according to the social rank of the worker, so fixed rules as to the standard of life for each group were necessary in oder that the cost of production could be determined. The value thus fixed was independent of the estimates of buyer and seller. It was an inherent value, and justice required that the law step in and fix the price in accordance with the above principle. This did not mean, however, that a man could not sell a thing for more than he had paid for it. According to Aquinas, he might lawfully charge more for a thing than he had paid for it "either because he has bettered the thing, or because the value of the thing has been changed with the change of place or time, or on account of the danger he incurs in transferring the thing from one place to another, or again in having it carried by another."[1] Furthermore, this

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1. Thomas Aquinas, Summa Theologica, Pt. 2, Q. 77, Art. iv.

true value was not to be determined with any great precision because, as Aquinas said, it "depends on a kind of estimate, so that a slight addition or subtraction would not seem to destroy the equality of justice."[2]

"The balance of justice is destroyed," Aquinas thought, "if either the price exceeds the value or, conversely, the value exceeds the price of the thing."[3] Consequently, to sell a thing for more than its worth or to buy it for less than its worth, is unjust and unlawful.

Application of these principles of value to money brought up the age-old question of usury. To take interest for a loan of money was to take more than the "just price" and was therefore unjust. This view was reinforced by a number of arguments: the Mosaic law prohibits interest-taking; Aristotle said money is barren and therefore cannot breed more money; to pay for money is to pay for time, and time is the common property of man and God; money is consumptible, according to the civil law, and its use cannot be separated from the ownership of it. A loan of money amounts to its sale, and to ask payment for the use of that which has been sold is unjust.

The reasoning of Aquinas on this point is made clear by the following quotation:

> To take usury for a loan of money is in itself unjust; for it is to sell what does not exist, which is an inequality, and therefore, an injustice. To understand this it must be known that there are some things whose use consists in the consuming of them, as when we consume wine . . . In articles of this kind, therefore, the use of the thing must not be reckoned separately from the thing itself; he who is given the use is thereby given the thing. And accordingly, in lending a thing of this kind, all the rights of ownership are handed over. If, therefore, a man wanted to sell wine and the use of the wine apart from one another, he would either be selling the same thing twice, or would be selling what did not exist. Wherefor he would be manifestly com-

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2. *Ibid.*, Art. i.

3. *Ibid.*, Art. ii.

mitting injustice and sinning. For the same reason, he would commit injustice who lent wine or corn, seeking for himself two rewards, the restitution of an equal amount of the article and also payment for its use, called usury. But money, as Aristotle says, . . . has been devised for the making of exchanges. So the first and chief use of money is its consumption or spending. Wherefor it is in itself wrong to receive a price for the use of the money.[4]

The development of industry and exchange wrought a gradual modification in the viewpoint toward lending at interest. Aquinas and his brother Scholastics recognized a number of important exceptions to the general restrictions. Notwithstanding their prohibition of taking or demanding interest, they tolerated its being given. It was unjust for the lender to require interest to be paid, but a borrower need have no scruples about paying it: "It is by no means lawful to induce a man to lend under a condition of usury; yet it is lawful to borrow for usury from a man who is ready to do so and is a usurer by profession."[5] The Jews and Lombards could accept usury and the Christians could pay it!

Other exceptions included those cases where an owner, being deprived of his goods for a period of time, might realize a loss; for instance, he might have to replace them at heavy cost. On the other hand, he might lose a chance to profit from the use of the goods. In either case a corresponding sum might be demanded of the borrower, although these seem more in the nature of damages than of interest. As time went on, the list of such exceptions was expanded. A buyer on credit was not prohibited from paying more than the cash price; discounts wereallowed on bills of exchange; penalties for non-payment of advances on their due dates were permitted to be included in loan contracts, as long as there was some period of free lending without int-

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4. Ibid., Q. 78, Art. 1.

5. Ibid.

erest, no matter how short this period might be. While in practice such penalties may have been intended to function as interest in another guise, they really do not partake of the essential nature of interest since payment of the penalty could be avoided simply by repaying the loan on time.

Late in the period, banking houses such as the Fuggers were associated with the financial operations of the Holy See. It thus became difficult for the Church to frown upon interest on bank deposits. Furthermore, the Papal See employed a company of Jewish "merchant strangers" to collect its revenues in England. This company took advantage of the exception and charged nothing for the first three months of a loan period, but exacted 50 per cent for each additional month that the loan remained unpaid, a total of 450 per cent for a year.[6]

While scholastics theorized at Paris and Oxford and other great universities, kings and nobles continued to borrow from professional usurers who were not prohibited from receiving interest. The prevailing rate charged by Jews was 40 per cent per year. However, letters patent of the French King John bearing the date 1360 are extant which authorize the Jews to lend in pledge at the rate of four deniers per week for every livre of 20 sous, which is more than 86 per cent.[7]

At the other end of the social scale where poverty necessitated borrowing, a Jew wounded a Christian within Colechurch in London in 1262 because he would not pay more than two pence for a loan of twenty shillings for one week, a rate higher than 43 per cent.

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6. J. B. C. Murray, History of Usury, p. 35.

7. Ibid., p. 35n.

It is also recorded that England's Henry III in 1272 restrained the Jews from charging poor Oxford scholars for books they had pawned, two pence per week for every twenty shillings loaned, also more than 43 per cent.[8]

The exactions of usurers had become so onerous, both nobles and commons being deeply indebted, that Roger, Bishop of London, in 1235 had excommunicated professional money-lenders. In 1290, Edward I expelled the Jews from England and left the Lombards with a clear field for their lending operations.

In Italy, the position of many money-lenders was quite different. Lorenzo de' Medici was an extremely important personage because he was a banker and lent money to princes at 15 or 20 per cent, a rate considerably lower, evidently, than that generally charged persons of lesser rank.[9]

Businessmen of the period, actuated by a desire to make an honest pound where only a shilling was before, exercised great ingenuity in devising ways to evade the prohibition against usury. One such method was the "triple contract." Partnership agreements had always been lawful, and there was no objection to a contract of assurance. Accordingly, A could enter into partnership with B, and insure with C against loss of capital, as well as with D against fluctuations in the profits of the partnership. Such contracts were therefore legal is made directly between A and B, amounting to a loan at interest, as A was furnishing B with capital at what was essentially a fixed rate of interest.

Some theologians, notably Johann Eck (1486-1543), Luther's great opponent, argued that the triple contract was legitimate, provided

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8. Ibid., p. 34n.

9. Francis Hackett, Francis the First, p. 33.

(1) that the investor was actuated by a prudent desire to conserve his capital and not by a sinful lust for gain, (2) that the recipient of the capital was a merchant, making gain by lawful means and not himself engaged in usury, and (3) that the merchant was known to be making profits. Also, the investor was not to be in necessitous circumstances.

Another interesting example was the "mons" (meaning a heap or fund of money), which represented the public debt of Italian cities at the end of the Middle Ages. These were a bone of contention between the different schools of Catholic thought, being justified on the grounds (1) that in some cases the loans that formed them were compulsory, and not made freely for personal gain, and (2) that the lenders forfeited the use of their money during the currency of the loans. It was argued, too, that the purchase of bonds for the purpose of increasing wealth was sinful but not where the objective was to procure a steady income suited to the lender's station in life. Later, the "montes pietatis," which were charitable loan funds from which advances were made to the poor on security of pawns, were treated on similar lines.

Briefly, it can be said that the exceptions covered cases where loans were used productively or for charity. Though some of them obviously violated both the letter and spirit of a rigid ban on usury, they were quite in keeping with the general position of the Church. Religious standards had to be workable in practical life. It had been reasonable enough to prohibit all interest when opportunities for the productive investment of borrowed capital were almost non-existent, but the situation was changing with the growth of trade and industry. The old regulations seemed to be hindering the development of economic activities, and the Church elaborated and extended its rules to meet the altered circumstances.[10]

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10. Whittaker, op. cit., p. 521-522.

The Protestant Reformation

Martin Luther favored a return to the strict attitude toward interest that had obtained before the exceptions allowed by the scholastics had been accepted. But in 1546 the French jurist Molinaeus (Charles Dumoulin) published his Tractatus Commerciorum et Usurarum, in which he contended that usury was not forbidden by divine law and that moderate interest should be allowed.

He was followed by the reformer Calvin, who likewise denied that interest, in itself, was sinful. Interest as such was neither permitted nor prohibited, he thought, but was subject to certain restrictions as indicated by the following: "Although I do not visit usuries with wholesale condemnation, I cannot give them my indiscriminate approbation, nor, indeed, do I approve that any one should make a business of money-lending. Usury for money may lawfully be taken only under the following conditions . . . That usury should not be demanded from men in need . . . he who receives a loan on usury should make at least as much for himself by his labour and care as he obtains who gives the loan."[11]

Although there may seem to be little actual difference between the Catholic viewpoint that usury was forbidden except in certain defined cases, and the position of Calvin that interest was allowable under given conditions, the latter was quickly taken up as approval of interest-taking generally, particularly by the Dutch who were rapidly becoming the commercial leaders of contemporary Europe. However, even in those countries which embraced the Reformation, the ideas and practices of the previous centuries were not abandonned all at once.

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11. W. J. Ashley, An Introduction to English Economic History and Theory, vol. 2, 4th. ed., London 1906, p. 459, quoted by Whittaker, op. cit., p. 523.

Ingenious ways were still necessary in England to get around the prohibition of interest. One, known euphemistically as "dry exchange," involved making a bill of exchange against an imaginary person in Amsterdam. When due, the purchaser paid exchange, re-exchange, protest fee, and incidental expenses, all amounting to some 20 to 30 per cent.

Recognizing that increasing needs of business and commerce, and that "the statutes prohibiting interest altogether had so little force that little or no punishment ensued to the offenders," Henry VIII, in 1545, legalized interest-taking. A rate of 10 per cent was made legal for the use of money and anything over this was forbidden as usury. There must have been considerable opposition to this low legal rate because the act was repealed seven years later by Henry's son Edward VI. The prohibition against interest remained in effect throughout the brief reign of his successor, Mary Tudor. That Her Majesty considered herself above the law would seem to be evident from her offer in 1558 to pay the City of London 12 per cent for a loan.[12] The statute of Henry VIII was reenacted by Queen Elizabeth in 1571, shortly after she came to the throne.

During the following century, rising commercial interests, and the necessity for recognizing what was actually taking place in business, were powerful factors in overthrowing the canonist doctrines. This was particularly true in the Netherlands where commerce and trade were flourishing and a complete system of banking and credit was developing. Transactions involving interest were very common there, and the practice had legal sanction. In 1638, Claudius Salmasius, in his "De Usuris," succeeded where his predecessor Molinaeus a hundred years before, had failed. He convinced the public of the fallacies in the

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12. Palgrave, Dictionary of Political Economy, vol. 2, p. 432.

canonical arguments against interest-taking. Although his ideas were taken principally from Molinaeus, he excelled in the way he arranged his arguments and in his manner of presentation.

Charles the First of England was beheaded on January 30, 1649. England ceased to be a Kingdom and became a Commonwealth, under the leadership of Oliver Cromwell. The following year the legal rate of interest was reduced to 8 per cent. Cromwell died in 1658 and the Commonwealth disintegrated. Two years later, Charles II, son of the beheaded monarch, returned from exile and was crowned king. Later that year the legal rate was again reduced, this time to 6 per cent.

Enrichment of the Dutch through extension of their trade and commerce was watched with jealous eyes by the English and French. Sir Josiah Child professed to see in the wealth of Holland a relationship to the low rates of interest prevalent there. In 1668 he published his "Discourse of Trade" which advanced the thesis that prosperity might be secured for England likewise if the maximum interest rate were reduced to 4 per cent. This drew a rebuttal to the effect that a low rate of interest fixed by law was not the cause of their national wealth, for in Holland there was no law limiting the rate of interest. It was argued that the low rate of interest was due to the abundance of ready money. The subject was one of great interest to businessmen and received much attention, but nothing was done about it until 1713 when the legal interest rate was lowered to 5 per cent by the Statute of Anne.

During this period of political and economic ferment, of mercantilistic thinking and dropping interest rates, French laws against interest continued to be the most severe in Europe.

CHAPTER IV

The Abandonment of Regulation

The sixteenth and seventeenth centuries were periods of great political and economic change in Western Europe. The great civilizations of the east had disappeared to such an extent that their peoples no longer exerted any measurable degree of influence on world affairs. The emphasis had shifted westward. These centuries saw the rise of two phenomena which were to reform mens' political, moral, and economic ideas, namely, the transition from Feudalism to Nationalism, and the great increase in trade and commerce which stimulated the growth of a money economy.

As these influences began to make themselves felt they attracted wide attention. The flow of silver from the newly discovered mines in North America greatly increased the amount of money in circulation and resulted in a rapid rise in prices. This provoked much economic speculation. Opinion was divided as to the advantages of lowering the interest rate by law, or removing all restrictions and letting it seek its own level in the market place.

Sir Thomas Culpeper favored the former method. In a pamphlet entitled "A Tract Against the High Rate of Usurie," published in 1621, he advocated reduction of the legal interest rate from 10 to 8 per cent. Succeeding in this, he published, in 1640, another tract advocating a further reduction to 6 per cent.

Sir Josiah Child also thought lower interest would be beneficial to trade and looked to the government to bring this about by law. In "A New Discourse of Trade" he wrote:

There is nothing in the World will engage our Merchants to Spend less and Trade more, than the Abatement of Interest, for the subduing of Interest will bring in multitudes of Traders, as it hath in Holland, to such a degree that almost all their People of both Sexes are Traders, and the many Traders will necessitate Merchants to Trade for less Profit, and consequently be more frugal in their Expences, which is the true Reason why many considerable Merchants are against the lessening of Interest . . .[1]

Generally; I say, the Dutch low Interest hath miserably lessened us in all Trades of the World, not secured to us by Laws, or by some natural advantage which over-ballanceth the disproportion of our Interest of Money . . .[2]

When I think of these things, I cannot but wonder that there should be English-men who want not Bread to eat, or Cloaths to wear, should yeat be so unkind and hard hearted to their Country, as strenuously to endeavor (for private Ends) the depriving her of so great a good, as would be the abatement of our Interest to 4 per cent. by a Law.[3]

In explaining how advantageous low interest was to business, Child continued:

. . . our greatest disadvantage is, that other Nations, especially our Industrious Neighbors the Dutch, are therein Wiser than we; For with them, and so in most Countries with whom we hold Commerce, there is not any Use (i.e., interest) for Money tollerated above the rate of Six in the Hundred: Whereby it must of necessity come to pass, though they have no other Advantages of Industry and Frugality, that they must out Trade us; for if they make a return of ten per cent. they almost double the Use allowed, and so make a very gainful Trade. But with us, where ten in the Hundred is so current, it is otherwise; for if we make not above ten, we are loosers; and consequently the same Trade, being with them and us equally good for the Publick, is to the private Adventurers lossful with us, with them very gainful.[4]

John Locke, on the other hand, was of the opinion that lowering the rate of interest would not be beneficial to trade:

High interest is thought by some a prejudice to trade; but if we look back, we shall find, that England never throve so well, nor was there ever brought into England so great an increase of wealth since, as in queen Elizabeth's and king James I. and Charles I. time, when money was at ten and eight per cent. I will not say high interest was the cause of it. For I rather think, that our thriving trade was the

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1. Sir Josiah Child, <u>A New Discourse of Trade</u>, Preface (xiv), quoted by Whittaker, <u>op. cit.</u>, p. 692.

2. <u>Ibid.</u>, p. 693.

3. <u>Ibid.</u>

4. <u>Ibid.</u>

cause of high interest, every one craving money to employ in a profitable commerce. But this, I think, I may reasonably infer from it, That lowering of interest is not a sure way to improve either our trade or wealth.[5]

Others, like Thomas Mun, maintained that the interest rate would rise or fall with the expansion or contraction of trade. Thomas Manley was of the opinion that "it is the scarcity of money (and many borrowers) that maketh the high rates of interest, . . . so the plenty of money and few borrowers will make the rates low." John Locke, too, argued that low rates of interest were the result of a plentiful supply of money. Sir Dudley North also explained than an abundance of capital and security made interest rates low in Holland. In his Discourses upon Trade he wrote: ". . . if there be more Lenders than Borrowers, Interest will also fall; wherefore it is not low Interest Makes Trade, but Trade increasing, the Stock of the Nation makes Interest low."[6] Sir Thomas Culpeper's son likewise published a Discourse attacking the then current interest rate of 6 per cent as too high.

The bitterness of the controversy, with its attendant flood of harangues, discourses, tracts, pamphlets, and parliamentary speeches, would give the impression that the fate of England and the welfare of every individual in it, were dependent solely upon the rate of interest on loans. The attention which the subject received through all available informative channels, caused many men to give the phenomenon of interest more critical analysis than it had received since the days of the Greek philosophers. Every teacher or writer on economic subjects had his own ideas as to the nature of or necessity for interest.

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5. John Locke, Some Considerations of the Lowering of Interest and Raising the Value of Money, quoted by Whittaker, op. cit., p. 692.

6. Sir Dudley North, Discourses upon Trade, quoted by Whittaker, op. cit., p. 532.

Important as are these theories as contributions to the sum total of economic knowledge, they had little practical effect. The rate of interest continued to be regulated, and its level was retained at 5 per cent until 1854 when all legal restrictions were removed.

In France, the subject of interest rates did not receive the same attention as in England. The French king in 1766 attempted by edict to reduce the legal rate of 5 per cent, which had obtained since 1665, to 4 per cent. The law being easily and safely evaded, however, money continued to be loaned in most of France at 6 per cent. Loans in connection with more speculative industries brought 8 to 10 per cent. This condition contributed to a financial crisis in the province of Angouleme, where A. R. J. Turgot was intendant. After a series of business failures, bankruptcies, and suspension of payments by the banks, bankrupt borrowers combined to prosecute lenders under the usury laws. Turgot had the cases remanded to the council of state and drew up his famous memorandum Sur Les Prets d'Argent, in defense of interest-taking.

This work may be briefly summarized as follows: The subject is divided into three parts. The first seeks to establish the necessity of interest-bearing loans for trade and industry and to prove that the rate is variable in proportion to the abundance or scarcity of capital and the nature of the risk. The second refutes the arguments of scholastic philosophers, jurists, and theologians, against interest per se. The third part seeks the historic causes of the hatefulness of usury and of the bad reputation of money-lenders. In conclusion, it recommends that interest-bearing loans be legalized and that the rate be left to the free agreement of lender and borrower. He also recommended that usurers who prey upon the passions and inexperience of youth be punished by laws relating to breach of confidence or other

kinds of imposition.

The canonists had argued that in a contract which was not gratuitous, equity demands that there must be an equality of the values exchanged, and that if interest is taken this equality is destroyed. Turgot answered this as follows:

> Between values exchanged, or between articles given and received, there is no such thing as metaphysical equality or in-equality. Equality of value depends upon the opinion of the contracting parties touching the degree of utility of the articles exchanged, for the satisfaction of their desires or needs. Having discussed in-equality, they allege as an example of in-equality the fact that the borrower, in returning more than the principal, gives back more than he received; and they infer that this is unjust. Such reasoning takes it for granted that the money received today and the money which is to be returned in a year, are two things perfectly equal. Is there not, on the contrary, an obvious difference between the two values - so obvious as to be recognized by the proverb 'A bird in the hand is worth two in the bush?'
>
> . . . .
>
> If these gentlemen supposed that a sum of a thousand francs and a promise of a thousand francs are exactly the same in value, they advance a still more absurd proposition; for if the two things were of equal value why should any one borrow at all?[7]

His views on the practice of governments in regulating the rate of interest are set forth in the following arguments:

> There is no reason for a law which fixes the rate of interest. The rate ought to be, as is the price of all commodities, fixed by agreement between the two contracting parties and by the relation of supply and demand . . .
>
> The rate of interest is, moreover, even more difficult to fix than is the price of any kind of merchandise because the rate of interest follows circumstances and considerations much more delicate and variable than does the price of a commodity, which are the time of making the loan, the time at which payment is stipulated, and especially the risk or the opinion of the risk which the capital must run. This opinion varies from one time to another; a momentary alarm, a series of bankruptcies, rumors of war, can cause a general uncertainty which suddenly tightens all negotiations for money. The opinion and the reality of the risk vary still more from one man to another and are augmented or diminished in all possible degrees. Consequently there must be just as many variations in the rate of interest.
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> A commodity may have the same price all over the country because all the people pay for it with the same money, and commodities in

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7. Turgot, Sur les Prets d'Argent, quoted by Ryan, Usury Laws, p. 49.

general use, whose production and consumption proportion themselves naturally the one to the other, have for long times had very nearly the same price.

But the money in a loan has neither the same price among all men, nor at all times, because in the loan, money is exchanged for a promise, and even if the money of all purchasers is alike, the promises of all borrowers do not resemble each other.

To fix by law the rate of interest is to deprive of the expedient of the loan, whoever cannot offer security proportioned to the lowness of the rate of interest fixed by the statute; it consequently renders impossible a multitude of commercial enterprises which cannot be carried on without risk of capital.[8]

Turgot's memorandum was so convincing in its presentation that at the time of the French Revolution the National Assembly declared all loans at interest to be legal, thus repealing the old usury laws and marking the end of three centuries of conflict between the canonists and the economists.

What Turgot had done for France was accomplished in England by Jeremy Bentham. Adam Smith had opposed legal prohibitions of interest, remarking that "This regulation, instead of preventing, has been found from experience to increase the evil of usury; the debtor being obliged to pay not only for the use of the money, but for the risk which his creditor runs by accepting a compensation for that use. He is obliged, if one may say so, to insure his creditor from the penalties of usury."[9] However, he was prepared to defend the existing law that fixed the maximum rate of interest at 5 per cent as "perhaps, as proper as any," and because he felt that if the legal rate were higher, the greater part of the money which was to be lent would go to prodigals and projectors (promoters) instead of to sober people who were either unable or unwilling to pay higher rates.

Smith thought that ordinarily, in such countries as Britain,

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8. Ibid., p. 50.

9. Smith, Wealth of Nations, quoted by Whittaker, op. cit., p. 525.

one-half of the so-called profit on stock could be regarded as interest on capital; and one-half as payment for superintendence and risk; but he said that the proportions varied from one country to another:

> The proportion which the usual market rate of interest ought to bear to the ordinary rate of clear profit, necessarily varies as profit rises or falls. Double interest is in Great Britain reckoned, what the merchants call, a good, moderate, reasonable profit; terms which I apprehend mean no more than a common and usual profit. In a country where the ordinary rate of clear profit is eight or ten per cent. it may be reasonable that one-half of it should go to interest, wherever business is carried on with borrowed money. The stock is at the risk of the borrower, who, as it were, insures it to the lender; and four or five per cent. may, in the greater part of trades, be both a sufficient recompense for the trouble of employing the stock. But the proportion between interest and clear profit might not be the same in countries where the ordinary rate of profit was either a good deal lower, or a good deal higher. If it were a good deal lower, one-half of it perhaps could not be afforded for interest; and more might be afforded if it were a good deal higher.[10]

Evidently Smith felt that the interest on capital varied more than did the remuneration for superintendence and insurance of the risk.

In his defense of usury, Bentham took Smith to task for the latter's attitude toward interest. It was Bentham's opinion that a man has a right to do what he will with his own. The first of his letters in defense of usury states his theorem: "That no man of ripe years and sound mind, acting freely and with his eyes open, ought to be hindered, with a view to his advantage, from making such bargain, in the way of obtaining money, as he thinks fit; nor (what is a necessary consequence) anybody hindered from supplying him, upon any terms he thinks proper to accede to."[11]

Bentham's task was simplified by the fact that the canonists' doctrines had been overthrown, and he could therefore concentrate all his arguments on the one problem of limiting the rate of interest by

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10. Ibid., p. 611.

11. Jeremy Bentham, Letters in Defence of Usury, p. 5.

law. He listed five arguments in favor of statutory maximums for interest rates which he proposed to refute: 1. Prevention of Usury; 2. Prevention of Prodigality; 3. Protection of Indigence against Extortion; 4. Protection of Simplicity against Imposition; 5. Repression of the Temerity of Projectors.

In disposing of the first argument he ignores the canonist arguments formerly used by Thomas Aquinas and others, since they no longer had any weight in England. He refutes the idea that there can be any correct rate of interest by showing that no one rate of interest is more proper than another. He shows that interest rates have varied widely at different times and in different countries, and that the rate of interest should be merely a matter of convenience between the parties to the contract. This is not as strong a point as Turgot's theory that the rate of interest varies with the supply of loanable capital, the duration of the loan, and the risks involved.

Taking up the second point, Bentham argues that interference to prevent prodigality is not necessary to the existence of society, and is a sort of paternalism. He also shows that it is not natural or customary for a spendthrift to pay a rate of interest above the ordinary market rate to supply his wants. He will usually spend what he has before he resorts to borrowing. Then, when all his money is gone, and he has no security to offer, he cannot borrow at any rate, so usually gets advances from his friends who, because of their friendship for him, make the interest a secondary matter. Furthermore, a statutory limit on the rate of interest cannot prevent the prodigal from buying goods on credit where he may, by reason of the price and terms, be paying the equivalent of an exhorbitant rate of interest. In fact, the law may be the means for compelling him to do this, since he may want the money to buy goods.

He next takes up the argument that legal maximums are necessary to protect the indigent or poverty-stricken against extortion. He contends, as Turgot had done, that no one rate can be equally suited to all situations. Some poor people may have to borrow at rates above the legal limit in order to avoid losing what they possess. Such situations happen quite frequently. Bentham points out that even if the borrower had to pay a high rate of interest he might be better off than if he could not borrow at all, and without adequate security or credit standing he probably couldn't. Apparently, it did not occur to him that a higher maximum might be established for consumer loans to enable the poor, when in desperate need, to borrow when otherwise they could not and would have to sell their meagre belongings or depend upon charity. Nevertheless, his arguments were perfectly valid as regards the usury laws in effect at the time he wrote.

In taking up the argument that usury laws are necessary to protect the simple, he answers that, if a man is so simple as to need protection, he needs it more in buying goods than in borrowing money, as he will buy goods many times more frequently than he will borrow money.

Bentham wrote a special letter to Adam Smith to combat the argument advanced by the latter that promoters ought to be repressed to prevent the waste and destruction of capital in risky undertakings, and that usury laws would help to accomplish this. He points out that it is a fallacy to say that promoters ought to be discouraged because: 1. In every period of history promoters have helped to improve society by financing new developments and improvements in the arts; 2. Restraints cannot lessen the proportion of unsuccessful projects to the successful ones, but would merely reduce the number

of projects; 3. The rulers of the State are the ones most likely to ruin it, not the people, as the former are the greatest spendthrifts in society. What support Bentham would have received today upon this observation!

He went on to say that the ruin of every promoter without exception would not be sufficient to disprove the usefulness of projects, and that since promoters take great risks, and either sustain large losses if they fail, or make big profits if they succeed, it is fair to charge them high rates of interest, and since they are willing to pay high rates the law ought not to interfere.

Bentham's Letters in Defence of Usury contain numerous other arguments particularly applicable to the situation in England in his time. Also, he discusses several ways in which usury laws work to the detriment of the commonwealth. This celebrated polemic so effectually silenced all the arguments in favor of legal maximums for interest rates that counter-legislation began to be enacted whittling away the scope of the statutes in various ways until in 1854 all the English acts against usury were repealed.

The effect of this action in Britain was far-reaching. Other countries of Europe followed suit in rapid succession: 1855 - Denmark; 1856 - Spain; 1857 - Holland, Norway, Switzerland, Sardinia; 1864 - Saxony, Sweden; 1865 - Belgium; 1867 - Prussia, and the North German Confederation.[12]

John Stuart Mill agreed with Bentham:

In so far as the motive of the restriction (on the interest rate) may be supposed to be, not public policy, but regard for the interest of the borrower, it would be difficult to point out any case in which such tenderness on the legislator's part is more misplaced. A person of sane mind, and of the age at which persons are legally compe-

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12. Ryan, op. cit., p. 57.

tent to conduct their own concerns, must be presumed to be a sufficient guardian of his own pecuniary interests. If he may sell an estate, or grant a release, or assign away all his property, without control from the law, it seems very unnecessary that the only bargain which he cannot make without its intermeddling, should be a loan of money. The law seems to presume that the money-lender, dealing with necessitous persons, can take advantage of their necessities, and exact conditions limited only by his own pleasure. It might be so if there were only one money-lender within reach. But when there is the whole moneyed capital of a wealthy community to resort to, no borrower is placed under any disadvantage in the market merely by the urgency of his need.[13]

With regard to the protection of prodigals from the extortions of usurers, Mill voiced the conviction that "no law can prevent a prodigal from ruining himself, unless it lays him or his property under actual restraint."[14] He also took exception to the proposal by Adam Smith that promoters should be "repressed" because

such laws may put a veto upon the prosecution of the most promising enterprise, when planned, as it generally is, by a person who does not possess capital adequate to its successful completion. Many of the greatest improvements were at first looked shyly on by capitalists, and had to wait long before they found one sufficiently adventurous to be the first in the new path: many years elapsed before Stephenson could convince even the enterprising mercantile public of Liverpool and Manchester, of the advantage of substituting railways for turnpike roads; and plans on which great labor and large sums have been expended with little visible result, (the epoch in their progress when predictions of failure are most rife), may be indefinitely suspended, or altogether dropped, and the outlay all lost, if, when the original funds are exhausted, the law will not allow more to be raised on terms on which people are willing to expose it to the chances of an enterprise not yet sure of success.[15]

The arguments of Turgot and Bentham, reinforced at a later date by John Stuart Mill, successfully demonstrated that the law was an ineffectual agent for the control of usury. Also, that it probably did more harm than good by driving the money-lending business underground and thereby making interest rates higher than they would have been if all lending and borrowing transactions were

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13. J. S. Mill, Principles of Political Economy, Bk. 5, Ch. 10, Sect. 2.

14. Ibid.

15. Ibid.

accomplished in the light of day. Since people always had and apparently always would be willing to pay interest for the use of other peoples' money, it became rather obvious that little could be expected, as little had been accomplished over several thousand years, in the way of prevention by the means advocated. Neither those measures which would prohibit interest-taking altogether, nor those which would put legal maxima on loans for the protection of borrowers, would be effective.

Accordingly, it seemed more rational to concede that interest was here to stay, and to inquire into its nature and the why of its being. Modern writers on the subject, with important exceptions among the socialists, have therefore tended to exclude the moral considerations of what _should be_ from their studies, and to theorize upon the nature of interest _per se_.

CHAPTER V

The Age of Theory

To examine all the theories of interest would be an impossible task. This paper does not pretend to accomplish even partially such a difficult feat. According only a brief space to such theories as should be included has necessitated the omission of others hardly less important.

The latter part of the eighteenth century has been taken as a starting point. Although theories of interest had their beginnings in a remoter past, earlier thought was concerned more generally with the moral aspects of interest-taking or the problem of regulation. Since the latter part of the eighteenth century more attention has been directed toward the Why? of interest. The number of theories discussed has been kept to a minumum in order to focus attention upon the main currents of thought.

Choice in such matters must necessarily be arbitrary, for it is not always easy to select the most representative or those which had the most far-reaching influence. The selection of certain theories for discussion does not imply, however, that those dealt with are in any way superior to those not included, either from the standpoint of abstract truth or social utility. Even the history of error can serve a useful purpose. Errors should not be forgotten. Everyone who wishes to make some progress in the search for truth should know something of the mistakes of others who thought they were extending the boundaries of knowledge. The study of error would be justified though the result were simply a determination to avoid it in the future.

Discussion of theories of interest in their historical sequence would tend to be confusing since at times they reappear under different conditions in a new guise so that the relationship is not obvious. Accordingly, each theory is discussed as an entity and without regard to chronological sequence. Should one theory be a development of another, or a variation which has attained the maturity of the original, attention is called to this relationship. Reappearances of theories, while seemingly affected by the whims of fashion, should be considered more in the nature of a struggle of ideas for existence. A theory which seemed at one time to be quite dead may arise under new conditions with greater vigor than ever.

The Exploitation Theory

The exploitation theory is based upon the premise that the capitalist robs the worker of part of the product of his labor. It was evidently this conception of interest-taking which prompted the restrictive legislation of King Hammurabi and numerous rulers and legislative bodies since his time. In early civilizations the only visible factors of production were capital and labor. It seemed that the only way in which capital could be made productive was through the application of labor. Accordingly, the entire product of the laborer's effort was rightly his. Any share of the product of labor which went to capital was considered to be a forced deduction from the total value of the product which is the natural reward of labor.

This view of interest was carried down through the centuries and became the cornerstone of medieval thinking, resulting in the prohibitions against interest-taking as unjust exploitation of the borrower. When the religious and ethical aspects were removed, and the matter viewed in an economic light, it was embodied in the teachings of Adam

Smith. He held that participation of capital in the product of the workers' labor could be traced to the desire of men "to reap where they had not sown." This may be considered the starting point of the exploitation theory. With Smith, this remark was merely a passing expression of his general anti-capitalistic leanings and is not of much consequence in his system. His remark would imply, however, that it was his opinion the laborer no longer received the entire product of his labor because of the grasping natures of capitalists and landowners.

A member of the classical school who developed an incomplete form of the exploitation theory was Simonde de Sismondi. According to his theory, the laborer's poverty places him at a disadvantage in bargaining with the employer and makes for a labor contract unfavorable to the former who received merely enough upon which to subsist. It might have been expected that Sismondi would pass from a statement of this theory to a condemnation of interest as exploitation of the borrower. He did just the opposite. He justified interest. As the landlord earned his rent by the labor he expended in settling the land, so, Sismondi said, the capitalist rested his claim on the labor of accumulation. The only difference was in point of time. The laborer's right to the product of his work depended upon his present effort; the rights of the landlord and the capitalist were based on labor of the past. Sismondi, therefore, beginning with the idea of exploitation, arrived at a labor explanation of interest.

A little thought will serve to show that this argument is invalid as a theory of interest. The labor incorporated in capital goods should be recompensed with an equal quantity of labor. There is nothing in Sismondi's argument to demonstrate why the remuneration

should include an additional amount in respect of interest.[1]

It might have been expected that David Ricardo, whose theory of rent has been so widely accepted that he has appeared to many as the greatest of all economists, would have developed a theory of interest. To Ricardo, as, indeed, to all the classical economists, capital profit is identical with interest, because no interest can be regularly paid except out of profit. Interest is profit passed on to the creditor whose loan has made production possible. Ricardo, however, did not inquire into the nature of capital and profit; he took them for granted. His writings would seem to imply, nevertheless, that capital formation and the growth of society would be stopped by a reduction in profit resulting from a rise in rents. In other words, as Turgot had pointed out, no capital can be formed unless there is a reasonable prospect of profit. This doctrine places capital side by side with labor in opposition to land, the revenue from which, according to Ricardo, is a mere surplus not needed for production. His view of capital, however, was logically untenable in a system founded on labor value, where capital was considered a special kind of labor - embodied labor, as it were. This inconsistency was made evident by Ricardo's failure to reconcile the existence of interest with the value theory. After the failure of Ricardo's theory, it became clear that, on the basis of the doctrine of labor value, the only logical explanation of interest is that it is the fruit of exploitation. The borrower is robbed of part of what he produces with the borrowed capital.

Socialist writers seized upon the Ricardian labor theory, and its corollary, the exploitation theory of interest, and denied capi-

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1. Whittaker, _op. cit._, p. 528-529.

tal any right to interest. Karl Marx, one of the greatest proponents of socialism, maintained that capital is not a factor in production but only the means of exploitation. He opened Das Kapital with the famous deduction of the capitalist law of exploitation from the general law of the exchange of equal labor values developed by the classical economists. The paradox of capitalism is in the existence of unearned profit in a world of equivalent exchange; in other words, in the combination of the law of the exchange of equal labor values with the law of wages. According to this law, wages are determined, not by the product of labor, but by the amount of labor necessary to reproduce labor, that is, the labor required to produce the worker's minimum standard of living. Marx resolved the paradox by distinguishing between the labor value of the product of labor (i.e., the amount of labor-time involved in producing it) on the one hand, and on the other, the labor value of the worker's labor power. The worker sells the latter to the employer because the former has no means of production and nothing that he could produce and sell independently. The difference between the two values, which is due to the increase in the productivity of labor to the point where the worker can produce more than his minimum standard, is the exploitation gain of the capitalist. If the worker had access to the means of production, he would not sell his labor power for its equivalent; he would sell the product of his labor for its equivalent. The latter is the higher, being the sum total of surplus value in its relation to labor and wage, and profit (including interest) in its relation to the capital invested in the business. Not having access to the factors of production in his own right, the laborer works only part of the day for himself; the rest of the work day is unpaid, and represents exploitation by the capitalist.[2]

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2. Karl Marx, <u>Das Kapital</u>, passim.

A later group of socialist writers, members of the Fabian Society, of which Sidney and Beatrice Webb were the most representative, protested against the lending of money at hundreds per cent interest to the needy. They characterized interest-getters as social parasites whose depredations are none the less real in that they are made with the sanction of the law. In support of their thesis that interest-taking at usurious rates is unconscionable exploitation of borrowers by lenders, the Webbs cited the following cases:

> An unfortunate worker borrowed the sum of 300 pounds from a money-lender, for which he gave a promissory note for 456 pounds, the money being repayable in monthly installments. He paid several installments regularly, and then for a subsequent installment the check was sent a single day late. The check was returned and payment of the balance due demanded. Default interest was charged, and when the borrower was haled into court he was compelled to pay besides installments of 114 pounds, a sum of 600 pounds - 714 pounds in all - for the loan of 300 pounds for a period of fifteen months, and annual rate of 110 per cent.
>
> A small business man borrowed 50 pounds, signing a promissory note for 200 pounds. Further advances were made to him during the succeeding twelve months totaling 120 pounds. Over the next two years the loan was repaid with interest, to the extent that at the end of three years from the date of the original loan, 461 pounds had been paid to the lender. In two years the 120 pounds borrowed had been repaid almost four times.[3]

Such practices as these were widely publicized by socialist writers of all nationalities and creeds. They strengthened the belief of millions of workers throughout the world that the interest they were forced to pay, either directly for their meagre loans for necessities, or indirectly through higher prices for these same necessities, or both, was an unearned share in the products of their labor, and constituted their robbery and exploitation at the hands of the money-lending fraternity. The ever-spreading acceptance of the exploitation theory as applied to wages and profits, suggests that the time is not far distant when there will be demand for its extension

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3. Webb, The Decay of Capitalist Civilization, p. 133n.

to the profit of capital which is interest.

The Money Theory

Another old view of interest was as a payment or rent for the use of money rather than for capital. This conception of interest is to be found in the writings of Aristotle and others of later dates. In the early stages of our present money economy, interest was spoken of as the price of money, and the price was considered to be determined by the relation of the amount of money in circulation to the demand for loans. It was believed that a plenitude of money had the effect of decreasing interest rates. John Gilbert, an English mint officer in 1625, said that "by plentie of monye the price of usury may of course decrease."[4] Sir William Petty echoed the same opinion when he said:

As to Mony, the Interest thereof was within this fifty years, at 10 pounds per cent. forty years ago, at 8 pounds and now at 6 pounds no thanks to any Laws which have been made to that purpose, forasmuch as those who can give good security, may now have it at less: But the natural fall of Interest, is the effect of the increase of Mony.[5]

Davenant offered a similar explanation, respecting the interval that Petty had studied:

About the year 1666, the value of land in the best counties, was from 18 to 20 years; and in the worst, from 14 to 16 years purchase; and the legal interest was then 6 per cent. and there was a greater plenty of money, than of securities; all of which will appear to any one that enquires into these matters. This considerable rise in the value of land, and fall in interest, did without doubt proceed from a greater quantity of money got some way or other into the kingdom . . .[6]

It was natural that such importance should be given to money and such powers ascribed to it during the early days of our capitalist economy. Money was the capitalist form of wealth as opposed to the

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4. Whittaker, op. cit., p. 530.

5. Petty, Economic Writings, quoted by Whittaker, op. cit., p. 530.

6. Charles D'Avenant, Discourses on the Publick Revenues, quoted by Whittaker, op. cit., p. 530-531.

feudal conception of wealth as land, fine clothes, silver plate, etc. In a capitalist economy money becomes available as business capital by being withheld from the purchase of consumer goods. A reduction in interest rates is, of course, to the benefit of all credit seekers. The writers of the period from Malynes through Child to Petty emphasized the stimulating effect of low interest rates on business activity, since the expansion of business depends on credit for new and larger transactions.

The views of this period toward interest rates echoed the tenor of medieval pronouncements against usury. Malynes in particular, a business man like most writers of this period, was better in his opposition to financiers. He accused them of making money artificially dear by drawing it into their "unproductive" transactions and thus withholding it from "legitimate" ends.

The opinion that the rate of interest was directly proportional to the quantity of money available to meet the demand was stated clearly by the philosopher and political theorist John Locke. In Some Considerations of the Lowering of Interest and Raising the Value of Money, he said "That, which constantly raises the natural interest of money, is, when money is little, in proportion to the trade of a country. For in trade every body calls for money, according as he wants it, and this disproportion is always felt. For, if Englishmen owned in all but one million, and there were a million in money in England, the money would be well enough proportioned to the debts: but, if two millions were necessary to carry on trade, there would be a million wanting; and the price of money would be raised, as it is of any other commodity in a market, where the merchandize will not serve half the customers, and there are two buyers for one seller."[7]

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7. John Locke, Works, quoted by Whittaker, op. cit., p. 531.

The popularity of the money theory waned when the mercantilist doctrine that one can gain only at the expense of another was demolished by its opponents. David Hume, a brilliant and original economist contributed largely to this result. Hume's doctrine of interest is remarkable for the wisdom with which he combined economic reasoning with historical and sociological analysis. While he did little to explain the nature of interest, he did investigate its rate. His starting point was to distinguish between money spent on consumers' goods, the increase of which raises prices and wages, and money in capital, the increase of which lowers interest. Not content with the mere separation of the two forms of money, his sense of reality prompted him to study the interaction between money spent and money invested.

To this end, he first surveyed the factors on which the rate of interest depends, namely, the intensity of the demand for loans, the magnitude of the supply of loan money, and the size of commercial profits, as indicative of the profits to be realized from loans. In a commercial-minded country, Hume argued, frugality prevails, there are many lenders and few borrowers, and competition in commerce makes for low profits and consequently low interest rates. Profligacy, on the other hand, which he associates with the preponderance of the landed gentry in a country, will manifest itself in a high rate of interest.

This result of his penetrating insight was combined with analysis of the inflationary process resulting from discovery of new mines. Hume contrasted two sociological types; the people of Spain, on the one hand, and those of Britain and France, on the other. In Spain, interest was low only for a short time while new riches from America, coming in large accumulated sums, were loaned out. But people in

Spain did not know how to turn money to commercial advantage and soon consumed the new wealth. In the end the usual high interest rates, with all they imply, were restored. The inhabitants of Britain and France, however, knew how to benefit from Spanish squandering, attracted the metal in payment for their exports to Spain, used it to stimulate domestic commercial activity, and were rewarded for their demonstration of all the capitalistic virtues by a low rate of interest.[8]

Turgot also contributed to the downfall of the money theory of interest. It was his view that money had two different valuations in commerce. One concerned its purchasing power over commodities, the other had reference to the interest rate. In this connection he stated:

Money may be very common in ordinary commerce, may there have very little value, may answer to a very small quantity of commodities, and the interest of money may at the same time be very high. . . . for the interest of money falls only when there is more money to lend, in proportion to the wants of borrowers, than there was before. But the money which is carried to market is not to lend; it is the money which is placed in reserve, the accumulated capitals, that are lent; and so far from the increase of money in the market, or the diminution of its price in relation to commodities in ordinary trade, infallibly and by immediate sequence bringing about a decrease of the interest of money, it may on the contrary happen that the very cause which increases the money in the market, and which increases the prices of other commodities by lowering the price of money, is precisely that which increases the hire of money or the rate of interest.[9]

It was not the quantity of money as such, therefore, which influenced the rate of interest, but the supply of capital, either in the form of commodities not needed by the owner for subsistence, or in the form of money with which such commodities could be purchased. The supply of money which affected interest was not money from mines but accumulated savings in excess of consumptive needs. Such a

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8. Eduard Heimann, History of Economic Doctrines, p. 46-47.

9. Turgot, Reflections on the Formation and Distribution of Riches, quoted by Whittaker, op. cit., p. 538.

supply of savings would be most evident in a land where people were frugal, and would be least in a country addicted to luxurious living.

The Abstinence Theory

Another view of interest is that it represents a reward for abstaining from consumption of present goods in order to enjoy future goods. Such abstinence is entitled to compensation, just as toil and trouble, the essence of labor, deserve a reward. In order to form capital, a man must refrain from spending part of his income, i.e., of his previous profit, and plow it back into production, either directly or through the medium of credit institutions. On the usual classical assumption that resources are always utilized to their fullest capacity, it is incontestable that capital formation requires postponement of consumption. If employed for the purchase of consumer goods, money stimulates production; if plowed back into production, it redirects the factors of production into the production of capital goods whose ultimate consumable fruits will become more plentiful, but not available until later. The sacrifice which deserves compensation is one of Time.

The theory of interest as a reward for abstinence was developed largely by Nassau William Senior. According to Senior, abstinence is "the conduct of a person who either abstains from the unproductive use of what he can command, or designedly prefers the production of remote to that of immediate results."[10] Like labor, abstinence is disagreeable, and so it "must therefore be called into exertion by the prospect of its specific remuneration . . . by the hope of profit . ."[11]

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10. Senior, Political Economy, quoted by Whittaker, op. cit., p. 541.

11. Ibid.

By refraining from utilizing a stock of capital goods or money, and loaning it to someone else, the owner thereupon becomes entitled to a payment for the period during which he waits for the return of his capital while it is in the use of or at the command of another. This payment may be called interest on the loan.

Henry George effectively showed that abstinence of itself does not sufficiently account for interest:

Interest, we are told in all the standard works, is the reward of abstinence. But manifestly, this does not sufficiently account for it. Abstinence is not an active, but a passive quality; it is not a doing - it is simply a not doing. Abstinence in itself produces nothing. Why, then, should any part of what is produced be claimed for it? If I have a sum of money which I lock up for a year, I have exercised as much abstinence as though I had loaned it. Yet, though in the latter case I will expect it to be returned to me with an additional sum by way of interest, in the former I will have but the same sum, and no increase. But the abstinence is the same. If it be said that in lending it I do the borrower a service, it may be replied that he also does me a service in keeping it safely - a service that under some conditions may be very valuable, and for which I would willingly pay, rather than not have it; and a service which, as to some forms of capital, may be even more obvious than as to money. For there are many forms of capital which will not keep, but must be constantly renewed; and many which are onerous to maintain if one has no immediate use for them. So, if the accumulator of capital helps the user of capital by loaning it to him, does not the user discharge the debt in full when he hands it back? Is not the secure preservation, the maintenance, the re-creation of capital, a complete offset to the use? Accumulation is the end and aim of abstinence. Abstinence can go no further and accomplish no more; nor of itself can it even do this. If we were merely to abstain from using it, how much wealth would disappear in a year! And how little would be left at the end of two years! Hence, if more is demanded for abstinence than the safe return of capital, is not labor wronged?[12]

Risk As A Justification Of Interest

From earliest times the risk of repayment inherent in any loan of an article or money has been considered a factor in justification of interest. J. B. Say wrote: "the ratio of the premium of insurance, which frequently forms the greater portion of what is called interest, depends on the degree of security presented to the lender; which

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12. Henry George, Progress and Poverty, p. 176.

security consists in three circumstances: 1. The safety of the mode of employment; 2. The personal ability and character of the borrower; 3. The good government of the country he happens to reside in."[13] Another factor to be considered, according to Say, is the ease with which the lender may terminate the period of the loan and receive back his capital: "Among the circumstances incident to the nature of the employment, which influence the rate of interest, the duration of the loan must not be forgotten; ceteris paribus, interest is lower when the lender can withdraw his funds at pleasure, or at least in a very short period; and that both on account of the positive advantage of having capital readily at command, and because there is less dread of a risk, which may probably be avoided by timely retreat."[14]

The view that interest includes a premium for insuring the loan against possible loss by the lender must assume that the lender is self-insured or has insured the loan elsewhere and must pay part of the interest as premium. In many instances, however, lenders require borrowers to insure the loan, or the capital in which the loan is invested, at the latter's expense. Evidence in the form of a paid policy is required as a condition of the loan. Even when this condition has been fulfilled, the lender generally demands the maximum rate of interest, making no allowance for elimination of the risk factor.

Risk, therefore, is not a justification for true interest. It is merely another of the returns upon loans which are demanded by borrowers and generally considered to be included in interest payments. If risk can be eliminated through proper insurance, it obviously cannot be a reason for interest in the truest sense.

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13. Say, A Treatise on Political Economy, quoted by Whittaker, op. cit., p. 541.

14. Ibid.

The Productivity Theory

The fundamental facts which create that form of income called interest are, as conceived by Alfred Marshall, that payment is offered for the use of capital because a gain is anticipated from its use; and that capital is scarce enough to require payment for its use because of the preference which the majority of people have for present over future gratifications. In other words, the demand for capital is based upon its productiveness, the supply upon the prospective action of individuals, or, more remotely, upon all the causes that induce people to save more or less of their incomes.

Interest, therefore, is payment for services which capital renders in production. Marshall distinguishes between what he calls net interest and gross interest. The latter includes other elements, including insurance against risk and the earnings of management. He says:

> The necessity for making this allowance for insurance against risk is so obvious that it is not often overlooked. But it is less obvious that every loan causes some trouble to the lender; that when, from the nature of the case, the loan involves considerable risk, a great deal of trouble has often to be taken to keep these risks as small as possible; and that then a great part of what appears to the borrower as interest is, from the point of view of the lender, earnings of management of a troublesome business.[15]

> The price, then, that the borrower has to pay for the loan of capital, and which he regards as interest, is from the point of view of the lender more properly to be regarded as profits: for it includes insurance against risks which are often very heavy, and earnings of management for the task, which is often very arduous, of keeping those risks as small as possible. Variations in the nature of these risks and of the task of management will of course occasion corresponding variations in the Gross interest, so called, that is paid for the use of money. The tendency of competition is therefore not towards equalizing this Gross interest; on the contrary, the more thoroughly lenders and borrowers understand their business, the more certainly will some classes of borrowers obtain loans at a lower rate than others.[16]

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15. Alfred Marshall, Principles of Economics, p. 588.

16. _Ibid._, p. 590.

Marshall points out that certain difficulties arise in trying to express the rate of interest as a ratio of the value of capital, "for the rate of interest which the borrower is willing to pay measures the benefits that he expects to derive from the use of the capital only on the assumption that the money has the same purchasing power when it is borrowed and when it is returned."[17] Another difficulty arises out of the fact that capital invested in the concrete appliances of industry, such as factories, machines, etc., may earn amounts in very different relation to their cost from that which may be earned by the free capital available for investment. The earnings of capital in concrete form may, for short periods, bear no distinct relationship to the cost of the concrete appliances. The stock of them is for short periods relatively fixed, and their earnings are related to the value of their products in the market place. For such periods their earnings may be compared to those of land. Viewed in this light, these earnings are not properly interest at all, but "quasi-rent." They can be expressed as a rate of interest only when they have been capitalized at the present interest rate.

The situation is somewhat different in the long view. Unlike land, which is fixed in quantity, industrial equipment can be multiplied, and new capital tends to flow into concrete forms with high earnings and avoid the forms with low earnings. This tends to equalize the earnings from various forms of invested capital. The tendency is, therefore, for all forms of capital to produce a normal rate of return, though this normal rate is not a fixed ratio, but shifts under the influence of changing conditions. The normal rate arises out of all the influences which determine the supply of capital and the demand for it.

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17. _Ibid._, p. 593.

The tendency of the earnings of capital toward a normal rate follows from the incentive of business men to push the use of each factor of production to the margin of profit. Normal interest, the normal earnings of capital in production, thus constitutes a special example of normal price or value. When arriving at this concept of a normal rate of interest, Marshall is applying his value theory to a special set of circumstances involved in the distribution of income from the productive process.

The main difference between Marshall's concept of the factors of production and those of earlier economists lies in his inclusion of organizing ability or enterprise, and his separation of the income for this factor as profits, distinct from interest which is the income of capital itself independent of the organizing ability or organization which makes it productive. It is the job of this factor to so adjust productive processes as to bring the prices of products as near as possible to the normal price which they would bring if all the influences affecting prices would remain sufficiently stable for the normal price level to be reached.

What to business men are costs of production affecting price levels are incomes to the recipients. Normal income would therefore result from normal price. The value of things being purely relative, they are expressed as the ratios which they bear to one another in exchange. Modern marketing systems cause values to be expressed as money prices. Normal price, therefore, presupposes normal value. A normal rate of interest would then be the income to capital of normal value engaged in the production of goods to sell at normal prices.

Marshall's concept of net interest justifies this payment to capital in production as a reward for waiting on the assumption that

accumulation of capital requires postponement of gratifications which, "in general," involve "a sacrifice on the part of him who postpones, just as additional effort does on the part of him who labours . . ."[18] This is simply a restatement of the Abstinence theory so carefully erected by Senior and so easily demolished by Henry George. Marshall made no further effort to justify net interest as payment to capital.

He did, however, throw some light on what he considered the rate of interest applying in England during the last quarter of the eighteenth century:

> At the present time the net interest on capital in England is a little under three per cent. per annum; for no more than that can be obtained by investing in such first-rate stock-exchange securities as yield to the owner a secure income without appreciable trouble or expense on his part. And when we find capable business men borrowing on perfectly secure mortgages at (say) four per cent., we may regard that gross interest of four per cent. as consisting of net interest, or interest proper, to the extent of a little under three per cent., and of earnings of management by the lenders to the extent of rather more than one per cent.[19]

The Agio Theory

It has been observed at all stages of man's development that present pleasures are generally preferred to those of the future. The factors which influence men to make this preference are numerous and vary with each individual. There is probably only one common to all - the intervention of death which may prevent anyone from enjoying the pleasures of tomorrow if he denies himself those of today. We speak here of earthly pleasures, of course, because those influences which cause men to give up the pleasures of this world for the rewards of the next are not of economic origin, even though their practice and adoption by large segments of humanity may have collateral economic effects.

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18. *Ibid.*, p. 587.

19. *Ibid.*, p. 588-589.

In commenting upon this propensity of man, John Rae noted that "Were life to endure for ever, were the capacity to enjoy perfection in all its good, both mental and corporeal, to be prolonged with it, and were we guided solely by the dictates of reason, there could be no limit to the formation of means for future gratification, till our utmost wishes were supplied. A pleasure to be enjoyed, or a pain to be endured, fifty or a hundred years hence, would be considered deserving the same attention as if it were to befall us fifty or a hundred minutes hence, and the sacrifice of a smaller present good, for a greater future good, would be readily made, to whatever period that futurity might extend."[20]

However, life is fleeting, man is finite, and men generally prefer present to future gratifications. Said Rae:

> But life, and the power to enjoy it, are the most uncertain of all things, and we are not guided altogether by reason. We know not the period when death may come upon us, but we know that it may come in a few days, and must come in a few years. Why then be providing goods that cannot be enjoyed until times, which, though not very remote, may never come to us, or until times still more remote, and which we are convinced we shall never see? If life, too, is of uncertain duration and the time that death comes between us and all our possessions unknown, the approaches of old age are at least certain, and are dulling, day by day, the relish of every pleasure. A mere reasonable regard to their own interest would, therefore, place the present very far above the future, in the estimation of most men.[21]

This emphasis upon present goods versus future goods is, in all probability, justified in many cases, but in general it is likely that men underestimate the intensity of future needs. For this Boehm-Bawerk ascribes three reasons: 1. want of imagination, which prevents them from picturing the intensity of their future desires; 2. weakness of character, which makes them unable to resist the cravings of

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20. John Rae, The Sociological Theory of Capital, quoted by Whittaker, *op. cit.*, p. 542.

21. *Ibid.*, p. 543.

the present; 3. the uncertainty of human life.[22]

As a result of these influences, present goods are, as a rule, worth more than future goods of like kind and number, so that people are willing to pay a premium or agio for present goods. That is to say, they are willing to pay interest. According to Boehm-Bawerk, "notwithstanding all differences in shape and appearance (of interest), the active cause in them all is one and the same, namely, the difference in value between present and future goods."[23]

He amplifies this statement as follows:

By far the simplest case of this difference in value is presented in the loan. A loan is nothing else than a real and true exchange of present goods for future goods; indeed, it is the simplest conceivable phenomenal form, and to some extent, the ideal and type of such an exchange. The lender A, gives to the borrower B, a sum of present goods - say, present pounds sterling. B gets full and free possession of the goods to deal with as he likes, and, as equivalent, he gives into A's full and free possession a sum of entirely similar, but future goods, say, next year's pounds sterling . . . Here, then, is a mutual transfer of property in two sums of goods, of which one is given as recompense or payment for the other. Between them there is perfect homogeneity, but for the fact that one belongs to the present, the other to the future . . . The borrower therefore, will, as a rule, purchase the money he receives now by a larger sum of money which he gives later. He must thus pay an 'agio' or premium, and this agio is interest. Interest, then, comes, in the most direct way, from the difference in value between present and future goods.[24]

But how is this increase in value of present goods over future goods to be explained? It is, according to Boehm-Bawerk, due to the

peculiar kind of activity which the undertakers (promoters) exert, and from which they draw their profit (interest). They buy goods of remoter rank, such as raw materials, tools, machines, the use of land, and, above all, labor, and, by the various processes of production, transform them into goods of first rank, finished products ready for consumption. In doing so they obtain . . . a gain approximately proportioned to the amount of capital invested in their business.[25]

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22. Boehm-Bawerk, Positive Theory of Capital, p. 254-255.

23. *Ibid.*, p. 285.

24. *Ibid.*

25. *Ibid.*, p. 299.

Now this gain comes about from the fact that some goods, particularly those of remoter rank, are present commodities, they are essentially future goods in that they will not be available in a form for consumption until some time in the future when they will become present goods and as such command a higher price as compared with goods in the still remoter future. On this aspect of interest-forming, Boehm-Bawerk says:

It is during the progress of production that the future commodity ripens gradually into the present commodity, and grows at the same time to the full value of the present commodity. Time elapses; what was next year becomes this year; and on the great changing stage of life everything - man himself, his wants and wishes, and with them the standard by which he measures his goods - shifts one scene forward. The wants which, last year, were future wants, and little thought of as such, attain their full strength and their full right of present wants; and a similar advance attends the goods which supply these wants. A year ago they were goods of the future, and had to be content with the lower value that attached to them as such; today they are present goods, ripe for consumption, and enjoy the full value of such goods. A year ago it was to their prejudice that they were measured in the, then, 'present' goods. Today that standard has sunk into the past, and if the men of today measure them again in 'present' goods, they stand equal with them in the first and chiefest rank, and suffer nothing by the comparison. In short, as time passes, it cancels the causes by reason of which the then future commodity suffered a shrinkage of value, and brings it up to the full value of the present good. The increment of value is the profit of capital.

This is not to say, of course, that, to make present goods out of future goods, it is sufficient that time should elapse and the future become the present. The goods themselves must not remain stationary. On their part they must bridge over the gap which divides them from the present, and this they do through the production which changes them from goods of remote rank into finished and final products. If there is no production process, if the capital is left dead, the means of production always remain undervalued future goods.[26]

If this conception of the nature of interest is tenable, and it certainly has much in its favor, there must be some good reason why people generally separate the future value of a thing into two components, the amount originally loaned or the value as a 'present' good, and the interest or premium in value as a future good. Boehm-

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26. *Ibid.*, p. 302.

Bawerk offers the following in explanation of this attitude:

According to our conception, interest is a complementary part of the price payable for a sum of present goods in future goods. It is a part-equivalent of the 'principal' lent. In itself there would be nothing to prevent this part-equivalent being paid along with the bulk of the price; in other words, interest and principal might be put together in one single payment at the end of the whole loan transaction. Reasons of practical convenience have, however, made it the general rule that, in loans made for any considerable length of time, the premium should be paid separately, and in rates graduated according to time - monthly, half-yearly, yearly, etc. With the essential nature of interest this method of payment has nothing to do; it may, indeed, be expressly provided otherwise in the loan contract. But quite possibly it is the case that this custom, which, practically, has prevailed from time immemorial, of separating the payment of interest from the payment of principal, has assisted - perhaps, even, directly caused - the popular opinion that the principal sum paid back is, by itself, the equivalent of the sum originally given, and that interest is a thing by itself, an equivalent for another and separate 'something.'[27]

Boehm-Bawerk recognizes that this simple view of the nature of interest becomes in practical, every-day application, "obscured by a multitude of casuistical details and developments."[28] These do not change the essential nature of the principle which he advocates, "but they conceal it under various phenomenal forms such as make recognition of it not always easy."[29] Some of the complications arise from the fact that "productive goods contribute various portions of their useful content to the making of various final products, which products arrive at maturity at various points of time."[30] "Another complication," he notes, "arises from the fact that almost all productive instruments admit of various kinds of employment, and that these employments turn out their finished products at different points of time."[31] Since some of these goods may be used in the present,

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27. Ibid., p. 296.

28. Ibid., p. 304.

29. Ibid.

30. Ibid., p. 305

31. Ibid.

some in the intermediate future, and some in the more remote future, it might seem that the principle laid down relative to the formation and increase of value does not apply to all circumstances. However, Boehm-Bawerk proves mathematically that each of the possible uses of a good allows "exactly that room for increase of value which the remoteness of its finished and final result demands."[32]

This is an attempt to explain in the abstract something which in everyday, practical business life is taken for granted. Interest is taken for granted without any attempt to analyze its causes, and is added or deducted in all calculations relating to the employment of capital. If a businessman is considering an outlay of capital which will yield a result in a year's time, he simply calculates whether the future return will leave at least the amount of his capital over and above the year's interest, and after its deduction. If he has deducted, in advance, from the future result an amount of interest proportional to the time and capital involved, it is naturally to be expected that the future proceeds, when actually realized, will yield that very amount of interest.

Boehm-Bawerk adapts, in a very ingenious manner, his agio theory of the increase in value of a good as it progresses from the stage of futurity to that of the present, to an explanation of interest from durable goods such as tools, houses, clothes, land, etc. Since such goods are capable of rendering several successive services during their life (not, like perishable goods, being capable of rendering only a single service which exhausts their useful content), they have varying degrees of value, depending upon whether the service is to be rendered in the present or in the future. A material good has the same value

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32. Ibid., p. 309.

as the sum of the values of the various services it is capable of rendering. In consequence, the value of the more distant services suffers the same depreciation as the value of future goods. While a service to be rendered next year may be technically the same as a service to be rendered next month, it is naturally of less value. A service to be rendered two years hence has even less value.

Thus the agio theory explains the interest yielded by a durable good which produces nothing, such as a dwelling-house, household furniture, a hired piano, or the books of a lending library. It also, according to Boehm-Bawerk, disposes of the fallacy of interest as exploitation of labor. "What laborers are exploited by the owner of a house?" he asks. "Suppose he has paid away the whole $10,000, the worth of his house, in wages to the laborers who built it, so that in the origin of the house there is not a particle of profit from exploitation: still, the house, year after year, yields him $500 of interest on capital. Where shall we find the worker from whom the $500 could have been taken either by fraud or force?"[33] He admits that interest may be associated with usurious exploitation but should not be condemned in essence any more than the healthy trunk of a tree should be cut down in order to get rid of certain diseased branches.

In contrast he points out "that the institution of interest has its manifold uses; particularly as the prospect of interest induces saving and accumulation of capital, and thus, by making possible the adoption of more fruitful methods of production, becomes the cause of a more abundant provision for the whole people."[34]

If the agio theory, as presented by Boehm-Bawerk and later ampli-

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33. *Ibid.*, p. 346.

34. Ibid., p. 363.

fied by the American economist Irving Fisher, be accepted as a satisfying explanation of the phenomenon of interest, it now becomes necessary to inquire as to what, under this theory, determines the rate of this interest. According to Boehm-Bawerk, who introduced the idea of the diminishing productivity of capital when used to help in the productive processes, the rate of interest must be such as will not exceed the product of the last increment of capital employed. "The rate is determined by the productiveness of the last economic extension of process, in such a way that the amount of capital making the extension possible must bear a less interest than the surplus return obtained by means of it . . ."[35] Thus the rate of interest corresponds to the marginal productivity of capital, and the determining factor is time preference operating through the capital supply.

According to Irving Fisher, men make an effort to so adjust their expenditures over a period of time that the utilities of the last item of expenditure at different times are equal. When they anticipate a greater need in the future, they save. If present utility looms more desirable in their minds, they borrow. A young married couple sets out to save in anticipation of greater expenses when children arrive. Later, when these children are in college, they hopefully expect that their needs will be less when the educational expenses cease. Savings and borrowings may likewise be influenced by anticipated changes in resources or income. A young doctor looks forward to a rise in income when his practice has grown; a man past fifty realizes that his earning power will soon decline.[36]

While the rate of interest may be a factor in determining the

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35. Boehm-Bawerk, Principles of Political Economy, quoted by Whittaker, op. cit., p. 545.

36. Whittaker, op. cit., p. 547.

proportion of income some people will save, others, influenced by such circumstances as those in the preceding paragraph, will save even though they receive no interest. They give priority to the security factor. The satisfaction which they experience from a feeling of security may greatly outweigh the satisfaction which would be theirs through expenditure of a greater part of their income for goods to satisfy present wants. If they will save even in the absence of interest because their preference for future goods (security) is greater than their desire to satisfy present wants, then Boehm-Bawerk's agio theory in explanation of interest becomes untenable.

The agio theory presupposes that men will make a rational choice between paying a higher price for present goods versus a lesser price for the same goods at some future time. Yet from the time of Aristotle it has been recognized that rational choice is only one factor in a complex human make-up.[37] Other motives, such as custom, prejudice, religious beliefs, may be at work and result in decisions quite at variance to those which would appear to be in the best interests of the individual or group.

While the most logical explanation of the nature of interest so far considered, and very ably upheld by Boehm-Bawerk, Fisher, and others, the agio theory falls short of being a completely satisfying proposal.

Interest and Saving

The effect which the rate of interest has upon the propensity of people to save a part of their incomes is a subject which has received much attention and provoked much discussion. One school of thought

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37. Ibid., p. 549.

maintains that higher interest rates ecourage saving. The opposite view, that high interest rates discourage saving, likewise has its adherents. Numerous arguments have been advanced to sustain both viewpoints. Senior argued that "The capitalist soon regards the increase of his capital (through accumulation of interest) as the great business of his life; and considers the greater part of his profit more as a means to that end than as a subject of enjoyment."[38] He, like Hume, felt that saving was largely a matter of habit which would be encouraged the greater the rate of interest, and discouraged if the rate of interest declined, because "there is nothing to which a capitalist submits so reluctantly as the diminution of the value of his capital (as measured in terms of interest return)."[39]

In the opinion of John Stuart Mill, "there is in every country some rate of profit (interest) below which persons in general will not find sufficient motive to save . ."[40] The French economist, Adolph Landry, assumed that the marginal utility lost through saving increased as the amount saved increased, thus leading to the conclusion that a higher rate of interest would induce greater saving. It has also been said that interest receivers, who form a large proportion of the saving class, will save more when interest rates are higher because they possess larger incomes from which to do so.

In support of the opposite view, that higher rates of interest discourage saving, Sir Josiah Child, when attributing to low interest rates the prosperity of the Dutch, came to the conclusion "That the Abatement of Interest is the Cause of the Prosperity and Riches of

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38. Senior, Political Economy, quoted by Whittaker, op. cit., p. 550.

39. Ibid.

40. Mill, Principles of Political Economy, quoted by Whittaker, op. cit., p. 550.

any Nation."[41] Adam Smith shared this view. In discussing the colonial trade monopoly, he opined that it had the effect of raising the rate of profit, which in turn had the consequence that savings were diminished. This was brought about by the luxurious and profligate living standards of those who received the excessive profits of the trade as interest on their loans (investments) and whose example was followed even by the laboring classes who had no margin to spare for luxuries, so that they are no longer able to save anything either. Thus the entire nation gives up saving and devotes its energies to dissolute living with the result that the capital of the country, instead of increasing, gradually dwindles away.

An arithmetical illustration of the manner in which higher interest rates might be expected to diminish savings is offered by W. L. Sargant, a Birmingham manufacturer interest in economics:

A clerk calculates that when his family have married away from his house, he shall be able to live on $400 a year. If interest were as low as in Holland formerly (2 per cent.), it would require $20,000 to supply this moderate income; at 5 per cent., $8,000 would suffice; at 10 per cent., $4,000. As interest rises, the necessary savings diminish.[42]

This same point was made by the Webbs:

A large part of the saving of the world is done with the motive of obtaining, at some future time, an income upon which to live without work. When a man saves in order to be able to retire from business or practice; when it is desired to make provision for a widow or for daughters; when the object is what is popularly known as 'founding a family,' it is some definite amount of annual income that is aimed at. This is especially the case with the professional and upper middle class, by whom a considerable proportion of the world's accumulation is nowadays made. If it takes $25,000 a year to maintain a family in a country mansion of the accepted stamp, or if the recognized portion for each daughter is $1,500 a year, there is a strong stimulus

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41. Child, A New Discourse of Trade, quoted by Whittaker, op. cit., p. 551.

42. Sargant, Recent Political Economy, quoted by Whittaker, op. cit., p. 552.

to go on accumulating until the necessary capital sum has been reached, and this capital sum becomes, of course, greater if the rate of interest falls.[43]

Alfred Marshall, noting the great increase in capital, investment, profits, and the power to save, which were experienced during the nineteenth century, came to the conclusion that men "may continue to save much even with a low rate of interest; yet while human nature remains as it is every fall in that rate is likely to cause many more people to save less than to save more than they would otherwise have done."[44]

None of these arguments seem conclusive. The effect of interest rates on savings, and vice versa, is a product of many factors. Some tend to induce saving when interest rates are low, others when they are high. Such factors as security and the propensity for hoarding have no relation to the rate of interest and are not affected by it. Yet the soundest view would seem to be that the greater the reward for saving in the form of higher interest, the greater would be the response of the average person who would perceive by this route an opportunity to achieve an ambition, whether it be to live on an income without working, to supplement earned income for the purchase of luxuries, to create an estate, to educate children, or to gratify future wants. On the other hand, the lower the rate of interest falls, the less attractive saving becomes, and the more attractive becomes the satisfaction of present wants. Present goods cost more than future goods, and their purchase tends further to reduce the capacity of individuals to save.

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43. Webb, Industrial Democracy, quoted by Whittaker, op. cit., p. 554.

44. Marshall, Principles of Economics, p. 223.

The Theory of Liquidity Preference

A rather novel view of interest has been postulated by Joseph A. Schumpeter. It was followed by the former German banker, Albert Hahn, and elaborated by the eminent English economist, the late Lord Keynes. According to this view, interest does not make saving equal to investment, as the classical theory holds, but makes interest equal to bank credit. Savings are too insignificant to support the dynamic development of modern production processes, and the interest they receive is only a reflection from the interest on the investable credit funds created by the banks. This point had been made by Hermann as early as 1832.

Lord Keynes used this material in building a unique concept of interest. He maintained that people save and invest their savings solely with a view toward speculative capital appreciation, and that such saving and investment would continue even if the interest rate were zero. Furthermore, it was his opinion that high interest rates discourage saving because of the depressing effect upon industrial activity which utilizes the saved capital. If liquid funds were made plentiful enough through an easy credit policy and liberal government spending, the interest rate could be lowered to the vanishing point because such policies would stimulate industrial activity and encourage saving to the point that there would be no lack of capital available.

Keynes held that the rising propensity to save and keep savings liquid is, like underconsumption, the gravest and ever-present danger to our economy. They indicate the inability of people to consume their growing incomes. The desire to keep savings liquid he traced to three major motives: 1. the transactions-motive, i.e., the need of cash for the current transactions of personal and business ex-

changes; 2. the precautionary-motive, i.e., the desire for security as to the future cash equivalent of a certain proportion of total resources; 3. the speculative-motive, i.e., the object of securing profit from knowing better than the market what the future will bring forth.[45]

In the first two instances, the demand for money will rise as prices rise and fall with falling prices, but savings will be lower in the expectation of rising prices, since people try to purchase goods before prices rise and thus add to the inflation by adding to the demand, and will be higher when a fall in prices is expected, thus accelerating the downward movement. In the third instance, when prices, for example, bond prices - which rise as the general rate of interest falls - have sufficiently risen to make some owners feel that the top has been reached, they will liquidate their holdings and keep their assets in cash. Only if prices fall and interest rises again will they part with their money, and the rate at which they do so is the measure of their liquidity preference.

Interest, therefore, is determined by forces independent of investment. A rise in the rate of interest, by checking investment, diminishes income and both the absolute and relative amounts of saving out of that income. Conversely, a lower rate of interest stimulates investment - if there is a given expectation of profit - and increases income and the absolute and relative amounts of saving. What interest equates to is neither saving and intended investment, nor bank credit and intended investment, but the supply of money issued by the banking system and the amount the public wants to hold. This amount is determined by the schedule of liquidity preference and

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45. Keynes, The General Theory of Employment, Interest, and Money, p. 170.

by the size of the income, which in turn is determined by the volume of investment at the given rate of interest.

One obvious weakness in Keynes' theory is the assumption that people save solely to benefit from capital appreciation and not from interest return. While it is undoubtedly true that many speculate in securities and commodities, the relatively small volume of shares and commodities traded on the exchanges as compared with the total quantities existent at any period, would seem to nullify this position. To Keynes assertion that people would continue to save for capital appreciation even though no interest were paid, it may be advanced that the demand for capital under such conditions would be so enormous that interest is required to keep it in check. Keynes reply is to the effect that, given a condition of full employment, there would be no scarcity of capital even without the payment of interest. Since there has never yet been a period of full employment in which such a system could be tried, it will remain for the future to determine the validity of Keynes' premise.[46]

Interest Under Socialism

In a number of important countries of the world, capitalism as we have known it, has been abandonned. Other kinds of economic systems have taken its place. During the past twenty years major changes have occurred in the organization of economic activities in the United States. Most of these systems and changes, while known by various names, have been trends toward socialism or communism as interpreted by different nationalities under differing conditions and stimuli. We will consider briefly the role of interest in such societies.

The premise of Karl Marx is well known. Interest represents ex-

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46. Ibid., Bk. IV, 3, passim.

ploitation of the workers who are thereby robbed of a share of the products of their labor which is rightly theirs. In Marx's communistic state, the taking of interest by private individuals would be abolished.

Boehm-Bawerk gave some thought to the action in a socialistic economy, of those causes which produce interest in an individualistic society. "Let us imagine," he says, "the Socialist State perfectly realised; all private property in land and capital abolished; all instruments of production vested in the hands of the community; all citizens working as labourers in the service of the commonweal; and the national product distributed to all according to work done. How is it now with the action of those causes which produced interest under the individualistic economy?"[47]

He offers the following answer to the question: "First of all, it must be made clear that the causes are still there. There is always a natural difference of value between present and future goods; and since under Socialism time does not stand still, future goods gradually become present ones, and bring a surplus value with them."[48] Accordingly, "even for the Socialist state, it is absolutely inconceivable that economic subjects, whether as individuals or as the powerful economic commonweal, should, in their economic judgment and their economic practice, treat present and future goods as on the same footing."[49]

His conclusion was, therefore, that "even in the Socialist state, present goods will be valued more highly (and) it goes without saying

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47. Boehm-Bawerk, Positive Theory of Capital, p. 365.

48. Ibid.

49. Ibid.

that, if there is an exchange between the two, it cannot be effected at par. Exactly as under the present economic organization, present goods, as more valuable, will claim and will receive an agio. The emergence of this agio - and with it the emergence of interest in its most legitimate form - could only be repressed if every opportunity for it were repressed; in other words, if the exchange or barter of present goods for future were removed out of the world altogether."[50]

He continues:

Thus we come to a very remarkable and noteworthy result. Interest, which today the Socialists abuse as a gain got by exploitation, a robbery from the products of labor, would not disappear even in the Socialist state, but would remain, in promise and potency, as between the community organized under Socialism and its laborers, and must so remain. The new organization of society may make some change in the persons who receive it, and in the shares into which it is divided, by altering the relations of ownership; but the fact that the owners of present commodities, in exchanging them for future commodities, obtain an agio, it neither will nor can alter. And here again, it is shown that interest is not an accidental 'historico-legal' category, which makes its appearance only in our individualist and capitalist society, and will vanish with it; but an economic category, which springs from elementary economic causes, and therefore, without distinction of social organization, and legislation, makes its appearance wherever there is an exchange between present and future goods.[51]

An advocate of that form of Socialism known as Economic Planning, G. D. H. Cole suggests that in a planned Socialist economy, interest may not exist at all. If it does exist, it will do so as a charge determined by the planners as an element in the economic plan. Whether interest exists at all will depend upon the decision of the collective entrepreneur to make or not to make a money charge for the use of capital and credit. If such a charge is made, the rates will be controlled rates, determined by the same entrepreneur in one capacity and paid in another.

Interest rates, if retained, will be at levels determined by the

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50. Ibid., p. 366.

51. Ibid., p. 371.

State. It can go further and impute them without their being actually charged. Each separate enterprise in the planned economy can bear an imputed interest charge without any money actually changing hands. The rate of such interest, however, being arbitrarily determined by the collective authority, is bound to be a flat rate. This would not destroy the usefulness of an interest charge as a means of checking the efficiency of the various enterprises. For the purpose of determining how much capital and credit an enterprise is using up, the rate of interest is quite irrelevant. The allocation of resources would be made in terms of the real things available, not in terms of the money values which may be imputed to them. The purpose of imputation, if adopted, would be, not to settle the allocation, but to check the efficiency of use.[52]

During recent years the capitalistic countries of the world have moved with increasing acceleration in the direction of socialism. Increasing government control of business, gradual expansion of national and municipal ownership and operation of productive enterprises, particularly public utilities, and reduction of inequality of income through taxation and the extension of free social services, have made much headway.

One of the most remarkable of social experiments on the grand scale is the Soviet Russia of Lenin and Stalin, professedly modelled after the ideas of Karl Marx. As such experiments unfold, the role of interest in a Socialistic economy may become clearer and more understandable. A pattern may develop which will be followed to a greater or lesser extent by the more liberal capitalistic societies.

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52. Cole, Economic Planning, p. 185.

CHAPTER VI

The Return of Regulation

In his Letters in Defence of Usury, Jeremy Bentham had presented valid arguments for the abolishment of legislative maximums for interest rates where the market rate of interest is determined by the interplay of economic forces. He did not distinguish, however, between different types of loans. When Bentham spoke of "loans," he included all types of loans, commercial, investment, and consumptive. The 5 per cent maximum interest rate permitted in England by the Statute of Anne was repealed in 1854, thus giving to the lender the power of demanding any rate of interest which the circumstances of the loan would allow and which the borrower would agree to pay. This was found to work well in the field of commercial and investment loans where there was a market rate of interest resulting from the interplay of economic forces.

But in the field of consumptive loans, some kind of control was necessary. People had little faith in competition between money-lenders as a means for protecting borrowers. Those who borrowed for consumptive purposes generally knew very little about methods of getting loans. Their need was often immediate and pressing. They had no time to shop around to see where they could get the best terms. Usually such borrowers wanted the matter kept from their friends and employers. Consequently shrewd and experienced money-lenders often drove hard bargains with such people and extorted unduly high rates of interest.

Therefore, in England after 1854 there grew up a rule of law

that "Equity will prevent the enforcement of any oppresive bargain."[1] Power with respect to excessive bargains was exercised by the Court of Chancery. As time went on it was found that the courts did not have power enough. There were some cases where the courts could not interfere in the bargains of money-lenders.

The English Money-Lenders' Act of 1900 was designed to preserve the existing powers of the Courts of Chancery and to add new powers. Under the Act the court may, if excessive interest has been charged, or if the transaction is harsh and unconscionable, or is otherwise such that a court of equity would give relief, reopen the transaction, and may:

1. Relieve the person sued from payment of any sum in excess of the sum adjudged by the court to be fairly due, in respect of such principal, interest, and charges, as the court, having regard to the risk and all the circumstances, may adjudge to be reasonable.

2. If any excess has been paid or allowed in account by the debtor, may order the creditor to repay it.

3. May set aside, either wholly or in part, or revise or alter any security given or agreement made in respect of money lent by the money-lender, and if the money-lender has parted with the security may order him to indemnify the borrower or other person sued.[2]

A later measure provided that interest amounting to 48 per cent per year was to be regarded as unconscionable unless the contrary was proved. This rate was permitted in view of the admittedly considerable expense of collecting small loans. Thus there came again, not a ban against interest itself, but a prohibition of unduly high rates.

Regulation had never been abandonned in the American Colonies and was continued when they became the United States of America. From their first establishment, the Colonies recognized the jurisprudence

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1. Stuart, V.C., in Barrett v. Hartley (1866), L.R. 2 Eq. 795; James v. Kerr (1889), 40 Ch.D. 449, quoted by Ryan, _op. cit._, p. 122.

2. Ryan, _op. cit._, p. 123.

of the mother country. They adopted the great body of English statutes, including the laws regulating interest. Rates in all the colonies except Virginia, however, were somewhat higher than the maximum rate of 5 per cent permitted by the Statute of Anne (1713), and there was no margin between the legal rate and the lawful maximum.

The penalties for illegal interest charges were generally severe, comprising forfeiture of the contract in all laws before 1767, and of two or three times the principal in some colonies. The following table gives the legal interest rates and penalties prescribed by the early usury laws of the American Colonies:

Name of Colony	Date of Statute	Legal Rate Max. Limit	Penalty for Usury
Connecticut	1718	6%	Voidance of contract
Delaware	1759	8%	Forfeiture of whole debt
Georgia	1759	8%	Forfeiture of three times the amount of the contract
Maryland	1692	6%	Forfeiture of three times the principal
Massachusetts	1661 1693	8% 6%	Voidance of contract
New Hampshire	1791	6%	Forfeiture of three times the excess interest
New Jersey	1738	7%	Forfeiture of contract
New York	1717 1718 1737	6% 8% 7%	Forfeiture of contract
North Carolina	1741	6%	Voidance of contract and forfeiture of twice the amount of the contract
Pennsylvania	- 1700 1705 1723	8% 6% 8% 6%	Forfeiture of contract
Rhode Island	1767	6%	Forfeiture of excess interest

South Carolina	1719 1748 1777	10% 8% 7%	Forfeiture of three times the principal
Virginia	1730 1734	6% 5%	Forfeiture of contract

[3]

In some colonies a somewhat higher rate was permitted for a loan of tobacco, wares, etc., which were to be repaid in kind. In Maryland, for example, the legal rate was 6% but on such loans 8% was allowed.

All the States of the Union today have legal rates and most have also a lawful limit. The latter is usually, but not necessarily, quite a bit higher, and is applied to consumer loans, commonly called "small loans." The rapid industrialization of the United States created numerous cases of necessity for loans on the part of workers who had no security to offer but whose need for small sums was immediate and imperative. Lenders were soon found to make such sums available at usurious rates averaging 10 per cent a month, but going as high as 200 per cent a month in some cases. Those engaged in this kind of lending soon earned the epithet of "loan shark" and pressure was brought to bear on state legislatures to limit the interest charge while recognizing that the type of loan involved, having little or no security, was subject to high risk of loss through uninsured death or unemployment of the borrower, excessive collection costs involving small sums at frequent intervals, and a great amount of bookkeeping and other administrative costs.

Most of the States have "Small Loan Laws" which permit interest rates generally in the range of 2 per cent to 4 per cent a month on loans of $50 to $300. A rate as high as 5 per cent a month may be allowed on loans of less than $50.

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3. Ryan, op. cit., p. 27.

It is evident that the greater part of the so-called "interest" on such loans is not interest at all, but insurance and collection expense. Such rates have no effect upon the commercial and investment field because small loan laws operate only in the field of consumer loans and are limited to comparatively small sums. In spite of the high rates permitted, small loan laws are socially beneficial because they interpose the police power of the state to strengthen the bargaining position of the weaker borrower.

CONCLUSION

Since very early times, lending at interest has been regulated by certain forces of social control, such as public opinion, custom, common law, and statutory enactments. This control has taken the form of rules for the paying and receiving of interest.

It was discovered early that certain evils arose out of the relation of borrower and lender. Laws were promulgated to mitigate the evils, but they persisted and were augmented by others resulting from the laws themselves. Even after the laws had passed into the discard, the evils remained. Later generations framed new rules, and the process has been continued to the present. Thus, over a period of several thousand years from the Babylonian Empire, history reveals a succession of regulations designed to improve the relation between borrower and lender.

Although interest-taking has been sanctioned by society since very early times, to our knowledge legal limits have been imposed only within the past 4000 years. During the past 2500 years the just rate has varied only slightly from an average of 6 per cent. In some periods it has been as high as 10 per cent, and in others as low as 4 per cent. There have been periods when no interest was permitted, and others during which there was no legal limit. By and large, an average legal rate of 6 per cent has been considered reasonable over a period of 25 centuries.

Rates charged borrowers outside the law, or during periods when there was no legal limitation, averaged considerably higher. Society generally considered charges above the legal limit as

usurious exploitation and dealt severely with offenders. Subterfuges for disguising interest when it was illegal usually resulted in payments higher than would have been asked if the transactions could have been accomplished openly. When there was no legal limit, unconscionable exploitation was the rule. Society finally came to the conclusion that some form of regulation was necessary to protect borrowers from the greed of lenders. Regulation became as universal as interest.

During the 2500 years that legal interest on borrowed capital varied only slightly from 6 per cent, practically every aspect of social organization underwent radical change. Empires emerged, developed into world powers, declined, and disappeared. Commercial activity rose and fell. During some periods there was a great demand for money; during others the demand for money was at such a low point that it was practically unknown to large segments of the world's population. The propensity of people to save varied greatly at different times and among different peoples. It would not appear, therefore, that these factors had any appreciable effect upon the legal interest rate over the long period. Such influence as they had was local and of short duration.

The desire of men to share in any gain resulting from human activities is observable in all stages of social development. Labor has demanded that its share be paid in the form of wages at frequent intervals during the productive process. Landlords have demanded rent at stipulated times regardless of the stage of production. Creditors have sought their share of profits in predetermined amounts at regular intervals. When the product of the productive process has been placed in the hands of the ultimate user, the entrepreneur has received his share. In many cases, agencies of transportation,

storage, distribution, and insurance, have likewise participated in the profits. All these are ultimately paid by the user of the finished good who also expects to gain from its consumption or use, either through sustaining or lengthening life, or to achieve improved physical health or mental happiness.

In the final analysis, interest is but one of a succession of gains added together in the process of producing an economic good out of raw materials supplied by nature. Each individual contributing to the placing of the finished good in the hands of the user, has taken an increment over and above what he put in, whether it be labor, land, management or capital. Interest is merely the gain taken from the productive process the owner of capital.

The gain permitted each class of contributor to the productive process has varied greatly in different periods and in different countries. Profits allowed landlords, processors, entrepreneurs, and distributive agencies, have at times seemed almost unlimited. Through the centuries, however, society has tried to restrict the gain received by the capitalist in the form of interest. During the rise and fall of empires, during war and peace, during periods of commercial activity or stagnation, society has limited the lawful return to capital to an average of 6 per cent annually. Neither the risk inherent in war, the stability of peace, the supply of money or the demand for it, the efficiency of inefficiency of productive methods, nor any of the other factors customarily offered in explanation or justification of interest, has had any lasting effect upon the legal rate.

Over the past five thousand years, all these factors have operated to lower the average rate of interest on borrowed capital.

From the days of the Babylonian Empire, when borrowers paid 20 to 33 1/3 per cent for loans of money or grain, down to the present, when money may be borrowed for 3 per cent or less, there has been a general downward trend in the legal interest rate. Figure 1. illustrates this trend graphically.

The persistence of the trend toward lower interest rates over such a long period of time suggests that it might be continued in the future, and that ultimately the interest rate on borrowed capital will be zero. Alfred Marshall mentioned the possibility of such a result:

It is a good corrective of this error (that men always prefer present over future gratifications, thus holding the accumulation of wealth in check and sustaining the rate of interest) to note how small a modification of the conditions of our own world would be required to bring us to another in which the mass of the people would be so anxious to provide for old age and for their families after them, and in which the new openings for the advantageous use of accumulated wealth in any form were so small, that the amount of wealth for the safe custody of which people were willing to pay would exceed that which others desired to borrow; and where in consequence even those who saw their way to make a gain out of the use of capital, would be able to exact a payment for taking charge of it; and interest would be negative all along the line.[1]

The late Lord Keynes also expressed the view that under a condition of full employment, savings would occur at a rate sufficient to prevent any scarcity of capital and make possible an interest rate of zero:

Let us assume that steps are taken to ensure that the rate of interest is consistent with the rate of investment which corresponds to full employment. Let us assume, further, that State action enters in as a balancing factor to provide that the growth of capital equipment shall be such as to approach saturation point at a rate which does not put a disproportionate burden on the standard of life of the present generation. On such assumptions I should guess that a properly run community equipped with modern technical resources, of which the population is not increasing rapidly, ought to be able to bring down the marginal efficiency of capital in equilibrium approximately to zero within a single generation . . .[2]

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1. Marshall, Principles of Economics, p. 582n.

2. Keynes, op. cit., p. 220.

Like most other changes in basic human affairs, the downward movement would probably be irregular and discernible only over a long period of time. The increasing tendency of government to participate in business and industry, through the medium of productive loans, may make unlimited capital available at very low rates of interest. Private capital would then be forced to accept ever decreasing levels of interest. It would not appear to be beyond the realm of possibility that at some future time, interest rates on borrowed capital may be reduced to zero, and the phenomenon of lending at interest will disappear.

Many theories have been advanced to explain or justify interest. Some have held to abstinence, or waiting; others, to the superior productivity resulting from the application of capital to productive processes. To many, interest has represented the fruit of exploitation, payment for the use of money, the wages of capital, or men's preference for present goods as compared to those of the future. None of the theories offered appears to have been completely satisfying. Each, after a period of acceptance, has been discarded or modified by subsequent theories based on new conditions and new experiences.

The general basis of theory is knowledge of past performance combined with observation of existing conditions and trends. Theorists synthesize these factors and formulate theories which are rationalizations of situations with which they are familiar. Thus, they tend to give undue weight to factors then predominant, and to minimize the experience of the past which suggests that existing conditions are only temporary and will in all likelihood be replaced by another set of conditions which may render their position untenable.

Few theorists have had the insight or courage of Alfred Marshall who, sensing that an era ended with World War I and the world was on the threshold of a period which would bring great political and econ-

omic change, admitted that "A thousand years hence 1920-70 will, I expect, be <u>the</u> time for historians. It drives me wild to think of it. I believe it will make my poor Principles, with a lot of poor comrades, into waste paper. The more I think of it, the less I can guess what the world will be like fifty years hence."[3]

One element essential to all theories of interest is Time. Time is required for production; for consumption; to abstain. Time is necessary for future goods to become present goods. For interest to accrue takes Time.

We say Time destroys, Time changes all things, and so on. We mean only that things perish in time, or that all things change after a while. We cannot conceive that Time of itself does anything. To be understandable, Time must be expressed in terms of positive actions, concrete circumstances, visible causes and relationships. The mere passage of time cannot create interest any more than it can bring about any other thing of itself alone, without the intervention of some other cause.

Nevertheless, Time enters into our conception of interest. The idea of Time lends itself to uniformity of treatment in all ages, in all climes, by all peoples. It is, therefore, useful as a formal determinant of interest. Consequently, it easily comes to be considered the real determinant. The individual entering into a loan contract is immediately confronted with the time element as a determinant of the interest payment. To him, Time appears to be the true determinant. And since Time is essential to the realization of the results contemplated in all theories of interest, it is natural that theorists should give it a determining role. The mere lapse of

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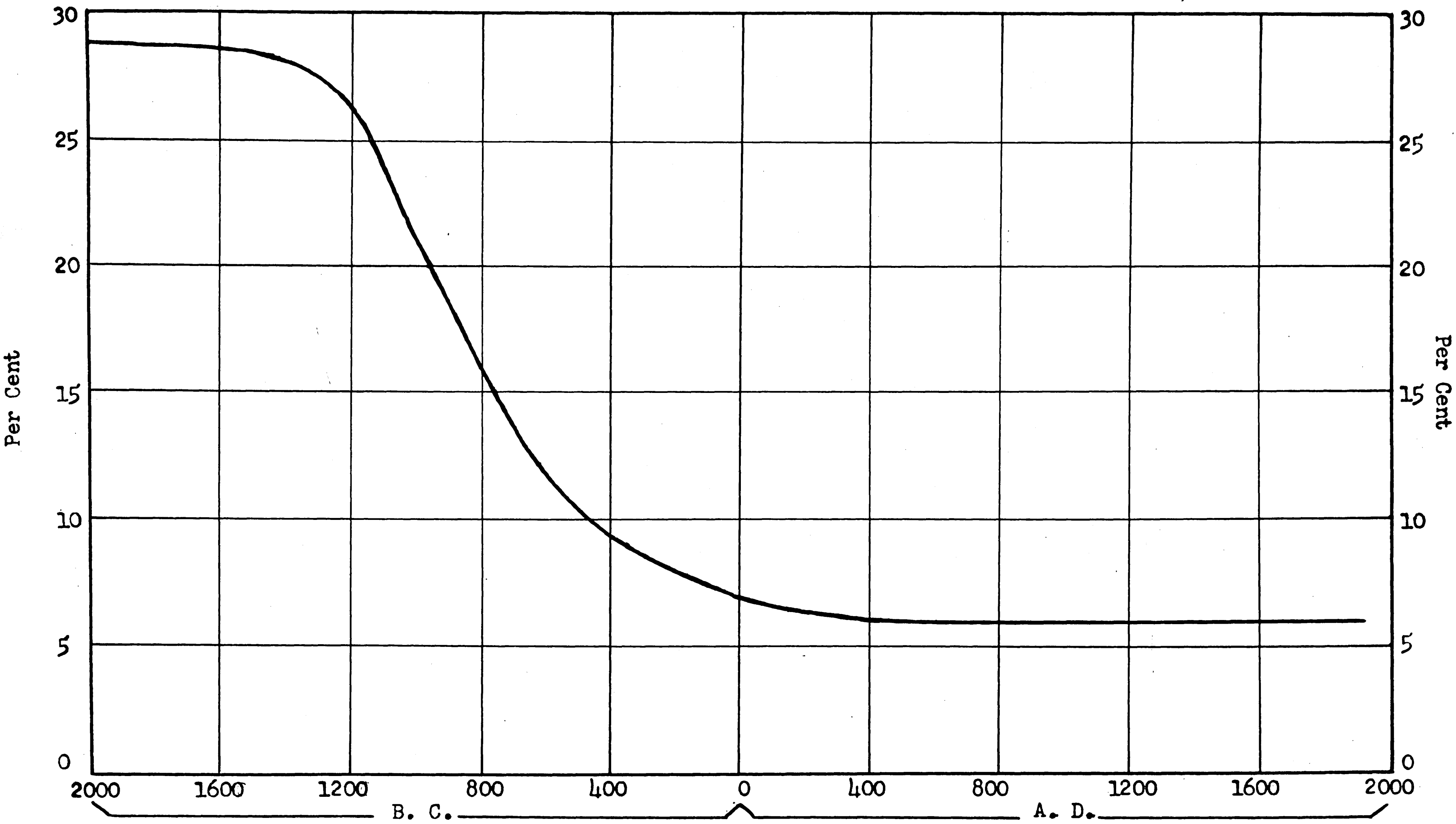
3. Homans, <u>op. cit.</u>, p. 272.

time, however, does not create interest. The true cause must lie elsewhere.

It has been stated that interest is but one of a succession of gains added together in the process of producing an economic good out of raw materials supplied by nature, and that each factor involved in placing the finished good in the hands of the ultimate user, whether it be land, labor, management, or capital, has taken an increment over and above what was contributed. Interest, then, is the gain taken from the productive process by the owner of capital in return for the contribution of an essential factor.

The true origin and cause of interest would seem to lie in the desire of men to make a gain out of relations with others. The persistence of the interest phenomenon through the centuries must be the reflection of universal acceptance of the view that some share in the gain from man's endeavors should go to the owners of capital who lend it for use by others.

The future may bring extensive social and economic changes. Full employment may be achieved, with savings at levels resulting in loanable capital sufficient to meet all demands. Governments may become dominant in productive processes. Security may loom so large in the minds of future generations that they will pay a premium to those who will safeguard their capital. Should such conditions be realized, it is not unlikely society would decide that capital is not entitled to share in the gain from productive processes. There would be no need for interest on borrowed capital. The accepted interest rate (to use present terminology) would be zero, or even "negative all along the line."



LONG TERM TREND OF LEGAL INTEREST RATES

Figure 1.

NON NUMERENTUR AUCTORITATES SED PONDERENTUR

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VITA

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